INVESTMENT COMPANY INSTITUTE

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European Commission's Consultation Assessing NBFI

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TO: ICI Members
ICI Global Members
Europe Regulatory and Policy Committee SUBJECTS: International/Global RE: European Commission's Consultation Assessing the Adequacy of Macroprudential Policies for NBFI

On May 22, the European Commission (EC) released a consultation paper assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI).[1] The consultation is open until November 22, 2024. ICI will prepare a response to the consultation over the coming months.

The consultation seeks to address what the Commission argues are financial stability risks from NBFI, highlighting in particular what they see as the potential vulnerabilities from unmitigated liquidity mismatches, excessive leverage, and interconnectedness among NBFI and between NBFI and the banking system.

The consultation contains 68 questions, with a stated objective "to seek stakeholders' view on the adequacy of the macroprudential framework for NBFI with the intent not to revisit recent legislative agreements (e.g. Solvency II review, EMIR 3)." The consultation further seeks to evaluate the effectiveness of existing macroprudential tools and supervisory arrangement, consider repurposing existing microprudential and reporting tools, and assess the need for new macroprudential tools and tools to improve EU-wide coordination.

The questions are organized around several key themes, including:

- Addressing the purported risks from NBFI in the areas of liquidity mismatches, leverage, and interconnectedness;
- Assessing the adequacy of data reporting and identifying any data gaps;
- Considering the potential use of system-wide stress testing; and
- Potential additional supervisory coordination arrangements across members states or at the EU level.

While the discussion questions generally appear to presume that there is a problem that needs to be solved, the consultation does acknowledge that NBFI and capital markets play a pivotal role in fostering the diversity of financial markets structure and contributing to the resilience of the financial system. The consultation further notes that in the context of the Capital Markets Union, policy interventions to address vulnerabilities and risks of NBFIs should not unnecessarily constrain funding opportunities that NBFIs bring to the financial system.

ADDITONAL DETAILS

The consultation is divided into six sections, with corresponding consultation questions in each section, with the exception of section 2.

Section 1: Key Vulnerabilities and Risks Stemming from NBFI

The Consultation paper identifies unmitigated liquidity mismatches, excessive leverage, and interconnectedness as key vulnerabilities, potentially leading to the emergence of systemic risks, including liquidity risk, counterparty and concentration risk, amplification risk, spillover risks, and underestimation of risks.

The discussion of each asserted vulnerability focuses on the following elements:

- Unmitigated Liquidity Mismatches - The consultation discusses potential liquidity mismatches in money market funds (MMFs), fixed income funds, and real estate funds. It highlights market stress during the COVID-19 related events of March 2020, and while it notes that no EU MMF had to introduce redemption fees, gates, or suspension, it asserts the ECB interventions in support of Commercial Paper and Certificates of Deposit markets contributed to that outcome.
- Excessive Leverage - The discussion focuses on the failure of Archegos Capital Management, a highly leveraged family office.
- Interconnectedness - The consultation focuses on the example of the surge in energy prices in Europe in 2022, the corresponding increase in margin calls for energy contracts, and the impact on energy derivatives trading companies, while highlighting the intervention of the German government to support the market. The consultation also notes the growing interconnectedness between traditional finance and digital/crypto assets.

The consultation further highlights challenges, coordination, and consistency among authorities. It highlights the potential for inconsistencies in the application of macroprudential tools arising from national application of rules and differing national mandates, as well as the coordination role that ESMA plays in the investment fund sector.

The consultation questions in this section seek to determine the sources of systemic risks and vulnerabilities, including channels for the transmission of liquidity risk, the critical functions that may be impaired by the failure of an NBFI, the risks emerging from the trading of crypto assets, the sectors that are more prone to a build-up of leverage, and the potential for macroprudential policies to support the role of NBFI in providing funding opportunities to companies.

Section 2: Overview of Existing Macroprudential Tools and Supervisory Architecture in EU Legislation

The consultation asserts that, "A more integrated EU macroprudential framework governing NBFI, and tackling emerging risks across NBFI sectors, is key to mitigate the build-up or manage the impact of systemic risk." While no empirical evidence is provided in support to this statement, the consultation draws a parallel with the macroprudential framework put in place for banks in the aftermath of the 2008 financial crisis. The consultation then describes the existing system of supervision of NBFI through the European System of Financial Supervision (ESFS), including the European Systemic Risk Board (ESRB), the European Supervisory Authorities (ESAs), such as the European Securities and Markets Authority (ESMA) National Competent Authorities (NCAs) across EU Member States.

The consultation describes at a high level the existing macroprudential tools available to authorities in Europe. It divides macroprudential tools into ex-ante tools (e.g., leverage limits, liquidity buffers) and ex-post tools (e.g., restrictions on short-selling or on redemptions), and further delineates them into activity-based and entity-based tools. A more extensive list of existing tools is included in an annex to the consultation. Section 2 does not include any consultation questions.

Section 3: Liquidity[2]

Section 3 is divided among a) MMFs, b) other open-ended funds (OEFs), and c) other NBFIs and markets. Each subsection has a description of liquidity risks specific to the given category and associated consultation questions.

MMFs

The consultation recalls that the July 2023 Commission report on the adequacy of the Money Market Fund Regulations (MMFR) "concluded that the MMFR safeguards (e.g. liquidity, repo recourse, diversification) are effective and successfully passed the test of liquidity stress experienced by MMFs in March 2020." The consultation also recalls the three potential areas for improvement identified in that report, namely: (1) evaluating the need to increase liquidity buffers; (2) decoupling the activation of liquidity management tools from the liquidity buffers for stable Net Asset Value (NAV) MMFs; and (3) enhancing supervision, the stress testing framework, and reporting requirements.

The consultation discussion and associated questions focus on the third area—enhancing supervision, the stress testing framework, and reporting requirements. The consultation seeks feedback on whether to empower NCAs to increase MMF liquidity buffers on an individual or collective basis to mitigate systemic risks, drawing inspiration from the leverage provisions in AIFMD Article 25. The consultation further seeks input on potential improvements to MMFR data reporting, and potential additional steps to the MMF stress testing framework, including a potential EU-wide stress test run. Finally, the consultation seeks to explore the instruments in which MMFs invest, and to determine whether to continue banning the "reverse distribution mechanism" in the EU.

Other OEFs

The Consultation acknowledges the many mitigants to liquidity risks in OEFs already included in the recent revision of the UCITS and AIFMD frameworks. Nevertheless, it seeks to further improve the ability of authorities to identify liquidity stresses. Consultation questions focus on: data reporting; practices for measuring and monitoring liquidity risks; and the use of stress testing, including potentially at the asset management company level.

Other NBFI and markets

This subsection focuses on commodity traders, short-term funding markets, and pension funds. The EC seeks to improve the resilience of Commercial Paper and Certificates of Deposit markets, in particular through a deeper understanding of the reasons that have led most EU-CPs to be issued outside of the EU. Regarding pension funds, the consultation seeks to improve reporting by pension funds and considers EU-wide stress testing for pension funds. This section also seeks to strengthen the resilience of commodity traders to meet margin calls as a result of sudden price spikes, and to better align the regulatory framework applicable to participants in the spot/physical market and futures markets.

Section 4: Excessive Leverage

Section 4 is divided into subsections discussing leverage in: a) OEFs, and b) "other" NBFI and markets. Although the sole example provided by the consultation to illustrate vulnerabilities from excessive leverage was a family office (Archegos), this section does not include any discussion or questions specific to family offices.

OEFs

The consultation acknowledges the existing requirements that restrict the use of leverage by UCITS and AIFs, but seeks to identify any remaining pockets of excessive leverage among OEFs, particularly from synthetic leverage through the use of derivatives. It also consults specifically on the use of yield buffers for Liability-Driven funds, as was done in Ireland and Luxembourg through Article 25 of AIFMD.

Other NBFI and markets

This subsection does not clearly define what "other" NBFIs are the focus of the discussion, and consults broadly on any areas of high leverage outside of OEFs, the potential to improve data reporting, and whether there is a need for additional macroprudential tools. It also inquires about risks from concentrated intraday positions in derivatives markets.

Section 5: Monitoring Interconnectedness

Section 5 seeks to better identify and understand potential vulnerabilities from "hidden" links among NBFI and between banks and NBFI, including in relations to risk amplification channels or potential herding behaviors. As a tool to support this goal, this section seeks feedback on potentially introducing EU system-wide stress tests, drawing on examples such as the Bank of England System-Wide Exploratory Scenario (SWES), the EU CCP stress tests conducted by ESMA, and the Joint Monitoring Mechanism recently conducted under the European Market Infrastructure Regulation (EMIR). The consultation envisions that such a system-wide stress test would cut across all sectors of the financial system, including banks and all types of NBFI. Section 5 also consults on data reporting and sharing arrangements, and whether they are sufficient to support a system-wide stress test at the EU level.

Section 6: Supervisory Coordination and Consistency at EU Level

Section 6 asserts that "A consistent application of macroprudential tools and sufficient coordination among supervisors within the EU, as well as with supervisors in third countries, are key to effective macroprudential policies. Insufficient coordination may lead to instability, driven by fragmentation among national jurisdictions and regulatory arbitrage between NBFI sectors." In this context, it consults on supervisory coordination approaches, focusing on a) OEFs, and b) other NBFI and markets.

OEFs

The consultation seeks feedback on two possible models for additional supervisory coordination of macroprudential policies for OEFs.

The first potential approach is to establish an Enhanced Coordination Mechanism (ECM) modeled on AIFMD Article 25. The ECM would establish a list of national macroprudential measures that authorities could apply to all OEFS or a subset of them. NCAs would remain responsible for adopting and using such measures but would need to obtain an opinion in advance from ESMA, in consultation with the ESRB.

As a second potential approach, the consultation suggests ESMA could be given specific coordination powers over large asset management companies. While the day-to-day supervision would remain with the relevant NCAs, ESMA would provide guidance and coordination across NCAs. NCAs also would need to obtain the opinion of ESMA prior to adopting certain decisions and explain any deviation from the opinion. ESMA also would be able to initiative and coordinate EU-wide stress tests and to initiative peer review analyses of NCAs.

Other NBFI and markets

The subsection on Other NBFI consults on whether the ECM mechanism suggested for OEFs could be extended to include other NBFI sectors. The consultation questions also ask whether ESAs should be given greater powers to intervene during systemic events, such as through EU-wide trading halts. In addition, this subsection has a particular focus on commodities trading, and seeks to explore whether a more integrated oversight system is needed to supervise both the financial and the physical infrastructure of the commodity futures exchange.

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Notes

[1] Available at: https://finance.ec.europa.eu/regulation-and-supervision/consultations-0/targeted-consultation-assessing-adequacy-macroprudential-policies-non-bank-financial-intermediation_en

[2] The title for section 3 used in the consultation paper duplicates the title for section 2, "Overview of Existing Macroprudential Tools and Supervisory Architecture in EU Legislation." Based on the content of section 3 and the organization of the paper, we believe this title was in error, as section 3 focuses on addressing liquidity risks.