ESMA's response to the European Commission's public consultation on the review of macroprudential regulatory policies for non-banking financial intermediation

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On 22 May 2024 the European Commission (EC) launched a targeted public consultation on the adequacy of macroprudential policies for Non-Bank Financial Intermediation (NBFI), as a response to the different events in recent years related to financial stability.

ESMA responded to the consultation in November 2024 highlighting the need to implement a macroprudential regulation to address the main vulnerabilities and risks resulting from the NBFI. Moreover, ESMA stressed the need for greater supervisory coordination at a European Union (EU) level to obtain a more effective framework, improve the quality of information, and foster cooperation at the European and international levels.

ESMA also believes it is beneficial to assess the different nature and activities of the entities engaged with the NBFI, that is, regulated entities subject to specific legislation, market infrastructures, unregulated market participants (e.g., family offices), and a wide range of activities that contribute to financial intermediation, such as repo finance.

How is ESMA's response structured?

In the European Commission's (EC) response to the public consultation on NBFI, ESMA makes several proposals related to different aspects, grouped in the following areas: key vulnerabilities and risks posed by NBFI, leverage of alternative investment funds (AIFs) and UCITS[1] funds, the interconnectedness of the NBFI with the rest of the financial system and supervisory coordination at EU level.

[1] Undertakings for Collective Investment in Transferable Securities, regulated by the UCITS Directive: Directive 2009/65/EC of the European Parliament and of the Council, of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

What are ESMA's main concerns?

1. **Leverage** as a common strategy in certain investment funds, especially funds with derivative-based strategies (e.g., hedge funds). Excessive leverage of investment funds can lead to a range of systemic side effects, including increased volatility, market instability and a domino effect. Taking into consideration these aspects, ESMA highlights the relevance of a macroprudential regulation and mentions the initiative, among others, taken by certain national competent authorities[2] (NCAs) aimed at activating the mechanism of Article 25.3 of the Alternative Investment Fund Managers Directive (AIFMD[3]) after the September 2022 crisis of the GBP liability-driven investment funds[4].

2. **Disparities in the liquidity of open-ended funds** investing, under certain conditions, in real estate or other illiquid assets. Such investment activities, under a situation of market stress, could lead to the sale of fund assets at low prices, which can exacerbate market downturns and trigger a cycle of fire sales. ESMA has identified vulnerabilities, such as exposure to potential liquidity mismatches or the valuation of portfolio assets[5], which might impact the funds' ability to meet redemption requests. Money market funds (MMFs) may also be affected by the vulnerabilities, such as an increase in redemptions or, in the case of deterioration of market liquidity of companies' commercial papers. An additional identified issue is the regulatory framework of liquidity management tools for MMFs, as it may lead to incentives for certain participants of such funds to request early redemption before others.

[2] More specifically, the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier (CSSF).

[3] Article 25.3 of Directive 2011/61/EU of the European Parliament and of the Council, of 8 June 2011, on alternative investment fund managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010: "The AIFM shall demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times. The competent authorities shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages could entail, and, where deemed necessary in order to ensure the stability and integrity of the financial system, the competent authorities of the home Member State of the AIFM, after having notified ESMA, the ESRB and the competent authorities of the relevant AIF, shall impose limits to the level of leverage that an AIFM are entitled to employ or other restrictions on the management of the AIF with respect to the AIFs under its management to limit the extent to which the use of leverage contributes to the build up of systemic risk in the financial system or risks of disorderly markets. The competent authorities of the home Member State of the AIFM shall duly inform ESMA, the ESRB and the competent authorities of the AIF, of actions taken in this respect, through the procedures set out in Article 50.".

[4] This type of fund invests in British sovereign bonds and is often used in pension schemes that guarantee the amounts that future pensioners will receive. The measure set by the aforementioned NCAs aimed at requiring managers to have such funds be able to withstand increases in interest rates of, at least, 300 basis points ("GBP yields").

[5] In particular, funds investing in real estate and corporate debt.

What measures does ESMA propose to tackle these issues?

1. **Address unmitigated liquidity mismatches in open-ended funds.** ESMA welcomes the amendments to the UCITS and AIFMD Directives, in particular those relating to liquidity management tools. Nonetheless, it acknowledges that there may be other sources of unmitigated liquidity mismatches. It mentions, in particular, that the EC did not fully reflected ESMA's proposals in the Delegated Regulation[6] that develops, among other aspects, the reimbursement policy for European Long-Term Investment Funds (ELTIFs). ESMA considers that this standard should have included a degree of enforceability in relation to the minimum notice period requirements for the redemption of ELTIF units. To this extent, ESMA suggests that the EC should consider such proposal when amending the governing Level 1 Regulation[7].
   It additionally proposes similar measures for funds that are not ELTIFs and invest in illiquid or long-term assets, noting that NCAs could even go as far as requiring them to be structured as closed-end funds. Moreover, ESMA supports the Recommendations made by the Financial Stability Board on the classification of open-ended funds according to the assets' liquidity. It also promotes the consistent application of such Recommendations throughout the EU.
2. **Risk assessment and monitoring.** ESMA stresses the need for good-quality, thorough and timely information as a key factor to any macroprudential policy. ESMA's Regulatory Technical Standards (RTS) developing the amendments recently introduced by UCITS and AIFMD Directives to such purpose shall specify the content of the information that management companies are to provide to the supervisor, with sufficient detail to assess the liquidity of assets. Likewise, it will take into account existing reporting requirements to avoid unnecessary burdens on market participants.

However, ESMA states that improvements to access and use of information may only be achieved if it appropriately resourced to ensure that information is properly collected and analysed for supervisory purposes.

3. **Improvements to the regulatory framework for liquidity risk.** Where appropriate, NCAs must make effective and systematic use of their power to require liquidity stress testing in the course of their supervisory activity, in conformity with the ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs. ESMA stands ready to develop, along with NCAs, a harmonised analytical framework for the regular assessment of liquidity risk of open-ended funds. In aims of improving access to appropriate information, ESMA could take advantage of the aforementioned RTS to include information that NCAs, in turn, could use to carry out liquidity risk assessment of open-ended funds.
4. **Managing unmitigated liquidity mismatches in MMFs.** ESMA supports the finalisation of the review of the MMF Regulation and the implementation of the Financial Stability Board Recommendations to improve the resilience of these funds.
5. **Additional non-banking financial intermediaries and energy markets: commodity and energy markets.** ESMA asks the EC to consider the MiFID[8] review report (Article 90.5) in order for the European Parliament to assess the framework for energy spot markets, financial markets and their supervision.
6. **Limits on leverage to UCITS and issues related to the VaR.** Although the UCITS Directive imposes limits on leverage to its regulated funds, where UCITS funds apply a "Value at Risk" (VaR) approach to calculate their overall exposure, the current regulatory framework does not set limits on their leverage. Therefore, determining if such approach creates systemic risk is necessary. Should it be the case, ESMA suggests the possibility of the EC considering the procedure to be applied to the matter, including the possibility of imposing leverage limits or any other appropriate solution.
7. **Monitoring interconnectedness: stress testing.** ESMA supports the development of an EU-wide stress testing system for non-financial banking intermediaries and the banking sector. In this context, two current exercises could serve as benchmarks: a) that carried out by the European Supervisory Authorities (ESAs) in collaboration with the European Central Bank (ECB) and the European Systemic Risk Board (ESRB), to assess the EU financial system's resilience and its ability to manage the EU Fit for 55 green transition strategy and the 2030 climate goals, and b) the liquidity stress test on ESRB's system to assess the impact of liquidity pressures on banks, insurance companies and investment funds at national and EU level.
8. **Coordination and consistency at European level: formal reciprocity framework.** ESMA believes that there is room to strengthen reciprocity of measures adopted by NCAs to, thus, mitigate fragmentation and arbitrage in the EU. Without reciprocity, macroprudential measures agreed by a Member State only apply, in principle, to domestic institutions and do not affect similar funds managed in a different jurisdiction, even if the funds are domiciled in the jurisdiction that has published a measure under Article 25 of the AIFMD Directive[9]. This makes the policy implementation inconsistent across the EU and makes it relatively easy to circumvent national measures. ESMA suggests that the EC consider the introduction of a reciprocity mechanism in the aforementioned article, in order for NCAs to be required to assess whether a national measure of another Member State on funds should be applied in their jurisdiction. ESMA, in cooperation with the ESRB, could be asked to consider extending the application of a national measure across the EU. ESMA is available to develop the implementation of such mechanism, which would not affect its ability to act on its own initiative, particularly when a risk is relevant to all EU jurisdictions.
9. **Additional EU measures.** ESMA suggests that the EC should consider the opportunity to confer on ESMA, in collaboration with NCAs and the ESRB, the formal power to request one or more NCAs to implement stricter macroprudential requirements to address risks at EU level.
10. **ESAs and ESRB's powers in emergency situations.** ESMA believes it is absolutely essential to define an effective and appropriate framework for ESAs when market circumstances require a quick

reaction, more specifically:

1. When the review of Levels 1 and 2 of the regulation requires a period that is not compatible with the need to intervene quickly with temporary or short-term regulatory measures.
2. When the measures established in Levels 1 and 2 of the regulation create interim situations until the effective application of the new rules, and formal powers are necessary to suspend certain requirements.

[6] Commission Delegated Regulation (EU) 2024/2759, of 19 July 2024, supplementing Regulation (EU) 2015/760 of the European Parliament and of the Council with regard to regulatory technical standards specifying when derivatives will be used solely for hedging the risks inherent to other investments of the European long-term investment fund (ELTIF), the requirements for an ELTIF's redemption policy and liquidity management tools, the circumstances for the matching of transfer requests of units or shares of the ELTIF, certain criteria for the disposal of ELTIF assets, and certain elements of the costs disclosure.

[7] Regulation (EU) 2015/760 of the European Parliament and of the Council, of 29 April 2015, on European long-term investment funds.

[8] Directive 2014/65/EU of the European Parliament and of the Council, of 15 May 2014, on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[9] Article 25 of the AIFMD: CELEX:32011L0061:ES:TXT.pdf.

Why is detailed and granular information the basis for effective supervision in the proposed macroprudential policy review?

ESMA highlights that high-quality, timely and granular information is essential for an effective macroprudential policy. For example, monitoring open-ended funds requires granular information, including data on fund portfolio holdings (by instrument or asset class) in order to be able to assess liquidity and concentration risks, as well as data on the ownership of fund participants to identify redemption risks. ESMA considers that the current reporting regime, specifically for UCITS and AIFs, lacks the necessary granularity and adequate structure, which hampers its ability to conduct an effective analysis. In order to alleviate this situation, as mentioned above in this article, ESMA proposes to improve the granularity of the information that management companies must provide to the supervisor, through the development of the corresponding RTS, as well as to create an integrated data system. Moreover, it mentions that access to data from non-fund sectors, such as banking (regular counterparty for derivatives financing transactions) and insurance (regular holders of units), could improve the monitoring of liquidity risks. In fact, access to enhanced data is, according to ESMA, essential to optimise stress testing and identify potential liquidity mismatches.

What are the next steps?

Commission services will use the information gathered in this consultation to inform the **policy planning of the upcoming 2024-2029 College of Commissioners.**

Link of interest:

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