

# ESMA's response to the EC consultation on the review of the EU macro-prudential policy framework for NBFIs

## Executive summary

1. On 22 May 2024 the European Commission (EC) launched a targeted consultation aimed at assessing the adequacy of macroprudential policies for Non-Bank Financial Intermediation (NBFIs), as a response to major events in recent years and the related financial stability concerns that have emerged.<sup>1</sup>
2. ESMA has taken the approach of addressing the issues identified in the consultation per “topical area”, as not all questions in the consultation are applicable to ESMA. However, ESMA is indicating which questions each section answers in the text:
  - i. Section 1 of the response outlines ESMA's views on the key vulnerabilities and risks stemming from NBFIs (response to section 1 of the EC consultation);
  - ii. Section 2 outlines ESMA's views on how to address unmitigated liquidity mismatches in open ended funds (Sections 2 and 3.2 of the EC consultation);
  - iii. Section 3 summarises ESMA's views on Money Market Funds (Section 3.1 of the EC consultation);
  - iv. Section 4 outlines ESMA's views on other NBFIs and markets (Section 3.3 of the EC consultation); var
  - v. Section 5 focuses on the use of leverage in AIFs and UCITS (Section 4 of the EC consultation);
  - vi. Section 6 provides ESMA's views on how to monitor interconnectedness (Section 5 of the EC consultation);
  - vii. Section 7 addresses the topic of supervisory coordination at EU level (see Section 6 of the EC consultation).

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<sup>1</sup> [Consultation document - Targeted consultation on assessing the adequacy of macroprudential policies for non-bank financial intermediation \(NBFIs\) \(europa.eu\)](#) Stakeholders have time to respond until 22 November 2024.

## Introduction

3. In 2009, the de Larosière Report laid the foundations of what has become the EU macroprudential framework. Drawing the lessons from the Global Financial Crisis (GFC), the high-level group recommended to establish a macroprudential framework with a clear mandate to address systemic risk. It also recommended to set up a framework for financial supervision in the EU, the European System of Financial Supervision (ESFS), which entails the European Systemic Risk Board (ESRB), the European Supervisory Authorities (ESAs) and the National Competent Authorities (NCAs).
4. While banking had been the focus of the macroprudential framework discussions at the outset, the non-bank financial sector (NBFI) is larger and more diverse than 15 years ago. The size of NBFI in the EU has more than doubled since then, from 18 trillion euros of assets around the Great Financial Crisis (GFC) to 45 trillion euros. The asset management sector especially has seen rapid growth: as of today, Euro area investment funds alone manage 19 trillion euros, nearly tripling in size since the GFC.
5. Additionally, a successful Savings and Investment Union project will imply even greater involvement of non-bank participants and larger and more interconnected EU capital markets. Ensuring their financial stability will have to be a key element of making EU capital markets stronger, fostering cross-border activities and developing the emergence of new funding sources.
6. When designing an expanded macro-prudential framework, it is necessary to consider the diversity of activities and entities involved in NBFI:
  - Regulated entities with specific sectoral regulations such as investment funds, pension funds and insurance companies. Other examples to illustrate the diversity of entities engaged in NBFI include institutions such as financial corporations or vehicles engaged in securitisation, financial auxiliaries, captive financial institutions and non-bank lenders.
  - Market infrastructures, which also have their own regulatory framework.
  - NBFI also covers a range of activities contributing to financial intermediation such as repo financing.
7. Adding to the complexity, some market participants may engage in NBFI without being regulated, such as family offices or high net worth individuals, or perform similar economic activities under different rules compared with investment funds, such as segregated accounts, which represent 44% of assets managed in Europe. Here, some differences of regulatory treatment may result from structural differences within NBFI activities (for example, segregated accounts are not exposed to run risk like open-ended funds although they could sell assets and that can impact the market asset price).
8. Owing to the need to develop a macroprudential framework to support the SIU, and conscious of the challenge of addressing risks posed by such diverse entities and activities, ESMA has identified key principles underlying its response:
  - i. Macroprudential policy is complementary to micro-prudential policy but must have a different perspective, as it focuses on safeguarding the stability of the entire financial

system rather than regulating individual institutions. While individual supervision and regulation have positive system-wide effects, they do not always address systemic risk caused by externalities.

- ii. While a single entity may have a systemic relevance if it is large enough, systemic risk is more likely to come from the collective actions of entities exposed to the same risks, the interplay between vulnerabilities, and the interconnectedness within the financial sector. The role of macroprudential policy is to identify and monitor such risks, and mitigate risks that have the potential to propagate throughout the financial system, posing systemic threats.
- iii. The macroprudential framework needs to be adapted to take into account the diversity of entities and activities involved in NBFIs. In particular, a mechanistic transposition of macro-prudential tools used in the banking space will be unlikely to properly address macro-prudential risks arising from NBFIs. Conversely, when activities or entities pose the same risks, they should be regulated in a consistent way.
- iv. The nature of systemic risk is to spread beyond where it originated, both in terms of economic sector and jurisdiction. Effective macroprudential policy therefore requires international coordination, including reciprocity (if assessed as necessary and appropriate) and a framework to ensure data quality and sharing.
- v. Having comprehensive, timely, and good quality data is essential to macroprudential policy. While the recent AIFMD and UCITS reviews include enhanced mandates with respect to data collection and sharing, ever-growing regulatory datasets should be accompanied with a proportionate increase in resources at ESMA level to ensure that the data can be properly collected and analysed for monitoring purposes.
- vi. The global nature of NBFIs activities and risks implies that consistency should be sought at global level as far as regional and national specificities allow. ESMA therefore supports the implementation of international standards, in particular FSB and IOSCO recommendations to address liquidity mismatches in open-ended investment funds<sup>2</sup> combined with the IOSCO guidance on anti-dilution liquidity management tools<sup>3</sup>.

## 1 Key vulnerabilities and risks stemming from NBFIs [questions 1; 3; 4; 5; 7]

9. From a macroprudential perspective the main concerns in the investment fund part of the NBFIs sector are the build-up of leverage and liquidity risk.
10. **Leverage** is a widespread practice in many investment strategies. Hedge funds (HF) use leverage commonly, particularly in strategies highly reliant on derivatives such as commodity trading advisor (CTA) and relative value arbitrage strategies<sup>4</sup>. While most HF are not substantially

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<sup>2</sup> [Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds](#)

<sup>3</sup> [FR15/23 Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes](#)

<sup>4</sup> [EU Alternative Investment Funds, ESMA, 2024.](#)

leveraged, the highest levered HFs reported an adjusted leverage above 20 times their NAV at the end of 2022<sup>5</sup>.

11. While leverage can enhance returns in favourable market conditions, it also amplifies losses during downturns. Excessive leverage in investment funds may lead to a range of systemic knock-on effects, including heightened volatility, destabilized markets, and contagion.
12. The GBP liability-driven investment (LDI) fund crisis in September 2022 is one example of how leverage can contribute to turning a stress event — which in the first instance affects individual funds — into a systemic concern. This episode shows how leverage can amplify shocks and trigger liquidity strains within the EU financial system, even if the initial shock originated outside the EU.
13. The other takeaway is the importance of macroprudential policy. Following the LDI stress event, NCAs engaged with GBP LDI fund managers to require that they maintain a certain level of resilience to interest rate shock. These initiatives were followed in 2024 by the activation of the Article 25(3) of AIFMD, to require from those funds that they maintain a level of resilience of 300bps to UK interest rate shocks, an initiative supported by ESMA<sup>6</sup>.
14. **Liquidity mismatches** on the other hand arise where the liquidity offered to investors is greater than the liquidity of the fund assets. Examples are open-ended funds investing in assets such as Real Estate (RE) without any notice period or with a high redemption frequency, or in assets that can become much less liquid under stress conditions, for example some High-Yield (HY) bonds.
15. When a significant number of investors rush to redeem their shares simultaneously under stress market conditions, funds may sell assets at low prices, if the activation of gates or the suspension of redemptions are not in the best interest of investors. This rational behaviour may exacerbate market downturns, which may trigger a cycle of fire sales. Losses then spread to other investors exposed to the same assets.
16. The 2020 market stress confirmed some of these vulnerabilities. As the markets faced a ‘dash for cash’<sup>7</sup>, some fund managers had to deal with large-scale redemption requests. At the global level, outflows from some equity and corporate bond funds in March reached levels not seen since the 2008 financial crisis, both in terms of absolute amounts and as a percentage of assets under management<sup>8</sup>. Eventually some funds had to suspend redemptions, due to valuation uncertainty (esp. corporate bonds, RE). Finally, empirical analysis<sup>9</sup> suggested high spillover effects, indicating that funds exposed to less liquid asset classes were more likely to be affected by shocks originating in other markets than funds invested in more liquid assets.
17. Following the 2020 market stress episode, the ESRB recommended that ESMA coordinates a supervisory exercise<sup>10</sup> with the NCAs to assess the resilience and preparedness to future adverse shocks of EU corporate bond and RE funds. This exercise showed that, despite the magnitude of the shocks observed during this episode, only a limited number of the analysed

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<sup>5</sup> [Assessing risks posed by leveraged AIFs in the EU](#), ESMA 2024.

<sup>6</sup> [Advice under article 25 AIFMD](#)

<sup>7</sup> [ESMA TRV 2 2020](#)

<sup>8</sup> [Holistic review of the March market turmoil](#), FSB, 2020.

<sup>9</sup> [Interconnectedness in the EU fund industry](#), ESMA, 2020.

<sup>10</sup> [Report on the ESRB recommendation on liquidity risks in funds](#), ESMA, 2020.  
[TRV 1 2021](#) ESMA, 2021.

funds would suspend subscriptions and redemptions while the vast majority would be able to meet redemption requests and maintain their portfolio structure. But it also confirmed some weaknesses that could be relevant from a systemic perspective<sup>11</sup>:

- some funds were exposed to potential liquidity mismatches due to their liquidity set up (e.g. a combination of high redemption frequency, no/short notice periods and no liquidity management tools ("LMTs") in the case of funds investing in asset classes either illiquid by nature or whose liquidity may recede during a period of market stress).
- concerns around the valuation of portfolio assets emerged, especially for RE funds for which the crisis could have a more significant impact over the longer term. The risk of unrealised losses in that sector is heightened in a context of falling RE prices, as RE funds especially need to reevaluate their portfolio regularly to avoid temporary valuation discrepancies.
- asset valuation issues were also reported for funds invested in corporate debt, which have impacted the ability of funds to meet redemption requests: fund share valuation uncertainty creates the risk of unfairly penalising remaining (redeeming) investors, by redeeming shares above (below) their fair price.

18. The 2020 turmoil also revealed some vulnerabilities in EU MMFs. EU MMFs were particularly affected due to heightened redemptions on the liability side, as part of the 'dash for cash' (as witnessed in March 2020), while on the asset side the liquidity of commercial paper markets deteriorated quickly. Outflows reached 10% to 30% of NAV, depending on MMF type (30% of NAV for US Prime institutional MMFs and EU USD LVNAV, and 20% for EUR LVNAV and more than 10% for VNAV). The sector was overall resilient with no fund suspension and a rapid recovery, but the event was also short-lived thanks to public interventions.
19. For MMFs, ESMA analysis identified potential ongoing vulnerabilities that have not been solved<sup>12</sup>. On the asset side, EU MMFs have a large market footprint in short-term private markets with limited liquidity implying that, in case of a wave of redemptions, MMFs may struggle to dispose of their assets. Moreover, the current regulatory provisions regarding LMTs (such as the use of fees and gates) might create incentives to redeem ahead of others. Finally, despite the overall resilience of the sector, the results of stress tests reported to ESMA and the NCAs also confirmed potential vulnerabilities. In particular, more than 80% of LVNAV would need to switch to variable NAV in 2 of the stress scenarios, potentially leading to disorderly asset liquidations<sup>13</sup>.
20. Finally, ESMA considers that systemic risk is more likely to materialise as a combination of risks. The GBP LDI stress, but also other stress events such as the default of the family office Archegos<sup>14</sup>, were characterised by an excessive use of leverage amid low liquidity and a high concentration of positions.
21. The Archegos event raises a series of issues. From a risk management perspective, the initial margins on TRSs held by Archegos were too small, allowing the firm to obtain a high level of

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<sup>11</sup> [Report on the ESRB recommendation on liquidity risks in funds](#) ESMA, 2020.

<sup>12</sup> [Vulnerabilities in MMFs](#) ESMA, 2021.

<sup>13</sup> Stress scenarios have been designed to reflect severe but plausible events, calibrated taking into account historical crisis episodes, see [Stress testing MMFs in the EU](#), ESMA, 2023

<sup>14</sup> [Leverage and derivatives the case of Archegos](#)

leverage. Margins should have also included an add-on related to risks stemming from the concentration of exposures. As a family office, Archegos was exempt from regulatory reporting requirements, raising the question of whether further regulation of family offices should be considered. Broadly, this also poses the question of potential hidden vulnerabilities, as leverage may be difficult to observe for complex strategies, or the risks posed by leverage may be underestimated. This is especially relevant from a macroprudential perspective as macroprudential risks are likely to arise from common strategies or exposures of funds that may not be identified ex-ante.

## 2 Addressing unmitigated liquidity mismatches in open ended funds [questions 16 to 19]

### 2.1 Regulatory framework

22. Both the UCITS Directive and AIFMD have several requirements in relation to liquidity management which are designed to manage liquidity risks in open ended funds and – for AIFs – in leveraged closed ended funds.
23. As far as the UCITS Directive is concerned, the Eligible Assets Directive of 2007<sup>15</sup> also requires liquidity to be ensured for all investments by UCITS and sets out specific rules for the eligibility of transferable securities, money market instruments and financial derivative instruments.
24. With respect to the AIFMD, there are no rules on the liquidity of assets in which AIFs may invest but there are very detailed rules on the AIFM to put in place liquidity management for open-ended AIFs and leveraged closed-ended AIFs. This includes an alignment of the investment strategy, liquidity profile and redemption policy of the fund, as well as putting in place appropriate liquidity management limits and stress tests.
25. As highlighted in the Commission Consultation Paper, the EU legislative framework for investment funds has gone through substantive changes recently. In particular, on 25 March 2024, the Directive amending the AIFMD and the UCITS Directive was published in the Official Journal.
26. This amending Directive modified the AIFMD and the UCITS Directive in a number of areas, including in the areas of Liquidity Management Tools (LMTs), supervisory reporting and depositaries. It also amended the AIFMD in relation to loan-originating alternative investment funds (LO AIFs).
27. The amending Directive has introduced new provisions on LMTs: according to Article 16(2)(b) of the AIFMD and Article 18a(2) of the UCITS Directive, AIFMs and UCITS shall select at least two appropriate LMTs<sup>16</sup>. AIFMs and UCITS shall include these tools in the fund rules or instruments of incorporation, to ensure these tools can be used in the interest of investors if needed. These new provisions will be supplemented by detailed implementing rules. In particular, ESMA shall,

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<sup>16</sup> The list of LMTs is: 1) suspensions of subscriptions, redemptions and repurchases, 2) redemptions gates, 3) extension of notice periods, 4) redemption fees, 5) swing pricing, 6) dual pricing, 7) anti-dilution levy, 8) redemption in kind and 9) side pockets.

- by 16 April 2025, develop draft Regulatory Technical Standards (RTS) to specify the characteristics of the LMTs<sup>17</sup>, and guidelines on the selection and calibration of LMTs<sup>18</sup>.
28. With respect to LO AIFs, the AIFMD provides that they shall be closed-ended unless AIFMs are able to demonstrate to their competent authorities that the liquidity risk management system of the loan-originating AIF is compatible with its investment strategy and redemption policy. In that context, ESMA shall, by 16 April 2025, develop draft RTS to determine the requirements with which LO AIFs are to comply to maintain an open-ended structure.
29. ESMA acknowledges that all these new provisions, in particular the ones on LMTs, once fully implemented, will help address potential liquidity mismatch in OEFs. However, it is in greater and more consistent use of LMTs, particularly anti-dilution LMTs, that the macroprudential benefits will unfold. As such, following the implementation of the RTS and Guidelines on LMTs, a careful monitoring of activation rates of LMTs will be needed.
30. However, despite these positive regulatory developments, ESMA remains concerned about the existence of possible remaining buckets of unmitigated liquidity mismatch in OEFs.
31. For example, on 19 July 2024, the Commission formally adopted the Commission Delegated Regulation supplementing the ELTIF Regulation (the ELTIF RTS)<sup>19</sup>. ESMA had submitted its draft RTS to the Commission in December 2023<sup>20</sup>. Following a letter from the Commission received in March 2024, ESMA had also published an Opinion on the ELTIF RTS in April 2024<sup>21</sup>.
32. ESMA took note of the fact that the ELTIF RTS which was adopted by the Commission departs from the proposals on liquidity related requirements in the ESMA Opinion. In particular, the key proposal made by ESMA on the determination of the notice period by the manager of the ELTIF, specified in paragraphs 13 to 29 of the ESMA Opinion, was not retained by the Commission.
33. ESMA is of the view that a certain level of prescriptiveness is needed in relation to the requirements on the notice period of an ELTIF. There are number of reasons for this: (i) the illiquid nature of certain assets in which an ELTIF may invest; (ii) ELTIFs could be marketed to retail investors; (iii) being more prescriptive would be in line with the international work on liquidity management conducted in particular at the FSB and IOSCO and ongoing considerations in the EU on specific vulnerabilities of NBFIs such as structural liquidity mismatches, as the present Commission consultation further confirms. This would also ensure that the ELTIF brand is not put in danger by a liquidity strain such as the one that affected certain types of RE vehicles in some Member States in 2023.

### ESMA's proposal

34. With respect to ELTIF, the European Commission has not retained the ESMA proposal for the notice period for ELTIF. ESMA therefore takes advantage of this Consultation to emphasize that

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<sup>17</sup> See Article 16(2)(g) of AIFMD and Article 18a(3) of the UCITS Directive.

<sup>18</sup> See the ESMA Consultation Paper (CP) on Draft RTS on LMTs under the AIFMD and UCITS Directive available at [ESMA34-1985693317-1095\\_CP\\_on\\_RTS\\_on\\_LMTs\\_under\\_AIFMD\\_and\\_UCITS\\_Directive.pdf](https://www.esma.europa.eu/sites/default/files/2023-12/ESMA34-1300023242-1095_CP_on_RTS_on_LMTs_under_AIFMD_and_UCITS_Directive.pdf) (europa.eu). See also ESMA CP on draft guidelines on LMTs of UCITS and open-ended AIFs, available at [ESMA34-1985693317-1097\\_Consultation\\_Paper\\_on\\_the\\_Guidelines\\_on\\_Liquidity\\_Management\\_Tools\\_of\\_UCITS\\_and\\_open-ended\\_AIFs](https://www.esma.europa.eu/sites/default/files/2024-04/ESMA34-1300023242-1097_Consultation_Paper_on_the_Guidelines_on_Liquidity_Management_Tools_of_UCITS_and_open-ended_AIFs) (europa.eu).

<sup>19</sup> [Delegated act details - Register of delegated acts](https://www.esma.europa.eu/sites/default/files/2023-12/ESMA34-1300023242-159_Final_report_ELTIIF_RTS.pdf) (europa.eu)

<sup>20</sup> [https://www.esma.europa.eu/sites/default/files/2023-12/ESMA34-1300023242-159\\_Final\\_report\\_ELTIIF\\_RTS.pdf](https://www.esma.europa.eu/sites/default/files/2023-12/ESMA34-1300023242-159_Final_report_ELTIIF_RTS.pdf)

<sup>21</sup> [https://www.esma.europa.eu/sites/default/files/2024-04/ESMA34-1300023242-167\\_Opinion\\_ELTIIF\\_RTS\\_2024.pdf](https://www.esma.europa.eu/sites/default/files/2024-04/ESMA34-1300023242-167_Opinion_ELTIIF_RTS_2024.pdf)

this might be a source of future systemic risk. ESMA understands that this key proposal of the ESMA Opinion was not retained because it was considered not compatible with the requirements of the level 1 ELTIF Regulation<sup>22</sup>. In this case, ESMA would be of the view that any future review of the ELTIF Regulation should consider allowing that such proposal is, at a later stage, included in the Delegated Regulation.

35. In addition, beyond the specific case of ELTIF, ESMA considers that similar rules should also apply to funds that are not ELTIF and invest in assets that are not liquid or that are long-term assets. The relevant authorities could also consider requiring that such funds be structured as closed-ended funds, to have an appropriate allocation to liquid assets or to implement a long notice period. In the EU, the ESRB expressed its views that RE funds in particular should be subject to a notice period<sup>23</sup>.
36. Finally, ESMA supports the FSB's recommendations relating to the classification of OEFs depending on asset liquidity (the so-called 'bucketing' approach). This is a crucial building block in implementing the FSB's revised recommendations and much of the technical detail has been left to jurisdictions to consider, accounting for the specificities of their local markets. ESMA therefore advocates for appropriate efforts to ensure the convergent and consistent application of these recommendations in the EU.

## 2.2 Risk assessment and monitoring

37. The monitoring of liquidity risks for open-ended funds requires timely and granular data related to the asset and liability side of investment funds. While information on derivatives and securities financing transactions is already available to NCAs, entity-level information for funds remains inadequate for UCITS and AIFs, as emphasized in ESMA' Opinion to the European Commission in 2020<sup>24</sup>.
38. On the asset side, granular information on **portfolio holdings** would allow the assessment of market liquidity risk at instrument or asset-class level, along with the ability to assess concentration risk and portfolio overlap across a group of funds. **Turnover data** also provides information on trading patterns and the ability of funds to dispose of assets. On the liability side, detailed information on fund shares ownership allows the analysis of investor concentration (by entity type or domicile) which can help identify redemption risks. Timely granular data on fund flows also supports the identification of outflow risks.
39. First, ESMA has no direct access to UCITS information, despite granular information being collected by NCAs and national central banks. Several reporting regimes by NCAs and by national central banks are already in place, but they are either not harmonised (NCAs) or not available to ESMA (central banks). However, it should be noted that this issue has been addressed to some extent by the UCITS review which, inter alia, has created a supervisory reporting for UCITS whereby UCITS will have to report regularly to their NCAs a set of information

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<sup>22</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32023R0606&from=EN>

<sup>23</sup> "The ESRB proposes a minimum baseline notice period of 12 months" for open-ended REIFs, in [ESRB response to the ESMA consultation on draft Regulatory Technical Standards and Guidelines on liquidity management tools](#), ESRB, 2024.

<sup>24</sup> [https://www.esma.europa.eu/sites/default/files/library/esma34-32-551\\_esma\\_letter\\_on\\_aifmd\\_review.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf)



on their portfolio holdings. In that context, ESMA will also have to develop draft RTS to specify the content of this supervisory reporting.

40. Second, while ESMA has access to AIFMD data, the structure and granularity of reporting remain an issue. On the asset side, AIFs only report exposures across broad asset classes (EU sovereign bonds, investment grade corporate bonds etc.) which hinders the analysis of liquidity risks on the asset side. For example, when analysing concentration risks for GBP LDI funds, the lack of detailed information on sovereign bonds held (including their duration and issuer) made it impossible to directly assess the ability of GBP LDI funds to use unpledged sovereign bonds to meet liquidity demands related to collateral calls and variation margins with AIFMD data. On the liability side, AIFs do not report information on the domicile of investors, as this information sits with the fund distributors (i.e. banks, insurers, platforms) which, given the cross-border nature of the sector, make the assessment of redemption risk challenging.
41. In addition, access to regulatory datasets outside of the fund sector, including banking or insurance sector data, could help monitor liquidity risks. For example, insurance companies and pension funds are the largest investors in EA investment funds<sup>25</sup>. Similarly, funds use mostly banks as counterparties for derivatives and securities financing transactions. Therefore, securities regulators having access to banking and insurance companies' regulatory datasets could support the monitoring of funds liquidity risk, including liquidity demands related to collateral or margin calls.
42. Better data and access to data could be used to improve liquidity stress testing by NCAs and ESMA to identify potential unmitigated liquidity mismatches (see section 2.3 thereafter). In particular, detailed information could help perform stress tests among group of funds performing similar investment strategies (e.g. LDI funds).
43. However, it should be noted that the recent AIFMD and UCITS reviews include enhanced mandates with respect to data collection and sharing, including the mandate for ESMA to develop draft regulatory technical standards to specify the details of the information to be reported by fund managers and a report regarding integrated collection of supervisory data in the asset management sector and technical standards to establish the revised reporting frameworks.

### ESMA's proposal

44. Having comprehensive, timely, and good quality data is essential to macroprudential policy. The recent AIFMD and UCITS reviews include enhanced mandates with respect to data collection and sharing.
45. In that context, ESMA RTS will specify the content of this supervisory reporting. The data to be reported should be granular enough to assess liquidity risk on the asset side, building on existing reporting requirements to avoid unnecessary burden on market participants.
46. Moreover, ESMA has already launched its work on the integrated reporting and it intends to study, in a comprehensive way, how to establish the reporting system that avoids overlapping and inconsistent requirements and ensures efficient sharing and use of data. Enhanced data sharing, including by the NCAs as well as the central banks, could help ensuring access by

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<sup>25</sup> See [EU Non-bank Financial Intermediation Risk Monitor](#) 2024 page 22.

ESMA and other authorities to all required information necessary to fulfil their tasks, without imposing new obligations on the reporting entities. This can be achieved by the reuse of already reported data instead of making new requests to the industry, so that the value added of the existing reporting regimes is maximised.

47. Finally, improvements in data access and use can only be achieved if proper resources are made available at ESMA level. The implementation of changes stemming from the review, subsequent operation of the reporting systems as well as the ongoing monitoring and supervisory convergence work to ensure high quality of reported data will require additional resources that have not been provided so far. Hence, ever-growing regulatory datasets should be accompanied with a proportionate increase in resources at ESMA level to ensure that the data can be properly collected and analysed for monitoring purposes. This is particularly important for monitoring the cross-border aspects of the EU asset management industry, in line with the objective of promoting a Savings and Investment Union. Since only ESMA can have an EU-wide view of the sector, it is key that ESMA is properly resourced to achieve its objectives.

### 2.3 Enhancing the supervisory framework on liquidity risk

48. From ESMA's perspective the correct implementation of the existing rules on liquidity risk management for UCITS and AIF should be the starting point to address unmitigated liquidity mismatches. The aggregation of supervisory evidence could then provide an indication of whether there are still unmitigated liquidity mismatches in the investment fund sector.
49. ESMA continues – as it did on a number of previous occasions<sup>26</sup> – to stress the importance of ensuring the respect of existing rules by industry participants. In this context, ESMA reiterates the importance for NCAs to use the full range of the supervisory and enforcement toolkit already available under the existing legal framework. Appropriate implementation by the industry and effective supervision by NCAs of existing rules on liquidity risk management for UCITS and AIFs are the first step to promptly address, at the micro level, potential unmitigated liquidity mismatches that exist in open-ended investment funds.
50. Fund managers are required to periodically conduct stress tests and, more specifically, Liquidity Stress Tests (LST). The ESMA LST guidelines<sup>27</sup> provide a comprehensive set of recommendations regarding the frequency (at least quarterly), the design, the governance and most importantly, the use of the results of LSTs.
51. Under the ESMA LST guidelines, NCAs have the power to request, at their discretion, the submission of the manager's LSTs "to help demonstrate that a fund will be likely to comply with applicable rules, including regarding the ability of the fund to meet redemption requests in normal and stressed conditions"<sup>28</sup>. Furthermore, NCAs can also be notified of other information relating to the LST, including liquidity stress test models and their results, "particularly the case during a

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<sup>26</sup> See the 2020 ESMA Report in response to the May 2020 ESRB Recommendation and the ESMA Final Report on the 2022 CSA on valuation, available, respectively at [esma34-39-1119-report on the esrb recommendation on liquidity risks in funds.pdf \(europa.eu\)](https://esma.europa.eu/press-material/press-events/documents/1802_2022_CSA_on_Asset_Valuation_-_Final_Report.pdf) and [ESMA34-45-1802 2022 CSA on Asset Valuation - Final Report.pdf \(europa.eu\)](https://esma.europa.eu/press-material/press-events/documents/1802_2022_CSA_on_Asset_Valuation_-_Final_Report.pdf).

<sup>27</sup> [esma34-39-897 guidelines on liquidity stress testing in ucits and aifs en.pdf \(europa.eu\)](https://esma.europa.eu/press-material/press-events/documents/1802_2022_CSA_on_Asset_Valuation_-_Final_Report.pdf)

<sup>28</sup> See Section V.3 dedicated to the interaction with NCAs.

period of large redemptions across the market”. On their side, managers should notify NCAs of material risks and actions taken to address those risks.

### ESMA’s proposal

52. First, ESMA is of the view that NCAs should, where appropriate, effectively and systematically use the power they have under the ESMA LST guidelines to request the submission of LSTs in the course of their supervisory activity. This would help NCAs monitor the liquidity risks of investment funds, especially under stressed market conditions, and to identify potential unmitigated liquidity mismatches. The analysis of this data would feed into their supervisory activity. At the micro level, this data could serve as a basis to assess whether liquidity mismatches are adequately mitigated by specific tools, such as LMTs. At the macro level, it would give an indication of the collective reaction to a common shock, and whether the scenarios used by managers adequately take into account the reaction of other market participants.
53. To further improve the liquidity risk assessment framework for OEFs, ESMA would stand ready to develop, together with NCAs, a harmonised analytical framework for regular liquidity risk assessment for OEFs. Such assessment would not only be a step forward in terms of data-driven supervision, but also allow for more harmonised supervisory actions on the basis of existing or new supervisory tools.
54. However, for this framework to be effective, NCAs and ESMA shall have access to appropriate data. ESMA could therefore take advantage of the RTS on supervisory reporting under the AIFMD and the UCITS Directive to include information that NCAs could use to perform their liquidity risk assessment of OEFs.

## **3 Addressing unmitigated liquidity mismatch in Money Market Funds [questions 8 to 14]**

55. The present consultation seeks stakeholders’ view on a number of topics in relation to Money Market Funds (MMFs) and how they could be best addressed.
56. ESMA takes the opportunity of this consultation to restate its position laid out in its [Opinion](#) containing proposed reforms to the regulatory framework for EU (MMFs) under the MMF Regulation (MMFR). The proposals aimed at improving the resilience of MMFs by addressing in particular liquidity issues and the threshold effects for constant net asset value (CNAV) and low volatility net asset value (LVNAV) MMFs.
57. These proposed reforms resulted from the lessons learnt from the significant liquidity difficulties faced by MMFs during the initial outbreak of the COVID-19 pandemic in March 2020. At the time investor redemption rates rose on the liability side with a corresponding deterioration in the liquidity of money market instruments on the asset side.
58. At international level, several workstreams have assessed the situation faced by MMFs during this crisis, and which policy options should be considered in order to address the issues which have been observed, and potentially enhance further the reforms on MMFs adopted following the 2008 financial crisis. In the EU context, the ESMA Opinion took the form of an assessment

of the functioning and potential need for amendment of the MMFR and its implementing measures.

59. The policy proposals made by ESMA in the abovementioned Opinion are explained in detail from page 11 to 35 of the opinion (see also Annex 1 of this ESMA answer for more detailed information).

#### *ESMA's proposal*

60. ESMA's proposal regarding MMFs is detailed in Annex I of the response.
61. In addition, ESMA supports the FSB recommendations relating to enhance the resilience of MMFs. FSB's recommendations include policy proposals to impose on redeeming fund investors the cost of their redemptions; absorb credit losses; address regulatory thresholds that may give rise to cliff effects; and reduce liquidity transformation. These recommendations are consistent with ESMA's proposals and should be implemented in the EU.

## **4 Other NBFIs and markets [questions 39 to 41]**

### **4.1 Commodity and energy markets**

62. The EC targeted consultation includes some specific questions on the structure and regulation of EU commodity markets, including on the link between energy spot and financial markets. ESMA however notes that under Article 90(5) of the revised Markets in Financial Instruments Directive (MiFID) "the Commission shall, after consulting ESMA, the EBA and Agency for the Cooperation of Energy Regulators (ACER), submit reports to the European Parliament and to the Council containing a comprehensive assessment of the markets for commodity derivatives, for emission allowances and for derivatives of emission allowances". Although the first part of the report has not been published yet, ESMA understands that the Commission continues working on this assessment of commodity derivatives markets, with a focus on energy spot and financial markets.

#### *ESMA's proposal*

63. ESMA therefore invites the Commission to use the opportunity of the MiFID review report to further assess the regulatory framework governing energy spot and financial markets and their supervision and have a holistic view of EU commodity derivatives markets.

## **5 The use of leverage in AIFs and UCITS [questions 45 to 48 and 50]**

### **5.1 Leverage limits under Article 25 AIFMD**

64. Article 25(3) of AIFMD gives NCAs the power to impose leverage limits or other restrictions on an individual fund or groups of funds, to limit the extent to which the use of leverage contributes to (i) the build-up of systemic risk in the financial system or (ii) the risk of disorderly markets.

65. This framework is further operationalised by ESMA guidelines aiming at ensuring that NCAs adopt a consistent approach: NCAs assess the risk posed by leveraged funds on a regular basis and report the result to ESMA, at least annually. Their risk assessments are based on common methodology and indicators and cover broad categories of systemic risks such as the risk of market impact, the risk from fire sales, the risk of direct spillovers to financial institutions and the risk of interruption of direct credit intermediation. Eventually, risks identified during this process can lead to the activation of Article 25 measures.
66. The article 25 framework has proved to be a flexible tool that works on various risks and leverage sources. Also, the measures taken to address risks identified may differ from a direct leverage limit. For example, NCAs in Ireland and in Luxembourg took measures that consisted in increasing the share of liquid assets (known as yield buffer) to enhance the resilience of the GBP LDI funds managed in Ireland and Luxembourg.
67. In fact, the Article 25 framework can be used to address any financial stability risk related to leverage, including some liquidity risks (e.g. liquidity demands stemming from margin calls). In that case, authorities can impose leverage limits and/or impose other restrictions to the management of the funds, including restrictions to the redemption policy. But this does not foresee the case where the risk is not directly attributable to leverage. For example, in some jurisdictions open-ended real estate funds may offer daily dealing and be exposed to fire sales if prompted to liquidate illiquid assets, even without exhibiting any leverage related risk. Therefore, the Article 25 power cannot be used to address risks posed by such funds.
68. In the preceding sections ESMA makes proposals to address structural liquidity mismatches in funds that invest in assets that are not liquid or that are long-term assets. Considering that liquidity risk may still exist in other open-ended funds, and that liquidity may deteriorate in some asset classes, ESMA also suggests the development of an analytical framework for liquidity in OEFs.
69. Finally, another element that is not addressed by the current framework on Article 25 is the lack of a formal “reciprocation framework” with regards to leverage limits, i.e. the activation of a measure in one jurisdiction without reciprocation in others or different implementing approaches across jurisdictions. ESMA believes that under specific conditions such framework would enhance the already existing coordination framework.

## **5.2 Leverage limits under UCITS and issues around the VaR approach**

70. Under the UCITS framework<sup>29</sup>, funds are subject to leverage limits. Balance sheet leverage is tightly limited as UCITS can only borrow up to 10% of NAV and only on a temporary basis<sup>30</sup>. Regarding synthetic leverage acquired through derivatives or securities financing transactions a UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio<sup>31</sup>.

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<sup>29</sup> See Article 51(3) of UCITS Directive

<sup>30</sup> See Article 83(2)(a) of UCITS Directive

<sup>31</sup> The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions.

71. The CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS<sup>32</sup> (hereinafter, 'CESR GLs') provide a harmonized definition of global exposure and set out detailed methodologies and limits to be respected by UCITS when they use the commitment approach or the Value-at-risk (VaR) approach. Under the commitment approach, UCITS are subject to a direct limit on leverage (after netting and hedging) of 200% of NAV. However, the VaR approach to calculate their global exposure does not impose direct leverage limits.
72. The VaR approach is more appropriate to evaluate the maximum potential loss of a portfolio due to in particular market risks. This is an advanced risk measurement methodology that is recommended for UCITS that engage in complex investment strategies for a non-negligible part of their portfolios (e.g. non-directional strategies). UCITS using the relative VaR approach are subject to a limit so that the VaR of their portfolio should not be higher than two times the VaR of a reference benchmark. Funds using the absolute VaR approach should have a one-month VaR, computed at the 99<sup>th</sup> level, lower or equal to 20% of their NAV.
73. Preliminary analysis by ESMA estimates that UCITS using the absolute VaR approach have a NAV of around EUR 923bn as of end-2023. Most funds using this approach are either fixed income and mixed funds or so-called 'alternative UCITS', i.e. funds pursuing hedge-fund like strategies (such as long/short, event-driven, global macro) under the UCITS framework..
74. The VaR approach does not impose a direct leverage limit, which raises a risk that certain funds might pursue highly leveraged strategies. Indeed, the 20% VaR constraint can be compatible with very high levels of leverage<sup>33</sup>.
75. Preliminary analysis by the ESRB shows that some UCITS implementing some sophisticated strategies and using the VaR approach, can have large levels of leverage, with gross leverage values above 700% of NAV<sup>34</sup>. Ongoing analysis by ESMA tends to show similar findings, with high levels of gross leverage for some UCITS using the VaR approach, especially funds pursuing 'alternative strategies'. There is a risk that some UCITS are even more leveraged than AIFs.
76. While high gross leverage does not necessarily imply high net leverage, gross leverage levels seen in some UCITS using the VaR approach are close or even higher than those observed for AIFs. However, given the lack of harmonised reporting requirements, at the moment, on net leverage for UCITS (i.e. measured by the commitment approach), it is very challenging to assess the net leverage for UCITS using the absolute VaR approach.
77. The current framework raises a number of issues. While AIFs under AIFMD can be subject to leverage limits under Article 25, there is no such harmonized tool for UCITS implementing sophisticated investment strategies and using the VaR approach for calculating their global exposure. Alternative UCITS are estimated to amount to around EUR 400bn in NAV compared to only EUR 113bn for Hedge Funds under AIFMD<sup>35</sup>. While those UCITS account for a small

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<sup>32</sup> [Microsoft Word - 10-788 Guidelines on risk measurement for publication.doc \(europa.eu\)](#)

<sup>33</sup> For example, a fund can invest in a portfolio with a low VaR (say 1%) and then use total return swaps to reproduce the performance of its portfolio and increase its exposure up to 20 times so that the VaR of the leveraged strategy would be equal to 20%.

<sup>34</sup> See the box 'The use of synthetic leverage by undertakings for collective investment in transferable securities' in the [EU Non-bank Financial Intermediation Risk Monitor 2024](#).

<sup>35</sup> See [EU Alternative Investment Funds 2023](#).

share of the investment fund universe (less than 5% of all UCITS NAV), their use of leverage should be further analysed as it might raise financial stability risks<sup>36</sup>.

78. Two main issues are to be considered: (i) should UCITS have the possibility to acquire high net leverage (irrespective of whether it is actually the case) and (ii) if some UCITS are found to have high net leverage, how should NCAs address the corresponding risks?

### ESMA's proposal

79. Currently, it has yet to be determined whether UCITS using the VaR approach create a systemic risk. Therefore, ESMA believes that this issue needs further investigation in the short term.
80. In that context, the future supervisory reporting under the UCITS Directive will be instrumental. The RTS on reporting obligation will be the opportunity for ESMA to consider what information UCITS (and in particular UCITS using the VaR approach) will report to enable, inter alia, a thorough assessment of the potential risks created by these UCITS, using the VaR approach and exhibiting high level of leverage. This information would include, inter alia, the level of leverage calculated under the commitment and gross method.
81. In case it is determined that these funds create a systemic risk, the European Commission could reflect on how best to address the issue, including through the imposition of leverage limits or any other tool deemed adequate.

## **6 Monitoring interconnectedness [questions 53 to 55]**

### **6.1 Stress testing**

82. The development of a stress testing framework has been a priority for ESMA, the other ESAs and all the authorities participating in the ESFS. ESMA has developed stress tests in a number of NBFIs areas.
- ESMA stress simulation (STRESI)<sup>37</sup> framework for investment funds aims at assessing the resilience of relevant parts of the investment fund sector to an adverse scenario and estimating the potential spillovers to the financial system, thus capturing financial stability risks beyond the individual fund level.
  - MMFs report the results of supervisory stress tests to regulators on a regular basis. The methods are provided by ESMA and the scenarios are updated annually by the European Systemic Risk Board (ESRB) in cooperation with the European Central bank (ECB).<sup>38</sup>
  - Due to their systemic nature, CCPs have been subject to sectoral stress tests since 2016. The ESMA supervisory stress test is different from the stress tests individual CCPs run on a daily basis. Especially, it considers how the default of one of its

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<sup>36</sup> Size is not always a precise measure of risks: EU GBP LDI funds created systemic issues although their NAV amounted to around EUR 200bn.

<sup>37</sup> [STRESI report](#), ESMA, 2019.

<sup>38</sup> [Guidelines on stress test scenarios under the MMF Regulation](#), ESMA, 2023.

clearing members or third-party providers impacts other CCPs. Therefore, the ESMA stress test is a critical tool in assessing the systemic implications of system-wide events and thus the resilience of the system of European CCPs.

83. The development of a system-wide stress **testing** framework should also be considered in relation with **the CCP Joint Monitoring Mechanism**. ESMA is of the view that data sharing arrangements made for the development of EU system-wide stress tests should also be beneficial to the Joint Monitoring Mechanism to monitor and analyse the clearing ecosystem, including links between credit institutions, NBFIs, and CCPs.
84. Following the adoption of the EMIR 3 review, ESMA will manage and chair the Joint Monitoring Mechanism to monitor, together with other relevant EU bodies, developments relevant for clearing in the EU, the potential risks arising from the interconnectedness of CCPs, clearing members and clients, and the implementation of the active account requirement (AAR). In addition, as part of its regular supervisory activities, ESMA conducts periodic stress tests on the resilience of EU CCPs and systemically relevant third country CCPs (Tier 2 CCPs) to adverse market developments.
85. One of the tasks of the Joint Monitoring Mechanism as set out in the EMIR 3 proposal is to contribute to the development of EU-wide assessments of the resilience of CCPs focussing on liquidity, credit and operational risks concerning CCPs, clearing members and clients.
86. The relevance to NBFIs might exist for entities who clear products at Tier 2 or EU CCPs. For example, NBFIs might use the client clearing services of clearing members giving rise to some degree of interconnectedness. Some NBFIs might also be subject to the AAR. Both client clearing relationships and the implementation of the AAR are within the scope of the Joint Monitoring Mechanism. However, its focus is on the clearing ecosystem rather than the wider financial system.
87. Likewise, any CCP-relevant reporting aims at monitoring risks specific to the resilience of CCPs or developments in the clearing ecosystem. Given that the focus of such reporting is on the CCP-clearing member relationship, the coverage of NBFIs activity would be limited. Other data sources such as EMIR derivatives reporting might be more relevant.
88. Hence, any EU system-wide stress test for NBFIs, while having a different scope than ESMA's CCP stress test or the tasks of the Joint Monitoring Mechanism, would have some overlap with ESMA's and the Joint Monitoring Mechanism's activities.

### *ESMA's proposal*

89. ESMA supports the development of EU system-wide stress test across NBFIs and the banking sector, as existing stress test exercises already consider the impact of stress event beyond its remit. ESMA also took note of the European Court of Auditors recommendation to develop a comprehensive model which allows for analysis of interconnectedness. In that context, two ongoing exercises are worth mentioning and could serve as a template for the development of future exercises:



- The European Commission has asked that the three European Supervisory Authorities (ESAs) conduct a one-off exercise in cooperation with the ECB and the ESRB. The exercise aims to assess the resilience of the EU's financial system, as well as its capacity to support the EU's Fit for 55 green transition strategy and the achievement of the 2030 climate targets.
- The ESRB launched a system-wide liquidity stress test, assessing the impact of a liquidity shock on banks, insurance and investment funds at EU-wide and national levels.

90. Similarly, at national level several EU<sup>39</sup> and non-EU<sup>40</sup> authorities have developed their approach to system-wide scenarios.

91. ESMA also wants to highlight the setup cost in designing a scenario and methodology, which is relevant and meaningful across sectors. Typically, investment funds, market infrastructures, banks, and insurance companies may not be subject to shocks of the same type and over the same time horizon and this needs to be taken into account when designing and implementing stress test scenarios and methodologies.

92. The biggest challenge for system-wide stress tests comes from data fragmentation and availability, as such an exercise relies on different data sets that may not be fully compatible and also relies on the availability of data sharing arrangements.

## 7 Supervisory coordination and consistency at EU level [questions 58; 59; 60; 61; 62; 66]

93. The ESRB plays an instrumental role in the development of a macroprudential framework in the EU, enabling the cooperation between central banks and NCAs. It had identified non-bank risks as a key area of work at an early stage and communicated on its macroprudential strategy “beyond banking”<sup>41</sup>. In terms of policy development, the ESRB issued several important recommendations on MMFs<sup>42</sup> and liquidity and leverage risks in investment funds<sup>43</sup>, followed by policy proposals for funds investing in less liquid assets<sup>44</sup>. Within the ESRB, the Non-Bank Expert Group, co-chaired by ESMA, has been driving the EU's non-bank risk analysis for more than a decade. With its NBF1 Monitor, the ESRB provides the annual document of reference on non-bank market developments and potential risks to financial stability in the EU.

94. ESMA considers that securities market regulators' expertise has proved crucial in that context and any review of the organisational structure of the macroprudential framework should ensure that securities market regulators are sufficiently and appropriately involved in the decision-making process.

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<sup>39</sup> [20171003\\_HCSF\\_Note\\_publique\\_CRE\\_EN.pdf \(economie.gouv.fr\)](#)

<sup>40</sup> [System-wide exploratory scenario | Bank of England](#);

<sup>41</sup> [Macroprudential policy beyond banking: an ESRB strategy paper](#), ESRB, 2016.

<sup>42</sup> [Recommendation on reform of money market funds](#), ESRB, 2021.

<sup>43</sup> [Recommendation on liquidity and leverage risks in investment funds](#), ESRB, 2017.

<sup>44</sup> [Policy options to address risks in corporate debt and real estate investment funds](#), ESRB, 2023.

95. As a securities market regulator, ESMA plays a coordination role with NCAs, particularly in times of market stress. In response to the COVID-19 pandemic, ESMA intensified the exchange of information among NCAs on the use of LMTs by EU/EEA UCITS and AIFs. ESMA also coordinated the NCAs response to the ESRB regarding the liquidity of investment funds during the March 2020 episode (see Section 1).
96. From a policy perspective, ESMA and the NCAs have promoted supervisory convergence at EU level on the way the compliance with the obligations arising from the relevant regulatory framework is supervised at national level. ESMA especially launched a Common Supervisory Action (CSA) with NCAs on the supervision of the asset valuation rules under the UCITS and AIFM Directives in 2022<sup>45</sup>, with specific follow-up actions for NCAs to address the issues identified, especially for funds exposed to less liquid assets. Previously, ESMA had launched, on 30 January 2020, a Common Supervisory Action (CSA) on UCITS liquidity risk management.
97. With regard to macroprudential measures, ESMA shall perform a facilitation and coordination role in relation to the measures proposed by NCAs under Article 25 of AIFMD and, in particular, shall try to ensure that a consistent approach is taken by competent authorities. ESMA believes this framework is relevant and could be further enhanced.

## **7.1 Developing a formal reciprocity framework**

98. Strong coordination is essential in macroprudential policy. This also applies to the asset management sector. As illustrated in the case of GBP LDI funds (see section 1), risks originated in the UK and affected funds domiciled in Ireland and Luxembourg, and managed in Ireland, Luxembourg and the Netherlands. It was therefore necessary to ensure that the same level of resilience applied to all funds across jurisdictions, as reflected in the ESMA opinion<sup>46</sup> on GBP-denominated LDI funds and the measures taken by the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier<sup>47</sup>.
99. Conversely, a lack of coordination could undermine the efficiency of measures taken in a jurisdiction to curtail a systemic risk and could create a risk of regulatory arbitrage, as managers could relocate to a different jurisdiction to avoid applying the measure.
100. The current framework, where the authority that adopts restrictions has to inform other relevant authorities and where ESMA has to issue an advice to the authority adopting the measure, reflects the cross-border dimension. While the current framework has been working well so far, in particular because of the good coordination and cooperation between authorities, there is no explicit legal basis for such coordination. As the fund sector grows in size and complexity, the current framework might have some limitations and should therefore be strengthened and enshrined in legal texts.
101. More specifically, a lack of legal basis for coordination could become relevant in the following situations:

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<sup>45</sup> [CSA on Asset Valuation](#) ESMA, 2022.

<sup>46</sup> [ESMA opinion on GBP LDI funds in Ireland and Luxembourg](#), ESMA, 2024.

<sup>47</sup> While Article 25 powers were not activated for NL managers, the NCA issued supervisory guidance towards relevant AIFMs to ensure that their GBP LDI funds were following the resilience requirements in place in the jurisdictions where the funds are domiciled.

- First, some funds might be managed by a manager established in another Member State than the Member State where the fund is domiciled. In that case, the NCA of the Member State where the fund is domiciled does not have the power to impose any restrictions under Article 25 of AIFMD as the responsible NCA is the NCA of the manager.
- Second, a financial stability risk may exist in several EU countries or be posed by funds managed from different member states. In that situation, there is a risk of inconsistency in the application of policy measures designed to reduce risk if different policy approaches are taken in different jurisdictions, This highlights the importance of international consistency and coordination to ensure there is no leakage from macroprudential measures introduced in different jurisdictions. Given the cross-border nature of the sector in Europe, such coordination on macroprudential policy is especially important to ensure the effectiveness of the measures.
- Finally, a financial stability risk may be relevant EU-wide. In that case, the same measure may need to be applied in all relevant home jurisdictions, making coordination even more essential.

### ESMA's proposal

102. ESMA is of the view that there is scope to go further on reciprocity, to mitigate the risk of regulatory arbitrage across jurisdictions. Reciprocity is defined by the ESRB as the means by which to safeguard the effectiveness and consistency of macroprudential policy across borders within the EU<sup>48</sup>. Without reciprocity, macroprudential measures taken in a given Member State in principle only apply to domestic institutions, i.e. local managers in the case of investment funds. They do not affect similar funds managed from another jurisdiction even when funds are domiciled in the jurisdiction which has issued a measure under Article 25 of AIFMD. This makes policy implementation inconsistent at the EU level and renders it relatively easy to circumvent national macroprudential measures.

103. Under a reciprocity framework, NCAs could be required to assess whether a national measure notified by one Member State should also be applied to similar funds in their jurisdiction. Similarly, ESMA – after having consulted the ESRB – could be required to assess whether a national measure notified by one Member State should also be applied across the EU. Such a mechanism would make national measures more effective by guarding against the potential for regulatory fragmentation or arbitrage across the EU. Therefore, the European Commission could reflect on the merits of introducing a reciprocity mechanism in Article 25 of AIFMD and ESMA would stand ready to further develop the implementation of such mechanism.

104. Finally, a reciprocity mechanism would not affect ESMA's capability to act on its own initiative, in particular if a risk has an EU-wide relevance. As highlighted above, the access to appropriate data will be necessary to the monitoring the EU-wide risks of the EU asset management industry.

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<sup>48</sup> [The ESRB handbook on operationalising macroprudential policy in the banking sector \(europa.eu\)](http://europa.eu)

## 7.2 Additional EU-level measures

105. Due to the cross-border nature of NBFIs activities, measures taken by competent authorities to address the risks identified in their jurisdiction may not be sufficient to fully address the risk in other jurisdictions or at EU-level. ESMA considers that a macroprudential framework has to consider risks posed at an EU-wide level, including externalities from NBFIs activities in another jurisdiction.

### ESMA's proposal

106. While macroprudential policy at national level would remain the responsibility of national authorities, the delineation between national and EU-wide additional macroprudential measures could follow the principle referred to in ESMA's position paper "Building more effective and attractive capital markets in the EU". ESMA has set out recommendations how supervisory activities and coordination could be designed for cross-border activities (recommendation 18). This includes:

- facilitating more cooperation and joint supervisory work amongst NCAs especially on large, cross-border firms, for example, in the form of mandatory supervisory colleges and coordinated supervisory teams.
- carrying out more central work on selected tasks to increase efficiencies, integration, and optimisation, for example, common data or risk analytics.
- centralisation of certain supervisory data collection and processing.
- fostering harmonised enforcement outcomes through enhanced cooperation and convergence.

107. The ESMA legislative framework and toolkit should evolve accordingly to allow for effective implementation of these objectives. Against this background, ESMA suggests that the Commission may consider the opportunity to give ESMA, in collaboration with NCAs and after consulting with the ESRB, the formal power to request the implementation of stricter macroprudential requirements by one or multiple NCAs to address risks at EU-level.

## 7.3 ESAs and ESRB's powers during emergency situations

108. Since its creation ESMA has faced many cases where market situations required quick reactions by ESMA, leading to some observations regarding ESAs and ESRB's powers during emergency situations:

- i. The time required to amend Level 2 or even more Level 1 frameworks is not compatible with the time available in situations where a market event requires short term or temporary regulatory measures.
- ii. Similarly, there are also cases when new measures set in Level 1 or Level 2 create an interim situation until their future entry into force, that cannot be addressed in the absence of a formal power to suspend certain requirements.

109. ESMA has faced many of these cases over the past thirteen years and has aimed to provide clarity to market participants by issuing statements. These statements indicated ESMA's expectations in terms of risk-based supervision and supervisory convergence, but did not provide any legal certainty to the concerned entities nor the NCAs, thus not addressing a number of risks associated to these cases.

#### *ESMA proposal*

110. ESMA strongly believes that there is a need to define an effective and adequate “no-action framework” for the ESAs.

## Annex 1 – MMF reform

1. In light of the specific questions raised by the Commission in the present consultation, ESMA would like to emphasize a selected number of key policy proposals needed which are, in the view of ESMA, needed to improve the MMF regulatory framework in the EU:
  - Amortised costs for LVNAV
2. ESMA would like to restate that one of the key proposals included in the abovementioned ESMA Opinion relates to amortised costs for LVNAVs, and that this proposal is not covered in the questions on MMFs raised by the Commission in its consultation.
3. The amendments of the MMF Regulation which would reduce threshold effects for constant NAV MMFs should indeed first aim at addressing the issues, related in particular to first-mover advantages, stemming from the ability for LVNAVs to offer a stable NAV under most circumstances. The ESMA Opinion proposed that no private debt MMFs should be able to use the amortised costs method, irrespectively of the investor base or the assets they hold. This would mean a ban of such a valuation method for LVNAV MMFs. The rationale behind this proposal is that these LVNAV mechanisms based on the amortised cost method imply nonlinearities (cliffs effects) by definition and make LVNAV MMFs therefore intrinsically prone to first-mover advantages and other amplification effects.
4. The MMF Regulation has indeed explicitly been structured in order to allow CNAV and LVNAV to be maintained, considering that the costs of eliminating the CNAV and LVNAV model would be significant, and the co legislators therefore preferred to set out specific rules aiming at ensuring financial stability while permitting these vehicles, rather than requiring a mandatory move to the VNAV model in Europe. However, more than ten years after the start of these discussions, ESMA is of the view that the considerations which led to the choice made in the MMF Regulation to maintain the model of LVNAV could now be revisited, in particular in light of the market events that took place during the March 2020 crisis. Indeed, while not only stable-NAV MMFs faced difficulties during the March 2020 crisis, but also VNAVs (and in particular standard VNAVs), it appears that the specific issues raised by nonlinearities inherent in LVNAV structures should be addressed.
5. Under the MMF Regulation, LVNAV MMFs are allowed to use the amortised cost valuation method to value certain assets and need to keep their NAV as calculated using this amortised cost method within a collar range of 20 bps as compared to the NAV using entirely the mark-to-market valuation method. When their NAV breaches this collar (Article 33(2) MMFR), these MMFs need to use mark-to-market valuation for all of their assets. The use of the amortised cost valuation method is therefore crucial to being able to offer a stable NAV to investors and provides a first-mover advantage as investors can redeem from the MMF at values of the underlying assets that do not necessarily reflect the market valuations of those assets. This is the reason why, ESMA consider that it is sufficient to remove the ability for LVNAV to use amortised cost, rather than completely removing LVNAV from the MMF Regulation.
6. ESMA also notes that the results of MMF stress tests as reported by managers of MMFs to NCAs, and then to ESMA under the requirements of Article 28 of the MMF Regulation tend to confirm that this issue is still material.

- Amendments of the DLA/WLA of VNAV (and LVNAV) MMFs, as well as the pool of eligible assets, including public debt assets, which can be used to satisfy these liquidity ratios.
7. Secondly, in view of addressing MMF liquidity issues, ESMA proposed in its Opinion amendments of the DLA/WLA of VNAV (and LVNAV) MMFs, as well as the pool of eligible assets, including public debt assets, which can be used to satisfy these liquidity ratios. This proposal relates to the question 8 and 9 of the present Commission consultation.
  8. ESMA is of the view that amendments of the MMF Regulation should ensure that MMFs are better able to meet periods of heightened redemption requests without destabilising underlying money markets. As such, requiring higher levels of liquidity buffers, through weekly and daily maturing assets, and the possibility of holding of public debt asset to meet daily and weekly liquidity ratios should ensure greater liquidity and reduced risk in the portfolio.
  9. Given their different nature, and the different package of policy options that ESMA suggested to apply to them, these additional liquidity requirements need, however, to be differentiated between VNAVs and LVNAVs.
  10. With respect to VNAVs (both short-term and standard), the DLA and WLA requirements should be increased to  $7.5\%+X(\text{VNAV})\%$  /  $15\%+Y(\text{VNAV})\%$  respectively (as compared to the current 7.5%/15%) while leaving the option to managers to include a maximum proportion of public debt (of a maturity up to 190 days) ( $Z(\text{VNAV})\%$ ) in the computation of the WLA (similarly to what currently applies to LVNAV, according to Art. 24(1)(g)).
  11. With respect to LVNAVs, ESMA is of the view that no additional liquidity requirements should apply to LVNAVs, since the DLA/WLAs for these MMFs are already higher than for VNAVs, and these funds also already have the possibility to meet WLA with certain public debt assets, under Art. 24(1)(g).
  12. ESMA is also of the view that, in order to ensure a high level of supervisory convergence on this matter, which appears to be key in relation to the potential financial stability related concern, the increase of the above liquidity buffers should be set in the MMF Regulation, and not left at the discretion of national or EU competent authorities.
  13. However, in the policy proposal A.2.3 of the abovementioned Opinion (Inclusion/Reinforcement of the possibility to temporarily use liquidity buffers in times of stress), ESMA also indicated that in stressed market conditions, in light of the difficulties faced by MMFs during the COVID-19 crisis in March 2020, it should be possible for the manager of the MMF to relax, for a limited period of time, the abovementioned liquidity requirements, which are set out in Articles 24 and 25 of the MMF Regulation.
  14. The release of these liquidity requirements should, however, not be activated by authorities on their own initiative, since there is a risk that when the authorities decide to release these requirements it will actually trigger the very contagion it intended to contain or simply because it could intervene too

soon / too late / disproportionately given that the authority often does not or does not at all times currently possess the detailed information on the market situation to be able to take action<sup>49</sup>.

15. The anticipation of the activation of LMTs by public authorities could also create the perception of a first mover advantage and precipitate redemptions ahead of such decision (therefore prompting the need to such activation).
16. The manager of an MMF shall however notify the National Competent Authority of such a decision of relaxation of the liquidity limits referred to Article 24 and 25 of the MMF Regulation without delay.

- Reporting requirements

17. In relation to reporting requirements (in relation with the question 10 of the present Commission consultation), the ESMA Opinion indicated that the amendments of the MMF Regulation which would enhance crisis preparedness and monitoring of the MMF market should aim to provide authorities with the necessary information to identify systemic vulnerabilities in the MMF sector. This is in particular the case with respect to the enhancement of reporting requirements to authorities under Article 37 of the MMF Regulation.
18. In stress market conditions, enhancing and harmonizing crisis-specific data-sharing arrangements should improve authorities' understanding of the systemic risk posed by MMFs and allow for potential further mitigating policy actions to be adopted.
19. Article 37 should be amended to specify that in stress market conditions, more frequent reporting (daily) would be expected on a certain number of key indicators. This would build on the experience which was acquired by national competent authorities during previous crisis times, such as the March 2020 events, developing ex ante a common EU reporting format for managers of MMFs to report to authorities, and then for the latter to ESMA and macroprudential authorities, such as the ESRB, in the more effective way in such crisis time, where time is of essence.
20. The specification of the exact indicators to be reported in these circumstances should be left to a delegated act, as well as the criteria that would define when exactly these requirements applying in crisis time only should be activated.
21. Apart from crisis times, ESMA is of the view that the frequency of reporting should also be raised in normal times from quarterly to monthly, for MMFs whose assets under management exceed EUR 100,000,000, and from annually to quarterly, for MMFs whose assets under management do not exceed EUR 100,000,000. This would be more in line with the ECB reporting requirements and would allow for more informed decisions from NCAs and ESMA (e.g. in relation to the supervision of MMFs).

- MMF Stress tests

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<sup>49</sup> In that scenario, that measure might also be applied differently by different Authorities (for the same reasons), and may hardly be appropriate for all MMFs, which would be in very different situations, given their differences in terms of investors and portfolio composition.



22. In relation to MMF stress tests (in relation with the question 11 and 12 of the present Commission consultation, the ESMA Opinion indicated that an enhancement of the MMF stress testing framework was needed.
23. ESMA indicated that a key issue is that while individual MMFs might be able to be resilient to the adverse scenario when considered in isolation, this might not be the case when all MMFs face a shock at the same time (as observed in March 2020). This is because individual MMF do not take into account what other MMFs might do at the same time. This coordination failure can create additional stress, especially given the high portfolio overlap, high market footprint and low liquidity of the markets MMFs invest in.
24. In addition, Article 28(6) of the MMF Regulation indicates that the report sent to NCAs containing the corrective measures that the manager of an MMF will take when results of stress tests reveal vulnerabilities of a specific MMF is also sent to ESMA. The extent to which this coordination mechanism between National Competent Authorities and ESMA is sufficient to address the abovementioned system-wide related issues needs to be assessed. ESMA noted in particular that, as of Today, no such report was ever submitted to NCAs, which might tend to show that the corresponding requirements of Article 28 would need to be amended to be even more effective.
25. Article 28 could therefore be amended to specify that ESMA would, together with NCAs, receive directly from the manager of the MMF the report mentioned in Article 28(5) of the MMF Regulation, so that ESMA can play its coordination role with NCAs in a more effective way, given in particular real-time information is of a significant value in such crisis situations as in March 2020. The conditions under which such a report shall be issued by the manager of the MMF could also be specified.
26. In addition, the hypothetical macro systemic shock specified in Article 28(1)(f) of the MMF Regulation should include relevant features to allow for the possibility to assess the systemic vulnerabilities of MMFs. It should explicitly require making assumptions (therefore also in the implementing guidelines on MMF stress tests) on other MMFs, financial entities and non-financial counterparties behavior. This would mean adding the words “including, where relevant, the behavior of other market participants” to Article 28(1)(f). The Guidelines on MMF stress tests would specify this new requirement, in the stress tests managers of MMFs conduct for their own operational purposes on the one hand (sections 4.1 to 4.7 of the Guidelines on MMF stress tests<sup>50</sup>), in the standardized stress tests the results of which are reported by managers of MMFs to NCAs, and then ESMA, on the other hand (sections 4.8 and 5 of the Guidelines on MMF stress tests).
- Reverse distribution mechanism
27. In relation to the question 13 and 14 of the present Commission consultation, ESMA is of the view that, for the sake of clarity and legal certainty, the EU ban on the reverse distribution mechanism should be explicitly included in the MMF Regulation, and that the review of the MMF Regulation that is envisaged by the Commission is a good opportunity to include such a requirement in the MMF Regulation.

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<sup>50</sup> [https://www.esma.europa.eu/sites/default/files/library/esma34-49-291\\_2020\\_guidelines\\_on\\_mmf\\_stress.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-49-291_2020_guidelines_on_mmf_stress.pdf)

- The international dimension of the EU MMF sector

28. The EU MMF sector plays a global role: more than half of EU MMFs are in USD and GBP. EU GBP MMFs account for around 90% of the global GBP MMF sector.

29. In that context, recent changes to the MMF regulatory framework in the US, and planned ones in the UK, contrast with inaction at the EU level. Such divergence could create regulatory arbitrage opportunities: in the US, Prime institutional MMFs are subject to liquidity requirements which are substantially higher than in the EU for LVNAVs, even though US funds have a floating NAV compared to a constant NAV for LVNAVs. In the past, such discrepancies have resulted in large inflows into EU USD MMFs, as seen after the 2016 US regulatory reform<sup>51</sup>.

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<sup>51</sup> For further details see also 'The international dimension of the EU money market fund industry', ESRB Non-bank Financial Intermediation Risk Monitor 2024.