22 November, 2024

By email: fisma-nbfi-consult@ec.europa.eu

DG FISMA
European Commission
Rue de Spa 2
1000 Bruxelles, Belgium

Re: European Commission Targeted Consultation Document: Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation

Dear Sir/Madam,

Managed Funds Association ("**MFA**")[i] appreciates the opportunity to represent the views of the global alternative investment industry in this written response to the European Commission's (the "**Commission**") targeted consultation on macroprudential policies for Non-Bank Financial Intermediaries ("**NBFIs**") (the "**Consultation Paper**"). We have set out our responses to the relevant questions of the Consultation Paper in the Annex.

Executive Summary

MFA welcomes the Commission's recognition that NBFI is a "source of financial diversification and so resilience in itself" and that in the "context of the Savings and Investments Union objectives ("**SIU**"), stable and integrated capital markets are key sources of funding for the economy and complement traditional bank lending, while they also provide tools to manage financial and non-financial risks."[ii] The European Central Bank similarly stated that "[n]on-banks have remained resilient to recent bouts of market volatility and have continued to support market-based finance in the euro area across all credit risk

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[i] Managed Funds Association ("**MFA"**), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[ii] European Commission, Targeted Consultation, Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation (NBFI) (May 22, 2024), avail. at https://finance.ec.europa.eu/document/download/ddd6c515-3796-4db3-b91d-88a1a64acf07_en?filename=2024-non-bank-financial-intermediation-consultation-document_en.pdf), at p. 7 (the "**Consultation**").

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categories.[iii] We agree, as MFA's members indeed "play a pivotal role in fostering the diversity of financial markets structure and contributing to the resilience of the financial system through private risk sharing and reduced overreliance on traditional (relationship) bank lending."[iv]

While MFA respects the Commission's objective of seeking stakeholders' input on the adequacy of the macroprudential framework for NBFI writ large, AIFs do not pose a financial stability risk and further macroprudential policies targeted at private funds are not warranted. Rather:

- AIFs serve as investment vehicles for sophisticated, typically institutional investors and are not funded with depositor assets or backed by deposit insurance or other government guarantees or liquidity facilities.
- Private credit funds and other AIFs do not pose financial stability risk given that investors are the source of private fund assets, rather than depositors or beneficiaries.
- Liquidity risk does not materialise in the private funds sector, particularly for hedge funds and private credit funds, due to their structural and operational characteristics. Liquidity is managed by contract and redemption rights are calibrated to the liquidity of the underlying portfolio assets. Iin short, there is no "run risk."
- AIFs in general do not exhibit excessive leverage, nor does their use of leverage pose a financial stability risk. Leverage is typically employed principally to hedge or manage risks (rather than amplify them), a fact that many common simplistic measures of leverage overlook and misstate.
- When considering the role of AIFs in the context of the European Savings and Investments Union, they play a vital role in providing diverse and flexible funding sources for European companies. Private credit also provides working capital and other financing to operating companies, helping fuel the real economy in the EU and elsewhere.
- In addition to acting as active participants in the primary and secondary markets, enhancing price discovery and market efficiency, they often times are the "buyers of last resort" during times of stress and aid in restructuring efforts and providing needed capital to European issuers and contributing to restructurings and recapitalizations.
- AIFs, along with their dealer counterparties and the central counterparties ("**CCPs**") at which they clear, maintain detailed, robust margin risk management practices to manage risk

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iii European Central Bank, Financial Stability Review (Nov. 2024), at 7 (avail. at https://www.ecb.europa.eu/press/financial-stability-publications/fsr/html/ecb.fsr202411~dd60fc02c3.en.html).

iv *See* Consultation, *supra* note ii (emphasis omitted).

exposures. One challenge MFA would note is the lack of transparency around CCP margin models and the fact that these may be changed unilaterally and without notice.

- While AIFs and banks operate within the same financial ecosystem, the nature of private funds and their relationships with banks supports the conclusion that their interconnectedness is unlikely to pose any potential financial stability risk.
- Well in excess of 1,000 funds close yearly, with several hundred new funds launching each year as well.[v] The failure of a private fund has not affected the real economy or created stability or macroprudential risks.
- Lastly, MFA supports enhanced information sharing among authorities to enable more coordinated responses to addressing any potential financial stability risks. Harmonising reporting requirements generally, including reporting requirements for AIFs in the US and Europe, would enable more effective macroprudential supervision among global regulators without needlessly imposing additional, new reporting requirements on market participants.

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MFA appreciates the opportunity to provide these comments to the Commission in response to the Consultation Paper. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact the undersigned at jflores@mfaalts.org or Rob Hailey at rhailey@mfaalts.org.

Respectfully submitted,

/s/ Jillien Flores

Jillien Flores
Executive Vice President
Head of Global Government Affairs
Managed Funds Association

v *See* McKinsey Global Private Markets Review 2024: Private markets in a slower era (Mar. 28, 2024), avail. at https://www.mckinsey.com/industries/private-capital/our-insights/mckinseys-private-markets-annual-review.

ANNEX

SECTION 1 – KEY VULNERABILITIES AND RISKS STEMMING FROM NBFI

Q3 To what extent could the failure of an NBFI affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced? Please explain in particular to which NBFI sector, part of the financial system and critical function you refer to, and if and how you believe such knock-on effect could be mitigated.

MFA represents over 180 alternative investment managers, including traditional hedge funds, credit funds, and crossover funds, collectively managing over $3.2 trillion across a diverse range of investment strategies. Our member firms assist pension plans, university endowments, charitable foundations, and other institutional investors in diversifying their investments, managing risk, and generating attractive returns over time. Throughout this comment letter, we refer to "private funds" interchangeably with alternative investment funds ("**AIFs**") under the EU Alternative Investment Fund Managers Directive (Directive 2011/61/EU) (the "**AIFMD**"), which both broadly encompass traditional hedge funds, private equity funds and credit funds (including private credit funds). Such funds may be domiciled in the EU, UK, US or elsewhere.

MFA notes that the universe of NBFI encompasses a diverse range of financial institutions engaged in a variety of different activities and posing very different prospective risks. NBFIs are subject to varying degrees of regulatory oversight based on their function and, indirectly, the beneficiaries they and their investors serve. For these reasons, a single set of standards of liquidity risk management or use of leverage would be inappropriate for general application to all entities in the NBFI universe. MFA urges the Commission to focus on the subsets of the NBFI universe where maturity transformation and excess leverage could potentially develop into a financial stability risk.

Considering AIFs within the myriad of NBFIs, the failure of a private fund would not significantly affect the provision of critical functions to the real economy or financial system, as failed funds are easily replaced. This conclusion is based on several important factors:

1) AIFs operate on an agency model, serving as investment vehicles for sophisticated, typically institutional investors that are fully aware of the investment risks and potential losses associated with such investments. Unlike credit institutions, private funds are not funded by liabilities that are redeemable at

par and on demand, nor do they benefit from deposit insurance or other government guarantees or facilities. They further do not maintain large balance sheets of their own assets, perform significant maturity transformation, or operate payment systems that are critical to financial stability.

2) The private funds industry is intensely competitive with relatively low barriers to entry. This competitive landscape ensures that, in the event of a fund's failure, other market participants can and do readily step in to fill any gaps.[1] History has proven this resilience of AIFs time and time again.

3) As both the Federal Reserve in the US and the European Securities and Markets Authority ("**ESMA**") in the EU have recently observed, investment funds do not pose systemic risk. For example, ESMA's January 2024 TRV Risk Analysis notes that the majority of EU hedge funds are not substantially leveraged, have limited liquidity mismatch, and pose low risk of spillovers to financial institutions[2], while the Federal Reserve's 2023 Financial Stability Report concludes that private credit funds pose limited potential financial stability risk.[3] A similar observation has been made by the European Systemic Risk Board ("**ESRB**") in its most recent NBFI Monitor of June 2024, where it concludes that "private finance does not seem to pose an immediate concern from a systemic risk perspective."[4] The same is true of private credit funds, which are limited users of leverage and require multi-year holding periods before investors can redeem.

Historical evidence supports this perspective. In excess of 1000 funds close every year, sometimes due to underperformance and subsequent investor redemptions, all without raising systemic concerns. In fact, a recent exploratory analysis by the Board of Governors of the US Federal Reserve System found that the failure of the five hedge funds with the largest counterparty exposures to US Global Systemically Important Banks would result in losses of

1 *See* Claude Lopez, *The Asset Management Industry, Systemic Risk, and Macroprudential Policy*, MILKEN INST.: THE CAPCO INST. J. OF FIN. TRANSFORMATION, https://milkeninstitute.org/sites/default/files/reports-pdf/SSRN-id2953076_2.pdf.

2 *See* Jean Baptiste, *Assessing the Risks Posed by Leveraged AIFs in the EU*, EUROPEAN SEC. AND MKTS. AUTH. 7-9 (Jan. 30, 2024), avail. at https://www.esma.europa.eu/sites/default/files/2024-01/ESMA60-1389274163-2572_TRV_article_-_Assessing_risks_posed_by_leveraged_AIFs_in_the_EU.pdf ("**ESMA 2024 TRV**") pp. 7-9.

3 *See Financial Stability Report*, FED. RSVE. 45 (May 2023), avail. at https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf, p. 45.

4 *EU Non-bank Financial Intermediation Risk Monitor 2024*, EUROPEAN SYSTEMIC RISK BD. 43 (June 2024), avail. at https://www.esrb.europa.eu/pub/pdf/reports/nbfi_monitor/esrb.nbfi202406~2e211b2f80.en.pdf ("**June 2024 NBFI Monitor**") p. 43.

only between 1.0 and 1.2 per cent of these banks' risk-weighted assets.[5] This finding suggests that the largest and most complex US banks can withstand the completely hypothetical failure of hedge funds with significant counterparty exposure without compromising overall financial stability.

This contrasts sharply with the banking sector, where the failure of significant institutions can have major negative externalities beyond the losses borne by investors, given the significant role that banks play in credit, maturity, and liquidity transformation. Unlike a private fund, a bank cannot reasonably halt depositor withdrawals, and thus a cascade of sudden withdrawal at the same time creates a situation where intervention and potentially rescue by regulatory authorities becomes necessary.

Q4 Where in the NBFI sectors could systemic liquidity risk most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFI? Please provide concrete examples.

MFA appreciates that liquidity risk within the NBFI sector is a key concern for regulatory authorities. MFA supports a resilient NBFI sector that can withstand market shocks and welcomes efforts to reduce liquidity risk.

Liquidity risk is highly unlikely to materialise in the private funds sector, particularly for hedge funds and private credit funds, due to their structural and operational characteristics.

Private fund investors are typically large, sophisticated institutional investors such as sovereign wealth funds, foundations, endowments, and pension funds. Such investors understand and agree to the redemption limitations on the fund and often have multi-generational investment horizons. They are advised by sophisticated financial and legal professionals.

These sophisticated investors understand that liquidity risk of a given private fund is correlated to the liquidity of the underlying assets. For example, a typical hedge fund, which is invested in a portfolio of liquid securities and other investments, may offer redemptions at a quarterly or even longer frequency, and at each such interval, only up to a stated

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5 *See Dodd-Frank Act Stress Test Publications*, FED. RSVE. (July 17, 2024) avail. at https://www.federalreserve.gov/publications/June-2024-Exploratory-Analysis-of-Risks-to-the-Banking-System.htm.

percentage of the fund's assets. Once that stated percentage is met, no additional redemptions are permitted for that period.

Similarly, many private credit funds or other funds that hold illiquid investments tend to be closed-ended, with redemption rights permitted on a limited basis after a holding period lasting five or more years. Private credit funds and other closed-end AIFs have not experienced "runs" because of these contractual limitations that are well understood and accepted by fund investors.

Moreover, AIFs with more open-ended structures employ a range of liquidity management tools ("**LMTs**") to manage liquidity risk effectively, including but not limited to:

- investor- and fund-level redemption gates, which impose pre-determined limits on the amount of invested capital that a particular investor and/or all investors in a given fund can redeem;
- lock-up periods, which prevent investor redemptions for specified periods as determined by the private fund manager; and
- notice periods, which require investors to serve a minimum notice for redemption requests, thereby slowing down the pace at which investor redemptions may be made and allowing the manager time to make necessary portfolio adjustments to avoid a liquidity mismatch.

These measures are disclosed clearly and agreed to by AIF investors prior to investment. Private funds' ability to manage redemption amounts on a contractual basis thus is an effective means of mitigating liquidity risk.[6]

In fact, data collected by the US Securities and Exchange Commission ("**SEC**") quarterly on Form PF (which requires SEC registered private fund advisers to report assets, leverage, and other metrics to the SEC for review by the SEC and the Financial Stability Oversight Council) demonstrates that hedge funds do not have the same kind of liquidity mismatch that banks and some other market participants have. In a staff paper published by the SEC in May 2017, it was noted that most hedge funds have a "negative liquidity mismatch," meaning that those funds hold relatively liquid assets compared to the combined liquidity of their liabilities plus

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6 This aligns with the ESRB's observation in the June 2024 NBFI Monitor that "the appropriate use of LMTs to align the liquidity profile of the underlying assets with redemption opportunities offered to investors (e.g. notice periods) could be another factor mitigating liquidity risk." *See* note 4, *supra*, at p. 23.

equity. The average mismatch in the SEC's sample is -85.5 days, meaning that on average, it takes a shorter time for the typical fund to liquidate its assets than it takes for its stakeholders to reclaim their financing and redeem equity shares.[7] Further reinforcing this view, the ESMA 2024 TRV notes that "[o]n average [hedge funds] report managing assets that can be liquidated in a short time horizon."[8]

Historical evidence further demonstrates that AIFs have been resilient during past periods of market stress.[9] For example, during the COVID-19 market selloff in March 2020, although private funds faced investor outflows, they were able to meet redemption requests without resorting to forced asset sales or triggering widespread market disruptions. In fact, private credit funds increased their lending during the COVID-19 pandemic.[10]

AIFs, as demonstrated by the COVID-19 experience, were able to sustain lending to and investing in the real economy during market stress, which helps stabilize the overall financial system given their relatively static investor base and private funds' varying investment horizons.

Q5 Where in the NBFI sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

Private funds have historically been relatively limited users of leverage among NBFIs. MFA moreover considers it imperative for macroprudential regulators to recognise leverage employed for risk reduction (*e.g.*, hedging) to avoid failing to recognise the risk-mitigating role leverage can play in a diversified portfolio. It is also important to note that leverage can

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7 *See* George O. Aragon & A. Tolga Ergun & Mila Getmansky & Giulio Girardi, *Hedge Fund Liquidity Management*, SEC 17 (May 2017), avail. at https://www.sec.gov/files/dera_hf-liquidity-management.pdf, p. 17.

8 *See* note 2, p.8.

9 European Central Bank, Financial Stability Review (Nov. 2024), at 7 ("Non-banks have remained resilient to recent bouts of market volatility and have continued to support market-based finance in the euro area across all credit risk categories.") (avail. at https://www.ecb.europa.eu/press/financial-stability-publications/fsr/html/ecb.fsr202411~dd60fc02c3.en.html).

10 *See* Belle Kaura, *Private Credit Through the Pandemic and Beyond,* AIMA J. ED. 127 (May 2021) (avail. at https://www.aima.org/asset/CA7B75A8-9BEE-4A2E-AB66E86CD112094D/); *see also* Fabio Cortes & Mohamed Diaby & Caio Ferreira & Nila Khanolkar & Harrison Samuel Kraus & Benjamin Mosk & Natalia Novikova & Nobuyasu Sugimoto & Dmitry Yakovlev & Charles Cohen, *The Rise and Risks of Private Credit*, INT'L MONETARY FUND: GLOB. FIN. STABILITY REP.: THE LAST MILE: FIN. VULNERABILITIES AND RISKS (Apr. 2024), avail. at https://www.imf.org/-/media/Files/Publications/GFSR/2024/April/English/ch2.ashx.

take different forms and must be assessed within the context of the specific investment strategy. For example, fixed-income funds may utilise higher leverage ratios compared to equity funds (because the fixed income fund hedges interest rate risk), yet this does not inherently translate to greater risk given the dramatically different volatility profiles of fixed income versus equity portfolios. Other strategies, such as private credit, tend to have very limited leverage usage.

Similarly, any risk that would be created through synthetic leverage, such as through the use of derivatives, is mitigated through strict margin and collateral requirements. Trade-by-trade daily reporting of derivatives trades to regulators provides them with a timely and accurate picture of risk created by various counterparties, dealers, and derivatives products. Therefore, leverage should not be viewed as a standalone risk measure but rather within the broader context of the portfolio and risk management practices, in addition to the regulatory requirements to which these products are subject.

Additionally, MFA notes that the AIFMD requires alternative investment fund managers ("**AIFMs**") to calculate leverage using both a gross method and a commitment method, with the former often being used by the European Supervisory Authorities ("**ESAs**") and national competent authorities ("**NCAs**") for the monitoring of leverage for systemic purposes.[11] As MFA has noted previously to the Financial Stability Board ("**FSB**"),[12] the gross method does not accurately reflect either leverage or risk in a way that aligns with industry practice or other major regulatory frameworks such as Form PF. The gross method is particularly problematic when applied to complex derivatives, where it produces significantly inflated leverage figures that do not reflect true economic exposure. The commitment method also has its limitations as the benefits of reducing risk through netting under this method are limited.

These inflated gross amounts would cause regulators to perceive leverage risk where it simply does not exist. For instance, interest rate derivatives typically carry much higher notional amounts than other derivatives for similar levels of risk, yet the gross method fails to account for this distinction. Furthermore, the inability to net down similar instruments on opposite sides of a trade creates an artificially elevated picture of leverage, even in cases

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11 *See*, *e.g. EU Alternative Investment Funds*, EUROPEAN SEC. AND MKTS. AUTH. (Feb. 3, 2022), avail. at https://www.esma.europa.eu/sites/default/files/library/esma50-165-1948_asr_aif_2022.pdf.

12 *See* Letter from Managed Funds Association, to Secretariat of the Fin. Stability Bd. c/o Bank for Int'l Settlements (Sep. 16, 2016) (avail. at https://www.fsb.org/uploads/Managed-Funds-Association-MFA-Alternative-Investment-Management-Association-AIMA.pdf).

where positions are specifically designed to hedge or offset each other. Dealers and banks have long relied on well-established netting principles to create a more accurate assessment of risk to enable them to reserve appropriate amounts capital and enable them to lend or invest greater amounts of capital than if netting was impermissible.

Nonetheless, AIFs have repeatedly been shown to not exhibit excessive leverage in a way that creates or amplifies any potential financial stability risk.

First, as the FSB notes in its 2023 report *'Financial Stability implications of Leverage in Non-Bank Financial Intermediation'*, over 90% of on-balance sheet leverage sits outside the investment funds sector, of which AIFs are a sub-set,[13] which aligns with the finding of the International Organization of Securities Commissions ("**IOSCO**") that leverage (including synthetic leverage) across the investment funds industry (both open-ended and closed-ended funds) is generally low.[14] This also aligns with IOSCO's 2022 Investment Funds Statistics report, which found that private credit and other closed-ended funds also "exhibit little to no leverage."[15]

Secondly, leverage is carefully managed through robust risk management practices at both the fund level and by counterparties through the implementation of margin and collateral requirements. Dealer counterparties and CCPs, for example, can and do adjust margin requirements to manage leverage and other risks as trading, credit, or market conditions warrant. In other words, margin and collateral requirements do not only serve as a safeguard against excessive risk-taking by a fund but create an economic disincentive for investors to incur excessive risk taking. This built-in mechanism further helps to naturally limit the build-up of leverage and enables the dealer to appropriately manage leverage as an important part of its overall risk management controls.

13 *See The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation*, FIN. STABILITY BD. 1 (Sep. 6, 2023), avail. at https://www.fsb.org/uploads/P060923-2.pdf, p. 1.

14 *See* The Board of the International Organization of Securities Commissions, *Investment Funds Statistics Report*, IOSCO i (Jan 2024), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD761.pdf, p. i.

15 The Board of the International Organization of Securities Commissions, *IOSCO Investment Funds Statistics Report*, IOSCO 5, 36 (Jan 2022), avail. at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD693.pdf, at pp. 5 and 36.

Finally, one of the episodes which the Commission cites as an example of the consequences of excessive leverage, the Archegos failure, simply is not an appropriate prism through which to assess the risks posed by AIFs.

Archegos Capital Management was *not* an investment fund of any kind. Rather, it was an unregistered family office managed by a single individual (who has since been convicted of fraud in the US and sentenced to 18 years in prison). As a family office, Archegos was exempt from having to register as an investment adviser with the SEC, and as such was exempt from the robust disclosure, regulatory, and reporting requirements imposed on registered advisers. By contrast, most private fund managers are registered with the SEC (in the US) or authorised as AIFMs (in the EU and UK) and subject to the respective regulatory frameworks as described elsewhere in this response.

The Archegos event introduced stability risk into the system when some counterparty banks failed to enforce margin calls and waived their own internal risk management controls when Archegos was unable to meet margin calls. Those counterparty banks that did enforce their own requirements remain in business today. While the criminal behaviour of Archegos undoubtedly played a pivotal role in this episode, it was the failures and inadequacies in some banks' risk management frameworks permitting such a concentrated exposure to Archegos that caused Archegos' failure to introduce stability risk.

The Archegos incident arose from the deliberate, fraudulent behaviour of Archegos, which enabled it to manipulate the price of those securities and mislead banks into providing Archegos with a continuous credit line. Archegos also was found to have misrepresented its overall position size to various dealer-counterparties, precluding its dealer counterparties from obtaining a complete and accurate picture of Archegos' overall exposure levels. Subsequently, when the value of the securities underlying the total return swaps held by Archegos fell sharply, it failed to meet margin calls from its dealer banks, which prompted a fire sale as each bank rushed to sell off its positions to satisfy Archegos' defaulting swaps.

Given all of these factors, there simply is not a build-up of excessive leverage in the private funds industry that makes it pose a potential financial stability risk. MFA would urge the Commission not to use the isolated case of an unregulated family office found to have engaged in criminal fraud, not to mention the risk management failures of its dealer counterparties, to inform policy decisions regarding heavily regulated AIFs or other NBFIs.

Q7 Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

AIFs play a vital role in providing diverse and flexible funding sources for European companies. For example:

- they are active participants in primary and secondary markets for corporate securities, including bonds and equities. Their investing activities provide liquidity and help maintain efficient pricing, narrowing bid-ask spreads, while their willingness to take on new issue risk directly supports EU companies' ability to raise, and diversify their sources of, capital.
- private credit funds and other AIFs also are buyers of distressed debt. As such, they are buyers of last resort and can play an important role in the rescue and reorganisation of distressed companies.[16]
- they play a key role in correcting market mis-pricings, preventing capital misallocation, and promoting more efficient markets. In particular, short selling by hedge funds helps curb price bubbles by accelerating price corrections and smoothing out excessive market peaks, which in turn reduces market volatility, and ensures that companies can raise capital at lower costs.
- private credit funds provide critical financing to operating companies in the EU and elsewhere that is critical to sustained growth of the EU economy. As the ESAs recently observed in its annual report on risks and vulnerabilities in the EU financial system, private credit "improve[s] access to finance and reduce[s] financing costs [through] better risk sharing."[17]

Macroprudential policies should therefore enable private funds' investment activities to continue contributing to liquidity and facilitating capital flows. As noted in the Consultation Paper, the NBFI sector "is a source of financial diversification and [as such contributes] to the resilience of the financial system through private risk sharing and reduced overreliance on

16 2010 O.J. (C 128) 55-64 (hereinafter Opinion of the European Economic and Social Committee), avail. at https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:128:0056:0064:EN:PDF, pp. 56-64.

17 Joint Committee of the European Supervisory Authorities, *Joint Committee Report on Risks and Vulnerabilites in the EU Financial System*, EUROPEAN SEC. AND MKTS. AUTH. 15 (Aug. 2024), https://www.esma.europa.eu/sites/default/files/2024-09/JC_2024_65_-_JC_Report_on_Risks_and_Vulnerabilities_2024.pdf, p. 15.

traditional (relationship) bank lending." MFA agrees with this statement, particularly as it applies to private funds.

More fundamentally, AIFs provide institutional investors, such as pension funds, endowments, and insurance companies, with returns that are largely uncorrelated from the broader markets. These investors depend on private fund returns to diversify their portfolios and meet their long-term obligations to beneficiaries and policyholders. If macroprudential policies were too stringent and restricted private fund activity, overregulation would remove an essential source of diversification and potentially harm institutional investors and, by extension, their underlying beneficiaries. Imposing macroprudential standards on private credit could also chill lending activities to EU businesses or at a minimum increase the cost of borrowing. It ironically is these consequences, caused by overregulation of the NBFI sector, which could conceivably create macroprudential issues.

SECTION 3.2 – MACROPRUDENTIAL TOOLS AND SUPERVISORY ARCHITECTURE – OTHER OPEN-ENDED FUNDS

Q16 How can NCAs better monitor the liquidity profile of OEFs, including redemption frequency and LMTs, in order to detect unmitigated liquidity mismatches during the lifetime of OEFs?

The current regulatory framework for AIFMs already includes significant and robust requirements for appropriate liquidity risk management. In particular, under Article 16 AIFMD, EU AIFMs are required to have appropriate liquidity management systems and procedures to address potential liquidity risks and, in respect of each AIF they manage, ensure the AIF's investment strategy, liquidity profile and redemption policy are consistent. Similarly, the ESMA guidelines on liquidity stress testing require all EU AIFMs to regularly test their funds' resilience to liquidity demands and to disclose the outcomes to their respective NCA (pursuant to Article 24(2)(e) AIFMD). Additionally, following the AIFMD review, EU AIFMs that manage open-ended AIFs will be required to select at least two appropriate LMTs to ensure they can meet redemption requests and mitigate risks to the financial system. These existing measures, alongside the ongoing work by the FSB and IOSCO,[18] provide a comprehensive approach to managing liquidity risk in AIFs and should enhance the resilience of AIFs, as the Commission acknowledges.

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18 *See FSB and IOSCO Publish Policies to Address Vulnerabilities from Liquidity Mismatch in Open-Ended Funds*, FIN. STABILITY BD. (Dec. 21, 2023), avail. at https://www.fsb.org/2023/12/fsb-and-iosco-publish-policies-to-address-vulnerabilities-from-liquidity-mismatch-in-open-ended-funds/.

Additionally, as noted in our response to Q4, above, AIFs maintain a prudent asset-liability match, with less liquid strategies having less frequent redemption terms. MFA members offer a wide range of redemption frequencies and liquidity management terms to investors, tailored to the liquidity of their underlying assets. For example, many hedge funds offer monthly or quarterly liquidity, with redemption notice periods that vary based on each fund's respective underling strategy. Private credit funds, as discussed in our response to Q4, have lock-up periods of several years. Redemption gates are also available to investment managers as tools to be employed in situations of liquidity stress and ensure fair treatment of investors and eliminate any "first mover advantage" of redeeming investors.

Nonetheless, MFA acknowledges the importance of effective monitoring of certain funds' ("**OEFs'**") liquidity profiles by NCAs to identify potential liquidity mismatches. For instance, MFA appreciates that while liquidity mismatch risk is less of a concern for AIFs – due to their typically longer redemption periods – other funds may be more exposed to this risk during times of market stress given the redemption rights provided to shareholders.[19]

Q20 [To asset managers] What measures do you find particularly effective to measure and monitor liquidity risk in stressed market conditions?

As outlined in our response to Question 4 regarding liquidity risk, AIFs employ well-established and effective measures to monitor and manage liquidity risk in both normal and stressed market conditions. A fundamental feature of this framework is the alignment of fund liquidity with investor redemption rights, typically limiting redemptions to defined

[19] *See Holistic Review of the March Market Turmoil*, FIN. STABILITY BD. (Nov. 17, 2020), avail. at https://www.fsb.org/2020/11/holistic-review-of-the-march-market-turmoil/.

periods of time (e.g., on a quarterly basis) with appropriate notice periods. This structural approach is complemented by several key monitoring measures:

- ongoing portfolio liquidity assessments, where managers regularly classify the liquidity profiles of individual assets and the overall portfolio;
- limited liquidity rights for investors (for more liquid strategies, typically on a monthly or quarterly basis), notice periods for redemption, and redemption gates and lock-up periods which may be employed in situations of distress;
- well-understood and agreed-to lock-up periods for private credit and other funds holding illiquid investments; and
- regular stress testing and scenario analysis, modelling portfolio performance under various historical and hypothetical scenarios (*e.g.*, a fund's ability to meet potential redemption requests without forced selling, with increased frequency, and during severe market stress conditions).

AIFs also closely monitor redemption patterns and investor concentration to identify potential liquidity demands and calibrate monitoring efforts (as described in the ESMA 2024 TRV) to maintain "a satisfactory amount of unencumbered cash or liquid assets to mitigate potential margin calls."[20] For funds that use derivatives or purchase securities on margin, monitoring of margin and collateral requirements from counterparties is also essential.

Q21 [To asset managers] What difficulties have you encountered in measuring and monitoring liquidity risks and their evolution? Are there enough tools available under the EU regulations to address liquidity mismatches?

As noted above, liquidity mismatches are uncommon in the private funds industry precisely because of the structural features and tools already in place and the contractual limitations imposed upon and understood and agreed by sophisticated AIF investors. Existing EU regulatory requirements, combined with established industry practices and robust LMTs (as explained above), have been shown to be more than sufficient to address potential liquidity mismatches in the private funds space.

MFA recommends that the Commission yield to the proportionate, principles-based approaches currently in place to monitor liquidity risk, leveraging existing regulatory requirements under AIFMD (as discussed above) and the ongoing work on liquidity risk

20 ESMA 2024 TRV, *supra* note 2.

management by the FSB and ESMA. This ongoing work includes forthcoming ESMA guidelines on the selection and calibration of LMTs by AIFMs for mitigating financial stability risks (pursuant to Article 16(2h) AIFMD).

Q22 [To asset managers] What are the challenges in calibrating worst-case and stress-case scenarios related to redemptions and margin calls?

Please see our response to Question 26.

<u>SECTION 3.3 – MACROPRUDENTIAL TOOLS AND SUPERVISORY ARCHITECTURE – OTHER NBFIS AND MARKETS</u>

Q26 What are your views on the preparedness of NBFIs operating in the EU in meeting margin calls, and on the ways to improve preparedness, taking into account existing or recently agreed EU measures aimed at addressing this issue? Please specify the NBFI sector(s) you refer to in your answer.

AIFs already have significantly strong risk management practices around margin management. This includes frequent monitoring of margin requirements, comprehensive stress testing of potential margin calls under various market scenarios, and dialogue with prime brokers and other counterparties regarding margin methodologies. Additionally, as discussed below, regulatory reporting requirements, such as Annex IV AIFMD reporting, have enhanced transparency for NCAs regarding AIFs' use of leverage and potential margin obligations (as we note in the response to Q5, above, issues exist currently with the leverage metrics).

Rather, the key issue from MFA members' perspective is the lack of transparency around the margin models used by central counterparties ("**CCPs**"). This is important because CCPs are the drivers behind margin calls, as opposed to NBFI sector market participants (who play a passive role as margin call takers).

These margin models are generally opaque to the NBFI counterparty, and certain of the inputs may be subjective and can be unilaterally changed by the CCP with little notice or input from the NBFI counterparty. This unpredictability can make it difficult for the NBFI to manage margin risk because CCP can change the requirements as it deems fit with those changed requirements being passed on to the NBFI counterparty, often times for reasons pertaining to other parties or unrelated stresses at the CCP (such as withdrawals or an unrelated default). As such, there is a predictability issue for NBFI sector market participants: despite appropriate liquidity management of margin and collateral amounts, AIFs may not be able to accurately account for potential margin calls when they are not aware of when such calls may be issued and of any unexpected changes in margin amounts or collateral (again, often for reasons having nothing to do with the AIF).

This issue was particularly evident during the March 2020 market stress, when, for example, UK CCPs transmitted stresses to clearing members, who in turn transmitted the same to clients, through sharp increases in initial and variation margin requirements.[21] This sudden increase made it more difficult and expensive for AIFs to hedge their portfolios against interest rate, currency, or other risks.

As both the Luxembourg Commission de Surveillance du Secteur Financier, and the ESRB in the June 2024 NBFI Monitor, observed,[22] increased margin requirements risk causing leveraged funds to "act in a procyclical manner during market stress, leading also to an amplification of liquidity risks when deleveraging."

To that end, MFA welcomes the forthcoming changes that EMIR 3.0[23] seeks to introduce, particularly the enhanced transparency requirements around margin models, including mandatory simulation tools, detailed disclosure of model methodologies, and clearer communication channels between CCPs, clearing members, and clients.

Nonetheless, to fully address the issues around margin transparency and predictability, MFA recommends the following additional measures which would complement the proposed amendments:

- CCPs should be required to provide enhanced disclosures of their margin models, including detailed explanations of their back testing and stress testing methodologies, as well as the assumptions underlying these approaches and their

21 *See* IMF Fin. Sector Assessment Program, *Vulnerabilites in NBFIs, Market-Based Finance and Systemic Liquidity*, Country Report No. 22/103 (Mar. 18, 2022), avail. at https://www.imf.org/en/Publications/CR/Issues/2022/04/07/United-Kingdom-Financial-Sector-Assessment-Program-Vulnerabilities-in-NBFIs-Market-Based-516267 ("IMF Country Report 22/103").

22 *See Macroprudential Policy for Investments Funds: Considerations by CSSF*, COMM'N DE SURVEILLANCE DU SECTEUR FINANCIER, avail. at https://www.cssf.lu/wp-content/uploads/Macroprudential_policy_investment-funds.pdf; *see also* June 2024 NBFI Monitor, *supra* note 4.

23 *See Capital Markets Union: Council and Parliament Agree on Improvements to EU Clearing Services*, EUROPEAN COUNCIL (Feb. 14, 2024), avail. at https://www.consilium.europa.eu/en/press/press-releases/2024/02/07/capital-markets-union-council-an-parliament-agree-on-improvements-to-eu-clearing-services/.

historical performance during stress events. These disclosures should be subject to regular auditing to ensure quality and consistency across entities.

- Dealers should be required to give adequate notice before modifying margin models, allowing NBFIs to adjust their collateral management strategies proactively. Indeed, as the International Monetary Fund's ("**IMF**") 2022 Financial Sector Assessment Program report on the UK notes: "increasing transparency on liquidity demands, in advance of a future crisis, would help balance the need for resilience of CCPs and the potential effects on clearing members, clients, and markets."[24]

Another challenge that the Commission is encouraged to address through the Consultation is the restrictive and inconsistent rules on eligible collateral across different jurisdictions. When collateral is overly restrictive, stress events will force market participants to convert securities to cash to meet margin calls. This heightens the risk of fire sales, which runs counter to the policy objective of the margin regime and in fact exacerbates, rather than reduces, risk in times of volatility. As such, MFA encourages the Commission to explore ways to harmonise and expand the range of eligible collateral (with appropriate haircuts) that can be used to meet margin requirements. This would provide NBFIs with greater flexibility in managing collateral during stress events and help reduce the risk of forced asset sales.

SECTION 4.1 – EXCESSIVE LEVERAGE – OPEN-ENDED FUNDS

Q45 While on average EU OEFs are not highly leveraged, are there, to your knowledge, pockets of excessive leverage in the OEF sector that are not sufficiently addressed? Please elaborate with concrete examples.

The OEF sector encompasses a wide range of funds with varying investment strategies, risk profiles, and investor base. The AIFs sector, as noted above, does not exhibit excessive leverage that could pose a financial stability risk.

As such, in the EU, MFA considers that the current AIFMD framework (as explained below) provides NCAs with sufficient power and extensive data with which to manage and monitor potential pockets of excessive leverage in AIFs. As the Commission acknowledges, AIFMD and EMIR impose reporting requirements at fund and transaction level respectively, which should allow for a comprehensive view of leverage, including synthetic leverage. Specifically, under the AIFMD:

24 IMF Country Report 22/103, *supra* note 21, at p.36.

- NCAs are empowered to introduce limits on the leverage used by AIFs, where necessary to contain the buildup of potential systemic risk in the financial system or risks of disorderly markets, under Article 25(3) AIFMD;

- AIFMs managing AIFs employing leverage on a substantial basis must report to NCAs the overall level of leverage employed by each AIF they manage, and a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, under Article 24(4) AIFMD;

- ESMA may request NCAs to impose additional reporting requirements on AIFMs, including in relation to leverage risks, in exceptional circumstances in order to ensure (among other things) the stability and integrity of the financial system, under Article 24(5) AIFMD;

- loan-originating AIFs will be subject to leverage limits (175% for open-ended funds and 300% for closed-ended funds) to safeguard financial stability, pursuant to Article 15(4b) AIFMD; and

- AIFMs will be required to report to relevant NCAs the total amount of leverage employed by AIFs they manage or market, under Article 24(2)(c) AIFMD.

As such, MFA considers that material changes to the regime governing leverage are neither necessary nor appropriate.

More generally, AIFs have strong incentives to monitor and manage leverage risks prudently and systemically. AIFMs have a fiduciary duty to manage risks in their investors' best interests and, for EU AIFMs as a condition to being authorised to manage AIFs, must not act in a manner that is detrimental to the integrity of the market (Article 12(1)(c) AIFMD). Additionally, counterparties, such as prime brokers, closely monitor funds' leverage and can adjust margin requirements as needed. AIF investors, who are typically sophisticated institutions such as pension funds and insurers, conduct extensive due diligence on leverage risks before investing, which adds another layer of scrutiny.

SECTION 4.2 – EXCESSIVE LEVERAGE – OTHER NBFIS AND MARKETS

Q47 Are you aware of any NBFI sector entities with particularly high leverage in the EU that could raise systemic risk concerns?

Please see our response to Question 45.

SECTION 5 – MONITORING INTERCONNECTEDNESS

Q52 Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

MFA appreciates efforts to identify and understand vulnerabilities stemming from links between different NBFIs, and between banks and NBFIs. While AIFs and banks operate within the same financial ecosystem, the business relationships between AIFs and banks are unlikely to create or exacerbate any potential financial stability risks.

First, EU banks' exposure to AIFs is not significant as to pose any purported financial stability risk. As the ESRB notes in the June 2024 NBFI Monitor, loans issued to investment funds, of which AIFs are a sub-set, and other financial institutions, combined with their equity and debt instruments held by banks stood at 7% of EU banks' total assets while "deposits from investment funds and [other financial institutions] amounted to around 6% of [EU] bank liabilities."[25] These figures indicate that EU banks' exposure to investment funds in general is modest within the overall context of EU banks' balance sheets.

Secondly, as the FSB has previously observed, investment funds primarily act as shock absorbers during periods of market distress.[26] For example, IMF analysis has found that while NBFI and bank lending cycles are largely synchronised, NBFI lending appears less procyclical than banks in stress tests.[27] This is demonstrated by the fact that AIFs have historically provided resilience and liquidity to financial markets, as noted above in response to Question 4.[28]

Thirdly, MFA observes that large and systematic portfolio overlaps among banks and non-banks should not necessarily lead to co-movement in prices or fire sales of assets. This is because NBFIs have many options besides asset sales to respond to periods of temporary market fluctuations. NBFIs also have different business models and funding structures, which

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25 June 2024 NBFI Monitor, *supra* note 4, at 23.

26 *See Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, FIN. STABILITY BD. 29 (Jan. 8, 2014), avail. at https://www.fsb.org/uploads/r_140108.pdf, at p. 29.

27 *See* IMF Country Report 22/103, *supra* note 21, at 7.

28 *See* June NBFI Monitor, *supra* n. 4, p. 23.

means they are not subject to the same "fire sale" risks that may affect banks or other types of financial institutions.

Life insurers, for example, can generally hold investments to maturity, enabling them to be counter-cyclical investors during market dislocations,[29] while private funds employing distressed securities strategies may be buyers when others are selling in stressed market conditions. In fact, during the 2008 financial crisis, insurers bought assets at depressed prices while banks were forced to sell procyclically.[30]

Moreover, as the European Economic and Social Committee noted in its 2010 opinion of the impact of private equity, hedge and sovereign funds on industrial change in Europe:

> "No evidence of hedge fund herding behaviour was found in the European Currencies crisis (1992), the Asian crisis (1997) or the IT Bubble (2002). With respect to the [2008 financial crisis], it has affected the funds more than the funds have affected the crisis."[31]

Within the NBFI umbrella, AIFs engage in a myriad of different investment strategies that often are uncorrelated to each other or the broader markets, further mitigating the risk that an issue with a bank or other NBFI participant would affect the operations of the private fund. In short, private funds are largely separated from any contagion risk and as discussed elsewhere, are purchasers during times of stress and can help stabilise the broader markets.

Next, it should be noted that any borrowing between a bank and private fund, such as to facilitate the financing of a significant risk transfer or asset sale, is secured. The bank will require collateral to mitigate its risk and thereby mitigate any interconnectedness risk that may arise if the nonbank is unable to service the bank loan. Collateralised positions currently are disclosed to regulatory authorities on the Annex IV.

Finally, partnerships between EU banks and private funds often have a risk-stabilising effect. For instance, consider bank lending to private credit funds versus direct bank lending to

29 *See* Yannick Timmer, *Cyclical Investment Behavior Across Financial Institutions*, J. of Fin. Econ. 1 (2017), avail. at https://papers.ssrn.com/sol3/peprs.cfm?abstract_id=2696647.

30 *See* Jeroen Brinkhoff & Sam Langfield & Olaf Weeken, *From the Horse's Mouth: Surveying Responses to Stress by Banks and Insurers*, EUROPEAN SYSTEMIC RISK BD. (Apr. 2018), avail. at https://www.esrb.europa.eu/pub/pdf/occasional/esrb.op15.en.pdf.

31 Opinion of the European Economic and Social Committee, *supra* note 16, at 7.

corporations. When banks lend to private credit funds, the loans are typically secured by the uncalled capital commitments of the fund's investors. This security reduces the bank's counterparty credit risk compared to direct lending to corporations. Bank financing of significant risk transfers ("**SRTs**") to AIFs also helps de-risk the bank by transferring the credit risk represented by the SRT and reducing the bank's capital charges.

Furthermore, private credit provides a more stable source of funding to the real economy. Unlike banks, investment funds are less leveraged, they do not generally engage in significant maturity transformation, and losses from investment decisions are absorbed by fund investors and thus should not transmit to the broader financial system. As such, even if a private credit fund is to fail, the resulting impact on banks, and the wider economy, should be minimal.

EU banks are also exposed to private funds through, for example, their prime brokerage relationships with AIFs. However, such exposures are collateralised, and margin requirements ensure bank counterparty credit risk exposure is contained through well-documented contractual provisions intended to protect the prime brokerage in the event of a counterparty default. Banks are also subject to counterparty credit risk and large exposure capital requirements, the aims of which is to prevent the potential transmission of risk from market participants to the banking sector, and in turn the financial system. Taken together, these measures limit the potential for any contagion from links between banks and AIFs.

As such, MFA advocates for a proportionate regulatory response that recognises the distinct nature of AIFs and the considerable risk mitigants in the financial ecosystem. Any purported systemic risk concerns should be addressed where they are most relevant – protecting depositor assets – rather than imposing unnecessary constraints on private credit funds and other AIFs.

Q53 What are the benefits and costs of a regular EU system-wide stress test across NBFI and banking sectors? Are current reporting and data sharing arrangements sufficient to perform this task? Would it be possible to combine available NBFI data with banking data? If so, how?

As a preliminary observation, MFA notes that firms in the AIFs sector can and do already carry out stress tests. For example, in the US, the SEC's Form PF requires funds to calculate ten stress tests each quarter, and liquidity management metrics also are reported on Form PF. Contractual terms in financing agreements and derivatives contracts also provide for appropriate counterparty monitoring, which includes metrics such as NAV triggers and concentration limits.[32]

However, to the extent that any further, system-wide, test is developed, it must be tailored to account for the differences in risk profiles between banks and NBFIs and across sub-sectors within NBFIs. A one-sized fits all stress test would not accurately measure risk by any particular counterparty and could distort any system-wide picture of risk: private funds have different stress scenarios than pension funds, which are different than insurance companies or OEFs. Any such tests must be carefully tailored to the unique characteristics of each NBFI participant type to avoid imposing unnecessary costs without clear financial stability benefits.

In that regard, MFA notes that the Commission proposes the use of "stress test data on banks regularly run by EBA to simulate stress scenarios across all the sectors of the financial system." MFA would emphasise that macroprudential stress testing in general, and particularly one designed for banks, is not suitable for AIFs. The risk profiles, liquidity structures, and investment strategies of private funds are fundamentally different from banks, and applying banking frameworks across sectors would be inappropriate.

For instance, banks are highly leveraged institutions that engage in maturity transformation and are critical to the functioning of the payments system. In contrast, AIFs are typically less leveraged, do not engage in maturity transformation to the same extent, and their failures do not threaten the payment system or financial stability in the same way that bank failures can. As such, AIFs should not be subject to bank-like stress tests or regulation. Instead, MFA would encourage the Commission to focus on sector-specific risk management practices that reflect the unique characteristics of private funds. Applying a one-size-fits-all stress test to such a diverse range of entities could yield misleading results and lead to sub-optimal policy decisions.

Additionally, MFA notes that many entities are not subject to any or the same reporting requirements as AIFs. This invariably limits regulators' ability to monitor potential systemic risk comprehensively. Without addressing these data gaps, MFA is concerned that system-

32 *See* Letter from Managed Funds Association, to Fin. Stability Bd. (June 18, 2024), avail. at https://www.mfaalts.org/wp-content/uploads/2024/06/MFA-FSB-Comment-Letter-re-Consultation-on-Collateral-and-Margin-Practices-061824-FINAL.pdf, p. 8.

wide tests relying on incomplete data could lead to skewed conclusions and hinder effective policymaking.

Furthermore, NCAs would need to exercise caution when interpreting aggregated results, as investment funds are diverse in their strategies, and different types of strategies will be exposed to very different risk factors. For example, a long-only equity fund will have a very different risk profile compared to a market-neutral hedge fund, and tests that do not account for these differences could produce misleading results.

As such, MFA would emphasise the need for close collaboration with market participants in designing any system-wide tests. In particular, greater clarity is required regarding: (i) the specific outcomes that the Commission aims to achieve through these tests; (ii) the structure of these tests, including whether they will focus on "liquidity" stress versus asset price stress; and (iii) the integration of the activities of unregulated entities into the assessment.

SECTION 6.1 – SUPERVISORY COORDINATION AND CONSISTENCY AT EU LEVEL – OPEN-ENDED FUNDS

Q57 How can we ensure a more coordinated and effective macroprudential supervision of NBFIs and markets? How could the role of EU bodies (including ESAs, ESRB, ESAs Joint Committee) be enhanced, if at all? Please explain.

MFA supports enhanced information sharing among NCAs to enable more coordinated responses to potential financial stability risks. MFA considers that harmonising reporting requirements generally, including Form PF in the US and Annex IV AIFMD reporting in the EU, would enable more effective macroprudential supervision without imposing additional reporting requirements on market participants.

To that end, the suggestion by the French AMF, CONSOB in Italy, the Spanish CNMV, and the Austrian FMA, in their joint position paper[33] to establish a single European data hub that combines valuation and portfolio data and accessible to NCAs may be worth considering exploring further, with additional discussion and consideration around the data elements in question. Such a centralised approach has the potential to streamline data collection and

33 *See A Macro-Prudential Approach to Asset Management*, AUSTRIAN FIN. MKT. AUTH., https://www.amf-france.org/sites/institutionnel/files/private/2024-04/position-paper-a-macro-prudential-approach-to-asset-management_1.pdf (last visited Nov. 6, 2024).

analysis, better enabling regulators to identify trends and potential risks across the NBFI sector.

MFA also notes there are various planned initiatives at EU-level that are aimed at making the reporting framework for investment managers more efficient, which the Commission should consider before proposing any changes to the reporting requirements applicable to AIFs and their managers. In particular, MFA notes that:

- ESMA intends to publish a report (alongside other ESAs and the ECB) that will seek to identify ways to reduce duplication and inconsistency in reporting frameworks and on standardising and efficiently sharing and using data already reported at EU or national level;[34] and

- the Commission will consult on the review of the EU Securities Financing Transaction Regulation (SFTR), with the aim of improving transparency on funding and lending transactions in order to allow for better monitoring of risks resulting from NBFI.[35]

More generally, MFA considers that the current data reporting requirements for AIFs under the AIFMD, which include detailed portfolio data, leverage metrics, and liquidity profiles, are sufficient to provide NCAs with comprehensive information to understand and monitor potential systemic risk in the investment funds sector.

MFA also notes that under Article 25(2) AIFMD, competent authorities are already required to share with other NCAs, ESMA and the ESRB, all information that AIFMs provide to their national NCAs, both through the periodic Annex IV AIFMD reporting, and as part of the AIFM authorisation process. Indeed, such empowerment and reporting requirements were introduced to address the precise issues the Commission highlights. For example, the Commission's 2009 AIFMD Impact Assessment noted:

> An important barrier to effective oversight is the variation in regulatory reporting requirements across Member States. Some national regulators do possess relevant information, for instance on the exposure of major prime brokers to the hedge fund sector. However, such data collection is often voluntary, infrequent and, crucially, segmented along national lines. There are currently no effective mechanisms for the sharing, pooling and analysis of this information at European or international level.

34 *See* June 2024 NBFI Monitor, *supra* note 4, at 28.

35 *See id.*

> Given the cross-border nature of these risks, the inability to piece together a comprehensive picture of AIFM leverage and activities in all major European markets is a major flaw in existing systems of macro-prudential oversight.[36]

As such, MFA does not consider that there is a need to enhance the role of EU bodies in this respect. MFA believes NCAs should seek to ensure data reported through existing frameworks is shared with NCAs and ESAs, as appropriate.

Q58 How could the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs by NCAs or ESAs (such as leverage restrictions or powers to suspend redemption on financial stability grounds) be improved?

MFA acknowledges the need for consistent application of macroprudential tools and sufficient coordination among supervisors in implementing macroprudential measures for OEFs. MFA appreciates that insufficient coordination among EU NCAs and their third country counterparts could limit the effectiveness of macroprudential tools during market stress.

Nonetheless, MFA is concerned about the Commission's observations that:

- "supervisory coordination could include ***more timely use*** of macroprudential tools to reduce the level of exposure or the excessive leverage"; (emphasis added) and
- "an Enhanced Coordination Mechanism (ECM) could be created for the adoption of a list of national macroprudential measures (NMMs) that are ***applicable to all OEFs or a subset of them***," with such powers including the power to suspend redemption rights and leverage restrictions. (emphasis added).

MFA would welcome more clarity on what "more timely use of macroprudential tools" could entail in this context. Without a clear understanding of the specific measures being proposed and the circumstances under which they would be implemented, it is difficult to assess their potential impact on market functioning and investor fairness.

Similarly, while MFA recognises the importance of coordination among supervisors, it is crucial that any ECM respects the expertise of investment managers and avoids imposing

[36] *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/…/EC*, at 18, COM (2009) 207 (Apr. 4, 2009), avail. at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009SC0576, p. 18.

overly broad requirements on market participants that may not be sensitive to differences in business models and risk posed.

For example, mandating increased use or greater uniformity in the application of macroprudential tools (*e.g.*, leverage restrictions or powers to suspend redemption on financial stability grounds) during stressed market conditions may lead to unintended consequences that undermine financial stability. As macroprudential tools, as currently envisaged, do not address the pro-cyclical behaviour of direct investors holding assets individually, the implementation of such measures may inadvertently drive investors away from collective vehicles and towards individual holdings, thereby limiting the effectiveness of these tools in promoting financial stability.

Furthermore, the application of these macroprudential tools may disproportionately benefit more informed investors who may be better equipped to anticipate restrictions on redemption during stressed periods. These investors could pre-emptively redeem their investments ahead of less informed investors, effectively creating the very "first mover advantage" that the Commission seeks to prevent – the fee or gate on an OEF, for example, creates the scenario where investors race to redeem, creating a procyclical redemption spiral for the OEF. Such unintended consequences have the potential to amplify market stress and erode investor confidence in collective investment vehicles, which may ultimately undermine the very objectives such macroprudential measures aim to achieve.

As such, any improvement to the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs must prioritise fairness for all investors, avoid unintended consequences that could disrupt market functioning, and respect the expertise of investment managers.

MFA recommends a more targeted, activity-based, approach to addressing any potential financial stability risks. For example, where an NCA identifies information from a particular investment fund that suggests the existence of potential financial stability risk, it should engage directly with the fund concerned to better understand the nature of the risk. Where the risk pertains to a number of funds, and is of a potentially systemic nature, NCAs should engage with ESMA and other relevant ESAs. Such an approach would be a more proportionate means of addressing the specific potential financial stability risk which fund data may indicate are present, rather than imposing broad, potentially unnecessary additional requirements on market participants.

Moreover, any national macroprudential measures that are to be implemented in relation to OEFs should be subject to an ex-ante objection procedure by the Commission, based on the opinions of the ESRB and ESMA, as the Commission suggests in relation to other NBFIs and markets. This would help to ensure that any measures are properly targeted, proportionate, and do not result in unintended consequences for market functioning or investor fairness.

Q59 What are the benefits and costs of introducing an Enhanced Coordination Mechanism (ECM), as described above, for macroprudential measures adopted by NCAs?

Please see our response to Question 58.

Q60 How can ESMA and the ESRB ensure that appropriate National Macroprudential Measures (NMMs) are also adopted in other relevant EU countries for the same (or similar) fund, if needed?

Please see our response to Question 58.