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Targeted consultation assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI)

Fields marked with * are mandatory.

Introduction

Setting the scene

Non-Bank Financial Intermediation (NBFI) comprises very diverse financial sectors including regulated entities such as asset management companies and investment funds, non-bank investment firms, pension funds, insurance companies, and unregulated entities, such as family offices and supply chain finance companies[1]. In autumn 2023, non-bank financial intermediaries (NBFIs) accounted for roughly €42.9 trillion (41% of EU total financial assets[2]), while banks' assets accounted for roughly EUR 38 trillion (36% of EU's total financial assets). Together with entities (NBFIs), capital markets are also a key component of NBFI and have grown over the years in Europe and globally to several multiples of global GDP.

In response to major events in recent years (e.g. the dash-for-cash in March 2020 and the UK gilt crisis in 2022[3]), **fina ncial stability concerns about NBFI have emerged in international policy discussions and with initiatives in a number of non-EU and EU jurisdictions.** This consultation, therefore, seeks to gather stakeholders' views on these international developments to inform our macroprudential stance on NBFI. In particular, the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO), and jurisdictions, such as the US and the UK, have put forward consultations on assessing gaps in the macroprudential framework for NBFIs, or have announced or implemented various initiatives for NBFI (e.g. money market funds reforms[4]). The FSB's work programme has been advancing in key areas for NBFI, such as leverage, margin preparedness and vulnerabilities for open-ended funds. IOSCO also consulted on anti-dilution Liquidity Management Tools (LMTs) and is progressing work in the area of private finance. The Central Bank of Ireland (CBI) has published a consultation paper on a holistic approach to macroprudential policies in the investment funds sector. CBI has adopted two macroprudential measures under Article 25 of the Alternative Investment Funds Directive (AIFMD): a leverage limit for Irish property funds introduced in 2022, and a yield buffer to mitigate leverage of GBP-denominated Liability-Driven Investment (LDI) funds (being adopted also by the Luxembourg market authority, CSSF).

Nonetheless, NBFI is also a source of financial diversification and so resilience in itself. In the context of the capital markets union (CMU), 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. **NBFIs and capital markets thus 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. Over the years, the European Union (EU) has introduced several regulations and directives governing activities of different NBFIs and markets, in some instances providing macroprudential tools that have been tailored to specific NBFI sectors (see section 2). Moreover, since the global financial crisis in 2008, banking reforms have gradually tightened prudential requirements and this can have (directly or indirectly) restricted the size and scope of activities performed by banks, creating opportunities for NBFIs to expand their activities in areas that were largely performed by banks.

Objectives of the consultation and target audience

The objective of this consultation is 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).

Article 513 of Regulation (EU) No 575/2013 (CRR) requires the Commission to review the EU macroprudential framework, including how authorities in the EU can be mandated with tools to address new emerging systemic risks arising from credit institutions' exposures to NBFI. In its recent report on the macroprudential review, in light of the emerging vulnerabilities in the NBFI sectors, the Commission announced the intention to go beyond the legal basis in CRR and collect more evidence on the effectiveness and consistency of macroprudential policies for NBFIs in the EU, focusing in particular on:

- Evaluating the effectiveness of the existing macroprudential tools and supervisory arrangements in achieving their purpose
- Considering repurposing or reviewing existing microprudential and reporting tools (e.g., their activation/trigger and design)
- Assessing, if necessary, the possibility to introduce new macroprudential tools, as well as tools to improve EU-wide coordination

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

Responding to this consultation

Responses to this consultation are expected to be supported by **qualitative and quantitative data** and accompanied by **specific views on potential policy interventions**.

Targeted stakeholders in this consultation include primarily EU institutions and bodies, national authorities, including national competent authorities (NCAs) that supervise NBFIs (as defined above) and markets, central banks and the NBFI industry. All stakeholders are nonetheless invited to respond to the questions set out below. Please note that some questions may indicate that feedback is particularly sought from specific types of stakeholders.

The consultation paper aims, first, to identify vulnerabilities and risks of NBFIs and map the existing macroprudential framework for NBFIs (sections 1 and 2). Second, it seeks to gather feedback on current challenges to macroprudential supervision and discuss areas for further improvements (sections 3 to 6).

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[1] The ESRB also includes an assessment of the crypto-asset ecosystem in the NBFI monitor, as it "may engage in types of financial intermediation that lead to similar vulnerabilities and expose them to similar risks". The FSB defines "the NBFI sector" as "a broad measure of all non-bank financial entities, composed of all financial institutions that are not central banks, banks or public financial institutions." This categorisation also includes financial market infrastructure under the category of 'market intermediaries'. Nonetheless, the FSB also identified a 'narrow measure' for NBFI, which is not based on entities, but as a bank-like activity measure.

[2] ECB Datawarehouse. Total financial assets include assets held by central banks.

[3] The FSB pointed at the significant contribution of NBFI to the 'dash for cash' during the March 2020 COVID crisis, especially via spikes in "redemptions from investment funds, margin calls [by market operators] resulting from increased volatility, and the need of some non-banks to unwind leveraged positions." Similarly, in September 2022, the quick rise in interest rates of UK Gilts (and subsequent fall in prices) sparked large margin calls in the pension funds sector, especially in the UK. In particular, pension funds pursuing Liability-Driven (LDI) strategies led to a major sell-off of UK Gilts, which in turn caused the Bank of England to intervene with a massive asset purchase programme. Moreover, the market stress caused by COVID in March 2020 revealed that Money Market Funds (MMFs) can be susceptible to runs by investors (implying a so called first-mover advantage) that can exacerbate liquidity shocks, as MMFs have to sell their assets to fund outflows. It is important to note that, despite the run, especially on USD-denominated funds, MMFs in the European Union were able to withstand such large outflows. This situation was also caused by structural illiquidity in underlying short-term funding markets (e.g. commercial paper). See ESRB recommendation

[4] On 28 September 2023, the Bank of England also announced a new monetary policy action with the plan to create a new liquidity tool for NBFIs, which will initially cover insurance and pension funds and may potentially be extended to all NBFI entities that meet certain eligibility (ex-ante resilience) requirements. Read "A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit" - speech by Andrew Hauser, Bank of England.

Please note: In order to ensure a fair and transparent consultation process **only responses received through our online questionnaire will be taken into account** and included in the report summarising the responses. Should you have a problem completing this questionnaire or if you require particular assistance, please contact fisma-nbfi-consult@ec.europa.eu.

More information on

- this consultation
- the consultation document
- macroprudential policies for non-bank financial intermediation (NBFI)
- the protection of personal data regime for this consultation

About you

*Language of my contribution

- ( ) Bulgarian
- ( ) Croatian
- ( ) Czech
- ( ) Danish
- ( ) Dutch
- (•) English
- ( ) Estonian
- ( ) Finnish
- ( ) French
- ( ) German
- ( ) Greek

- ○ Hungarian
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- ○ Latvian
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- ○ EU citizen
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- ○ Non-EU citizen
- ○ Non-governmental organisation (NGO)
- ○ Public authority
- ○ Trade union
- ○ Other

* First name

Guido

* Surname

Faltoni

* Email (this won't be published)

GFaltoni@StateStreet.com

* Organisation name

255 character(s) maximum

State Street Corporation

* Organisation size

- Micro (1 to 9 employees)
- Small (10 to 49 employees)
- Medium (50 to 249 employees)
- ● Large (250 or more)

Transparency register number

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Check if your organisation is on the transparency register. It's a voluntary database for organisations seeking to influence EU decision-making.

2428270908-83

* Country of origin

Please add your country of origin, or that of your organisation.

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Guadeloupe
Guam
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Guernsey
Guinea
Guinea-Bissau
Guyana
Haiti
Heard Island and McDonald Islands
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Mauritania
Mauritius
Mayotte
Mexico
Micronesia
Moldova
Monaco
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Montenegro
Montserrat
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Mozambique
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New Caledonia
New Zealand
Nicaragua
Niger
Nigeria
Niue
Norfolk Island

Slovakia
Slovenia
Solomon Islands
Somalia
South Africa
South Georgia and the South Sandwich Islands
South Korea
South Sudan
Spain
Sri Lanka
Sudan
Suriname
Svalbard and Jan Mayen
Sweden
Switzerland
Syria
Taiwan
Tajikistan
Tanzania
Thailand
The Gambia
Timor-Leste
Togo
Tokelau

- Burundi
- Cambodia
- Cameroon
- Canada
- Cape Verde
- Cayman Islands
- Central African Republic
- Chad
- Chile
- China
- Christmas Island
- Clipperton
- Cocos (Keeling) Islands
- Colombia
- Comoros
- Congo
- Cook Islands
- Costa Rica
- Côte d’Ivoire
- Croatia
- Cuba
- Curaçao
- Cyprus
- Czechia
- Hong Kong
- Hungary
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- India
- Indonesia
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- Ireland
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- Jersey
- Jordan
- Kazakhstan
- Kenya
- Kiribati
- Kosovo
- Kuwait
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- Romania
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- Rwanda
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- Saint Helena Ascension and Tristan da Cunha
- Tonga
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- US Virgin Islands
- Uzbekistan
- Vanuatu
- Vatican City
- Venezuela
- Vietnam
- Wallis and Futuna
- Western Sahara
- Yemen
- Zambia

- Democratic Republic of the Congo
- Lesotho
- Saint Kitts and Nevis
- Zimbabwe
- Denmark
- Liberia
- Saint Lucia

*Field of activity or sector (if applicable)

- [ ] Accounting
- [ ] Auditing
- [x] Banking
- [ ] Credit rating agencies
- [ ] Insurance
- [ ] Pension provision
- [x] Investment management (e.g. hedge funds, private equity funds, venture capital funds, money market funds, securities)
- [ ] Market infrastructure operation (e.g. CCPs, CSDs, Stock exchanges)
- [ ] Social entrepreneurship
- [ ] Other
- [ ] Not applicable

The Commission will publish all contributions to this public consultation. You can choose whether you would prefer to have your details published or to remain anonymous when your contribution is published. **Fo r the purpose of transparency, the type of respondent (for example, 'business association, 'consumer association', 'EU citizen') country of origin, organisation name and size, and its transparency register number, are always published. Your e-mail address will never be published.** Opt in to select the privacy option that best suits you. Privacy options default based on the type of respondent selected

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Glossary

A glossary of acronyms used in this consultation is available in the consultation document.

1. Key vulnerabilities and risks stemming from NBFI

Based on the recent Commission's report on the macroprudential review for banks and NBFI, this consultation paper identifies the following key vulnerabilities stemming from NBFI:

1. unmitigated liquidity mismatches[5]
2. the build-up of excessive leverage
3. interconnectedness among NBFI sectors and between NBFI and banks

Moreover, a lack of consistency and coordination among macroprudential frameworks across the EU can exacerbate the negative impact of such vulnerabilities, leading to unaddressed systemic risks (see Table 1 below).

Table 1 – Key vulnerabilities and systemic risks stemming from NBFI

Vulnerabilities	Systemic risks
Unmitigated liquidity mismatches	Liquidity risk
Excessive leverage	Liquidity risk, counterparty risk, concentration risk
Interconnectedness	Liquidity risk, counterparty risk, concentration risk, risk amplification, underestimation of risk, spillover risks

On **unmitigated liquidity mismatches**, events in March 2020, during the market stress caused by COVID-19, revealed, for instance, that some Money Market Funds (MMFs) experienced runs by investors to secure cash[6]. While no EU-based MMF had to introduce redemption fees or gates, or suspend redemptions, the European Central Bank (ECB) intervened with a purchase programme in the underlying short-term funding markets, in particular in Commercial Paper (CP) and Certificates of Deposits (CD) markets, which also contributed to stop outflows in those MMFs. Similar vulnerabilities may also arise in other investment fund segments with less liquid underlying markets, such as open-ended fixed income and real estate funds[7]. With regard to MMFs, the MMF Regulation (MMFR) includes specific safeguards to ensure the stability, liquidity and safety of investments in MMFs. These include liquidity requirements, maturity limits, quality standards for investments, and bi-annual stress testing executed by managers, the results of which are communicated to supervisors. Maintaining adequate liquidity buffers is crucial to effectively monitor and manage liquidity risk. Changes in buffers usually reflect adjustments to risk and/or changes in the composition of the investor base, which require holding a smaller or bigger liquidity buffer.

On **leverage**[8], the failure of Archegos Capital Management, an unregulated 'family office' operating on behalf of a wealthy investor is an example of the potential negative impact of excessive leverage on lenders and the financial system as a whole[9]. Archegos leveraged at least 5-6 times their invested capital to build excessively large and concentrated equity derivative exposures disregarding risk management best practices, like limiting asset concentration[10]. Moreover, an entity that takes a leveraged position, for instance through derivatives, may also be exposed to counterparty credit risk if the counterparty providing liquidity to fund margin calls is not sufficiently robust to keep providing liquidity in stressed conditions. Excessive leverage could also go undetected when using complex investment strategies involving several legal entities and fund of funds.

Interconnectedness, which is key to generate efficiencies in financial markets, can make systemic risk difficult to detect, as it can create unforeseen risk amplifiers and transfer of risk within NBFI sectors and/or between the banking and NBFI sectors (e.g. in funding markets). For instance, the sudden surge in energy prices in 2022 led to a sharp rise in margin calls for key energy contracts, which in turn led to a sale of assets to cover margin calls by both banks and NBFIs and to the downward move in prices of such assets intensifying a vicious circle in asset prices[11]. Unexpected margin calls, due to large price shocks or procyclical effects, does thus increase liquidity risk. During the surge in prices, some big energy derivatives trading companies were not sufficiently prepared for a spike in prices and the subsequent significant margin calls and had to request government support to avoid large losses on their hedges[12]. In recent years, crypto assets markets have also grown in size, as they are increasingly becoming target markets of institutional investors. Understanding the risks emerging from the growing interconnectedness between traditional and emerging digital financial assets is essential. The entry into force of the Markets in Crypto Assets Regulation (MiCAR) will ensure regulation and supervision of crypto assets and crypto asset service providers and will enable supervisors to have a better picture of these risks. Interconnectedness could also emerge from the failure of a NBFI, which can have knock-on effects on other NBFIs, the banking sector or the economy and may require mitigation measures.

On **coordination and consistency**, the macroprudential tools available to supervisors in NBFI are applied or activated by supervisors that often operate with varying mandates and enforcement powers even within the same jurisdiction. This can lead to an inconsistent application of macroprudential tools, an unlevel playing field within the EU and a heightened risk of supervisory and regulatory arbitrage, as well as an inability to detect systemic risk. In addition, due to the cross-border nature of the non-banking sector, the lack of cross-jurisdiction coordination in times of systemic crisis could magnify the negative impact of such vulnerabilities. For the investment fund sector, the European Securities and Markets Authority (ESMA) is tasked with a coordination role over supervisory activities by NCAs. During the COVID-19 crisis, ESMA held bi-weekly meetings with NCAs, supported by an ad-hoc data collection on liquidity risks. Under Article 25 AIFMD, after considering the advice of the European Systemic Risk Board (ESRB), ESMA issued advice to NCAs on the use of leverage limits by AIFMs, when leverage poses a substantial risk to the stability and integrity of the financial system[13]. ESMA has also published guidelines to promote effective and convergent practices on stress testing and to identify leverage-related systemic risk, which helps NCAs to define when the conditions to impose leverage limits are met[14].

Against this background, NBFIs are also a source of funding opportunities for companies seeking access to finance from capital markets. 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.

[5] A liquidity mismatch is a financial situation typical of entities that are engaged in liquidity transformation, whereby the liquidity of the invested assets does not correspond (either in full or in part) to the liquidity of the liabilities of that given entity. For instance, liquidity mismatch in investment funds implies that some of the assets cannot be liquidated within the same timeframe that is required by the fund to fulfil under its redemption policy scenario. An 'unmitigated' liquidity mismatch is a situation where such liquidity mismatch is not adequately mitigated by specific tools, such as liquidity management tools to withstand a plausible redemption scenario.

[6] In particular, some MMFs that offered stable redemption prices, but invested primarily in assets issued by private entities that are less liquid than cash, experienced acute stress. Among those, USD-denominated LVNAV saw the largest outflows during the period. See Commission report on the functioning of the MMF Regulation. During this period, the European Central Bank (ECB) also intervened with a purchase programme in the underlying short-term funding markets, in particular in Commercial Paper (CP) and Certificates of Deposits (CD) markets, which also contributed to stop outflows from those MMFs.

[7] In the case of real estate funds, several funds across the EU had to introduce longer notice periods to deal with illiquidity and rising redemption rates.

[8] 'Leverage' means any method by which a legal or a natural person increases its exposure to an asset whether through borrowing of cash (financial leverage) or through borrowing securities or through leverage embedded in derivative positions (synthetic leverage).

[9] Archegos collapsed in Q1 2021 and spread large losses across financial institutions (and most of all on Credit Suisse with a $5.5 billion loss) due to a too large exposure to a few stocks via total return swaps and contracts for difference. Please, see Archegos info kit – Credit Suisse. See ESMA on Archegos. In particular, in the US, where the family office was located, market participants had to disclose stakes (direct holdings) in companies if they own more than 5%, but synthetic exposures through Total Return Swaps (TRSs) were not included. In the EU, as ESMA clarified, Member States had the discretion to impose notification for capital holdings, which include TRSs.

[10] Although exact figures are unknown, Archegos held assets on the order of $10 billion, with exposures of between $50 billion and $100 billion (even higher according to some reports). These exposures were largely concentrated in shares of Viacom CBS and Discovery (U.S. telecommunications groups) and in various Chinese technology companies (e.g. Baidu). See Archegos and Greensill: collapse, reactions and common features.

[11] It should be noted that most financial entities mark their assets to the current market prices, and thus adverse price movements impact their solvency, and subsequently their perceived creditworthiness and their cost of funding.

[12] Germany pledges €67bn to bolster struggling energy companies, Financial Times

[13] According to Article 25(6) of AIFMD, the European Securities and Markets Authority (ESMA) shall issue advice on whether the conditions for taking action appear to be met, whether the measures are appropriate and on the duration of the measures.

[14] ESMA publishes final guidance to address leverage risk in the AIF sector; Guidelines on liquidity stress testing in UCITS and AIFs and ESMA updates the parameters and methodology for MMF stress testing.

Questions 1 to 7

When answering the following questions, please consider how the question applies to different NBFI sectors (entities and markets) and specify the NBFI sectors concerned when providing a response. Please also provide quantitative evidence, where possible.

Question 1. Are there other sources of systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street welcomes the discussion and the work initiated by the European Commission to get a better sense of the risks and vulnerabilities, as well as the potential interconnection, in the financial system. We appreciate the difficulty and novelty of this exercise and we welcome the opportunity to share our views at an early stage of this discussion. We are basing our response on our experience as a global custodian, providing investment services to many entities across the non-banking financial intermediation sector (“NBFI”), and as a global asset manager, managing UCITS and AIFs structures in the EU.

The emergence of NBFI had a positive impact on the financial system by making it less dependent on the banking sector and by adding new sources of financing to the real economy. The increased diversity of the financial ecosystem improves overall market efficiency and functioning by making the actions of financial market participants less correlated among each other.

At the same time, the NBFI is a diverse and vast landscape, made up of different players with different business models and applicable regulatory regimes, and to talk about an "NBFI sector" is in fact not accurate. Moreover, the funds sector is only one part of this ecosystem and, especially in the UCITS and regulated fund space, it already adheres to high regulatory standards aimed at preserving investor protection and at reducing ex-ante vulnerabilities that might emerge from liquidity mismatches and leverage.

For these reasons, we believe that a macroprudential framework cannot be targeted solely at the funds sector, and that any financial stability discussion needs to take into account the broader ecosystem and adopt a holistic approach, whereby all actions by actors who are active in a given market are considered, especially less regulated entities.

Therefore, while the European Commission identifies in its paper the right potential vulnerabilities which are relevant from a financial stability perspective, we believe that the proposed analytical framework lacks a clear definition of which systemic risks the EU authorities seek to address. Only after articulating this policy question, and the critical market functions that need to be preserved from a financial stability perspective, it will be possible to identify where the actual sources of vulnerability are, within the system and within a given market.

Without the articulation of a clear policy goal, State Street would like to caution against any policy to introduce new tools targeted at the funds sector, and especially at UCITS and regulated funds. A better regulatory approach should instead build on the already existing regime and close any potential gaps that may be identified, without introducing an additional regulatory layer with new macroprudential tools.

While we recognize the leadership of the EU in these matters, we would also like to stress that given the global scale and nature of the financial system, this inherently needs to be a global discussion. Policy conclusions, if any, should be drawn jointly by the international standard setters. We note that work is ongoing at the level of the Financial Stability Board (“FSB”) and the International Organization of Securities Commissions (“IOSCO”), where important progress has already been achieved in the work on liquidity mismatches in open-ended funds (“OEFs”), while more work continues on leverage.

Question 2. What are the most significant risks for credit institutions stemming from their exposures to NBFIs that you are currently observing?

Please provide concrete examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street is a global leader in the provision of custody banking services to institutional investor clients. We offer targeted extensions of credit to our clients, including in particular UCITS funds, pension funds, and other similar regulated investment funds. This credit support is primarily in the form of discretionary overdraft protection and short-dated loans to address certain narrowly defined liquidity needs. We do not engage in leverage lending or other long-date extensions of credit to our custody clients.

Under EU legislation, banks are required to carefully assess and control their counterparty risks, including those arising from non-bank counterparties. Moreover, the latest CCR III reforms in the context of the Basel III package that entered into force in July 2024, have materially increased the scope of information that banks are required to report to competent authorities.

In our experience, the custodial relationships that banks, such as State Street, have with regulated investment funds are of high quality and low risk, with limited exposure amounts and almost no loss history. This reflects the important but narrow range of financial services offered by custody banks and the fairly limited credit needs which these services entail.

As such, we believe that exposure risks to NBFI resulting from custody banking services are already adequately captured under the current prudential framework. Furthermore, we believe that it is crucial to recognize that not all bank exposures to the NBFI are the same and that different bank business models present very different risk profiles.

In addressing Question 2, we note that the EBA has been tasked in the CRR III to submit by 31 December 2027 a report to the EU Commission on the relative contribution of non-bank entities to the credit exposures of banks, including the appropriateness of potential aggregate limits or tighter limits to individual exposures. While we do not believe that the provision of custody banking services creates meaningful credit concentration concerns, we believe that this question should be addressed in that context, with the recognition that different bank business models vary significantly in their operational risk profiles.

Question 3. To what extent could the failure of an NBFI affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced?

- [x] 1 - To a very low extent
- [ ] 2 - To a low extent
- [ ] 3 - To a significant extent
- [ ] 4 - To a high extent
- [ ] 5 - To a very high extent

Don’t know / no opinion / not applicable

Please explain your answer to question 3, 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:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

From the perspective of the funds sector, the likelihood that a failure of a fund would have knock-on effects on the provision of critical functions to the real economy is very remote. Contrary to banks, funds do not take deposits, and any fluctuations of their asset portfolios are absorbed by their investment fund shareholders /investors, while counterparty risks towards other entities such as banks tend to be limited and captured by banks’ counterparty risk frameworks.

That is not to say that problems in the funds sector would not have implications on the real economy. Money Market Funds (“MMFs”), for example, are a very important source of short-term funding for many issuers and a cash management tool for investors. The MMFs sector proved its resiliency even during recent stress events such as March 2020, where they continued to fulfill their crucial role as liquidity providers. As these cases have demonstrated, risk mitigation is best addressed through the current microprudential tools at fund level, enshrined in the EU MMF Regulation, whose framework overall successfully passed the test of liquidity strains during recent stress events, although it could be improved in specific areas as we discuss under Question 8.

Question 4. Where in the NBFI sectors could systemic liquidity risk most likely materialise and how?

Which specific transmission channels of liquidity risk would be most relevant for NBFI?

Please provide concrete examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

With the growth of the NBFI sector there is a need to account for interlinkages with the banking system and the broader economy. When it comes to direct channels of exposure, we would like to point out that concentration limits for UCITS and MMFs are already in place in the current framework for funds and also across the banking sector.

Concerning indirect channels, we believe that system-wide stress tests which do not consider the funds sector in isolation can be an effective tool to aggregate data and improve the understanding of the behavior of non-bank financial institutions and their interactions with the banking sector during stress market scenarios.

We suggest that this supervisory approach would help avoiding singling out a specific class of counterparty such as investment funds, and would instead highlight that the funds sector itself can also be negatively impacted by developments originating in different parts of the NBFI and banking sectors, as it was the case of March 2020 when, for example, liquidity needs originating in other parts of the economy drove outflows from MMFs.

State Street believes that the policy goal of macroprudential regime for NBFI should be to enhance this system-wide view by securities regulators through better quality data on the market activity of all NBFI players, especially the less regulated entities, and their interactions with the rest of the financial system.

Question 5. Where in the NBFI sectors do you see build-up of excessive leverage, and why?

Which NBFIs could be most vulnerable?

Please provide concrete examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

With respect to leverage, State Street supports the work at the FSB level to address concerns around transparency and lack of data on leverage. As stated in the 2023 FSB report on “Financial Stability implications of Leverage in Non-Bank Financial Intermediation”, leverage across the NBFI sector is unevenly distributed. More than 90% of on balance sheet leverage sits within a group that encompasses a range of miscellaneous entities from broker-dealers to holding companies and securitisation vehicles, but does not include investment funds nor MMFs. These figures are consistent with the IOSCO’s “Investment Funds Statistic Report” from January 2023, which also recognized that leverage across the asset management industry remains low either through derivatives or direct borrowing.

We have also supported work by IOSCO and ESMA in the past to develop a consistent approach in the assessment of leverage-related systemic risk and on the calibration in the EU of leverage limits by national competent authorities, but we continue to believe that leverage limits should be imposed only in exceptional circumstances.

Regarding the objective of assessing financial stability risks related to the use of leverage, regulators should look beyond the fund sector and to the broader ecosystem when considering the source(s) of leverage. In this sense, addressing any discrepancies with regards to quality and consistency of data that NCAs currently receive could help regulators to identify areas in the system where there is an accumulation of risk. We therefore suggest a consolidation across borders and within ESMA of the data already provided in the context of the AIFMD reporting.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 7. Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs’ ability to provide such funding opportunities to companies, in particular through capital markets?

Please provide concrete examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We would like to stress that unintended negative impacts can also stem from an over-regulated funds sector. In fact, limiting the financial intermediation capacity of investment funds can come at the price of preventing the positive added value that the funds sector offers to the economy in terms of financing opportunities, giving an incentive for risk to move towards less regulated parts of the financial sector.

Concrete examples are the impacts that over-regulation might have on MMFs, on their capacity to act as cash and liquidity management tools for European investors and the provision of short-term funding for financial and non-financial companies; or the role of pension funds in financing productive investment. Over-regulation can also be particularly detrimental if single asset classes are stigmatized and made unattractive to large portions of the investment market.

On the contrary, if the macroprudential discussion leads to an agenda which enhances liquidity in the markets at time of stress, not by introducing additional regulatory layers but by expanding the intermediation capacity and supply of capital in key funding markets at times of stress (such as for example the repo and short term funding markets), then the broader European capital markets stand to benefit in terms of deepness and added liquidity.

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

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. In the aftermath of the 2008 financial crisis, the EU enhanced its **microprudential framework** and introduced for the first time **macroprudential oversight** for banks and key NBFI sectors, such as the investment funds and insurance sectors. For banks, moreover, it also introduced a common macroprudential framework, with tools exclusively designed to mitigate systemic risks, together with a comprehensive crisis management framework to provide more powers and tools to deal with systemic crises (Bank Recovery and Resolution Directive (BRRD)).

On supervision of NBFI, the European System of Financial Supervision (ESFS), which includes, among others, the ESRB and the European Supervisory Authorities (ESAs) – The European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA) –, is designed to ensure the stability and proper functioning of the EU financial system. The ESRB – established with Regulation (EU)1092/2010 – is the body responsible for macroprudential oversight at the EU level and thus contributes to the prevention and monitoring of systemic risks in the EU (Article 3(1), ESRB Regulation). ESMA – established with Regulation (EU)1095/2010 – and EIOPA – established with Regulation (EU)1094/2010 – are, each in specific NBFI sectors, responsible for monitoring, assessing and measuring systemic risk (Article 8 of the ESMA Regulation and Article 8 of the EIOPA Regulation). In recent years, EBA – established with Regulation (EU)1093/2010 – has also gained a greater role in NBFI with oversight responsibilities of significant asset-referenced and e-money token issuers under the MiCAR. The ESAs are also tasked to promote strong, effective and consistent regulation and supervision, as well as a more harmonised and consistent application of EU rules. The ESRB and the ESAs work collaboratively to monitor and assess risks, coordinating with NCAs across EU Member States, also developing own tools, such as stress tests.

On regulation, EU legislation already includes **a number of macroprudential tools** that have been introduced in sectoral legislation over the years (see following sections for more details). Macroprudential tools are requirements or procedures designed to directly mitigate vulnerabilities and to protect the financial system as a whole from large systemic events[15], while **microprudential tools** may only indirectly mitigate systemic risk by addressing entity or transaction-level risks[16]. Macroprudential tools typically take the form of:

- pre-emptive measures (i.e. ex ante measures activated before systemic risk materialises, such as leverage limits)[17]
- ex-post measures (i.e. measures activated once systemic risk materialises, such as suspension of investors' rights to redeem units of investment funds)[18]

As the NBFI includes very diverse business models and markets, macroprudential tools are tailored for the different NBFI sectors to successfully address systemic risks. For instance, while capital buffers tools are generally applicable to insurance companies (a principal-based business), these tools may not fit the business model of investment funds or family offices (agent-based businesses). Moreover, macroprudential tools can be a combination of activity-based and entity-based measures. Activity-based measures are applicable, based on financial stability concerns, to the type of activity provided regardless of the NBFI entity providing it. Entity-based measures include leverage limits applicable to a specific entity or group of entities.

Table 2. Examples of macroprudential tools for NBFI in EU legislation and key characteristics

	Activity-based	Entity-based
Pre-emptive tools	Leverage limit for loan-originating funds (introduced in the AIFMD /UCITS review)	Structural liquidity buffers (pre-emptive measure; Art. 24-25 MMFR)
Ex-post tools	Power to prohibit/restrict short selling transactions in case of serious threats to financial stability (ex post measure; Art. 28 Short Selling Regulation)	Suspension of redemption rights (Art. 45 AIFMD and Art. 84 UCITS Directive)

Macroprudential tools should be typically accompanied by effective and well-coordinated oversight, coordination (at least at EU level), as well as adequate reporting and disclosure rules to ensure visibility over market participants' actions and to ensure that the tools are properly implemented. Given the cross-border nature of NBFI, oversight should be done not only at national, but also at an EU level to ensure that all relevant NCAs have the necessary information to mitigate systemic risks in the EU. It should be assessed whether more needs to be done to strengthen the macroprudential oversight and coordination mechanisms of the EFSF in the EU.

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[15] As stated in the De Larosière Report, "the objective of macro-prudential supervision is to limit the distress of the financial system as a whole in order to protect the overall economy from significant losses in real output."

[16] For instance, leverage limits are prudential measures that have a microprudential nature when they are designed and implemented to face an idiosyncratic entity or transaction-level risk, but they are macroprudential tools when they are designed and implemented at sector-wide level, disregarding the individual business model or activity. This is the case of structural limits for Alternative Investment Funds, under the recently agreed AIFMD/UCITS review, which qualify as macroprudential tools.

[17] This subset, among other, includes: 1) capital, margin, or liquidity buffers to prevent the build-up of vulnerabilities, and thus mitigate the materialisation of risks stemming from or leading to a systemic shock; 2) Limits to the build-up of leverage for banks and non-banks that are designed exclusively to increase the loss absorption of financial institutions against a systemic event or restrict certain activities/behaviours.

[18] This subset, among other, includes: 1) tools designed to avoid procyclicality of margin haircuts or to better manage the liquidity of investment funds against redemption risk (so called, liquidity management tools, LMTs); and 2) powers to halt trading in specific instruments or activities in

times of extreme volatility or in case of a systemic event to protect the public interest, e.g. via the suspension of redemptions of units of investment funds.

2.1 Asset management and open-ended funds (OEFs)

The EU's investment fund sector operates under a comprehensive regulatory framework, primarily governed by the AIFMD and the UCITSD. In addition, MMFs are subject to additional rules provided for by the MMFR. These pieces of legislation include a wide array of regulatory requirements addressing the use of leverage, liquidity risk management, transparency and portfolio concentration and diversification.

For instance, the AIFMD (Article 25) empowers NCAs under certain circumstances to introduce limits on the leverage used by AIFs. On this legal basis, in 2022, the CBI introduced a leverage limit for Irish property funds. Furthermore, on the same basis, the CBI and CSSF both plan to introduce in Ireland and Luxembourg respectively yield buffers for LDI[19] Funds.

To ensure sound liquidity risk management, the EU rules require AIF and UCITS managers to conduct stress testing, which is further specified in ESMA guidelines on liquidity stress testing in UCITS and AIFs. According to the MMFR, MMF managers should conduct such stress tests twice a year[14]. In calibrating risk parameters and adverse scenarios, ESMA worked closely with the ESRB and the ECB (As part of ESMA's responsibility in the possibility to run EU-wide stress tests, Art. 21(2), ESMA Regulation). If stress tests reveal vulnerabilities, the MMF manager must report and come up with a 'proposed action plan' to be communicated to the NCA thereof.

UCITSD and MMFR rules requiring diversification and imposing limits on investment concentration also address some of the risks stemming from interconnectedness with other financial and non-financial entities and sectors. AIFMs report to the supervisors on the principal exposures, concentrations and main counterparties, including on their risk profile, to monitor risk build-up in the financial system.

The 2024 review of the AIFMD/UCITSD amends the two legal frameworks by harmonising the definitions and application of LMTs designed to enhance UCITS and open-ended AIFs' ability to manage liquidity risks effectively. Moreover, the review sets a new structural leverage limit for loan-originating funds and requires risk diversification where loans are originated to other providers of financial services, thus further strengthening the sector's risk management capabilities. It also allows for the broadening of the scope of reporting for supervisory purposes potentially covering portfolio data, while improving reporting efficiency and minimising administrative burdens, where possible.

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19 Liability Driven Investment (LDI) Funds, Central Bank of Ireland and CSSF communication on GBP Liability Driven Investment Funds consultation.

20 According to Article 28 of MMFR, those stress tests shall cover hypothetical changes in asset liquidity, credit risk, interest rates, exchange rates, redemption levels, spreads among relevant indices, and macro systemic shocks affecting the broader economy. To support the process, ESMA produced MMF-specific guidelines on the parameters and methodology for simulating impacts of asset sales under stress market conditions. See ESMA updates the parameters and methodology for MMF stress testing.

2.2 Insurance

The insurance sector is regulated by a comprehensive EU prudential framework similar to the framework applicable to banks but with some notable differences due to key structural differences in their funding structures and business models. Compared to the banking sector, the risk stemming from financial leverage is rather minor in the insurance sector[21]. The main liability of insurance firms consists of technical provisions, which are considered stable funding and are less prone to a sudden withdrawal than bank debt (as in the case of bank runs). Insurance companies are instead more exposed to the risk stemming from synthetic leverage, via derivative exposures, to manage their long-term liabilities.

These exposures are managed under the Prudent Person Principle of Solvency II (Art. 132), insofar as they contribute to a reduction of risks or facilitate efficient portfolio management[22]. Furthermore, Solvency II requires regular reports to supervisory authorities of derivative positions, which are part of the broader information disclosure taking place under the Solvency and Financial Condition Report (Art. 51 of Solvency II Regulation). Liquidity risks for insurance companies are identified, monitored and addressed under the Own Risk and Solvency Assessment (ORSA).

The recently agreed Solvency II review introduces for the first time a macroprudential toolkit for the insurance sector in the EU, which includes a couple of amendments as regards liquidity risks. In particular, supervisory authorities will have the possibility, in exceptional situations and as a last resort measure, to impose on individual companies, or the entire market, temporary freezes on redemption options on life insurance policies. Supervisors will also be granted with the powers to restrict capital distributions in exceptional circumstances, such as dividend payments, to preserve insurers' liquidity and capital positions in stressed conditions. Moreover, insurers will have to develop liquidity risk management plans (LRMP) to explain how they intend to maintain adequate liquidity to settle their financial obligations even under stressed conditions. Lastly, a framework for the recovery and resolution of insurance and reinsurance undertakings was recently agreed by co-legislators, which would ensure more coordination and better tools to manage systemic crises in this sector[23].

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21 According to EIOPA, since 2007, debt funding does not represent more than 8% of an insurer's capital base. Please, see EIOPA's second set of Advice to the European Commission on specific items in the Solvency II Delegated Regulation

22 Article 6(1)(g) and (h) and Article 10(e) and (f) of Commission Implementing Regulation (EU) 2015/2450 of 2 December 2015 laying down implementing technical standards with regard to the templates for the submission of information to the supervisory authorities according to Directive 2009/138/EC of the European Parliament and of the Council

23 See the compromise text on the recovery and resolution of insurance and reinsurance undertakings Directive resulting from political agreement in interinstitutional negotiations in January 2024

2.3 Other NBFIs and markets

Regarding pension funds, Member States should ensure that NCAs duly consider the potential impact of pension funds' operations on the stability of the financial system in the EU, in particular in emergency situations (Art. 47 of IORP Directive). For large investment firms, capital coefficients for cash and derivative trading flows can be adjusted by NCAs if they 'seem overly restrictive and detrimental to financial stability' (Art. 15(5) of Investment Firms Regulation).

On markets, there are several measures that have been introduced over recent years. Among those, there are post global financial crisis measures, such as the central clearing obligation for over-the-counter derivatives (Art. 4 of EMIR Regulation), and requirements to limit procyclical effects in collateral haircut calculations for margins[24]. ESMA, EBA and NCAs have the power to prohibit or restrict marketing of a financial instrument or a financial activity to protect financial stability (Art. 40-42 of MiFIR Regulation). Finally, rules for the securitisation market have introduced macroprudential oversight by the ESRB (Art. 31 of Securitisation Regulation). For a preliminary list of macroprudential tools for NBFI, please see the annex.

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24 Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties.

3. Unmitigated liquidity mismatches

This section aims at gathering data and information on potential unmitigated liquidity mismatches and tools to mitigate systemic risks in MMFs, OEFs and other NBFI sectors.

3.1 Money Market Funds (MMFs)

In the past two years, the Commission has conducted a comprehensive assessment of the regulatory framework for MMFs, considering both prudential and economic perspectives.

Drawing upon economic analysis and industry feedback from the 2022 Commission targeted consultation, the July 2023 Commission report on the functioning of the MMF Regulation 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. Additionally, the MMFR imposes detailed reporting and periodic stress testing requirements (to be performed by MMF managers), allowing NCAs to identify potential unmitigated liquidity mismatches. The report also highlights that a large majority of EU MMFs have maintained their levels of liquidity buffers well above the current regulatory minimum. However, the report also identified some vulnerabilities that warrant further attention.

In particular, three potential areas for improvements were identified:

1. evaluating the need to increase the liquidity buffers
2. decoupling the activation of LMTs from the liquidity buffers for stable Net Asset Value (NAV) MMFs
3. enhancing supervision, the stress testing framework, and reporting requirements

While industry feedback and data have already been collected on the first two areas for improvement, further consultation is needed on the third area. Moreover, we seek views on the current definition of a "money market instrument".

On supervisory powers, we seek feedback on the feasibility to empower NCAs to increase MMF liquidity buffers on an individual or collective basis to mitigate systemic risk and ensure market stability. In this context, ESMA could have a coordination role focusing on systemic risk assessment and ensuring a consistent approach across jurisdictions, especially in a market crisis or when disputes between NCAs arise. This could mirror NCAs' intervention powers on leverage pursuant to Article 25 of AIFMD, which tasks ESMA and the NCAs with assessing whether the leverage employed by an AIFM, or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system. Based on these assessments, NCAs have the authority to impose leverage limits on AIFMs to ensure financial stability and to prevent disorderly markets. For more details, see section 6.

On reporting, we are seeking views on potential ways to streamline and improve MMFR reporting to more effectively identify stability risks, while minimising the burden for reporting entities.

On the stress testing framework, we are consulting on potential additional steps to the current common stress testing framework for MMFs, which could include:

- additional elements on the knowledge of the investor base, particularly on investor concentration
- strengthened supervision and remediation action in case liquidity risks are detected. For instance, ESMA, after consulting the ESRB, could assess the effectiveness of corrective measures for liquidity risks, with NCAs providing a report indicating how the risks have been addressed
- improved reporting for supervisory purposes (including stress testing), such as timely access to data on portfolio composition and disclosure of underlying data and simulation models to NCAs, while minimising the reporting burden
- a Union-wide stress test run, e.g. by ESMA in coordination with the ESRB, at fund and asset management group levels

On the reverse distribution mechanism (this mechanism would involve the redemption and cancellation of a number of units of MMFs to offset the negative yield generated by the fund), the consultation paper wants to explore whether this mechanism should continue to be banned under EU rules or not.

Another area being explored is the instruments in which MMFs invest in, such as 'short-term assets' (Art. 2(1) of MMF Regulation) and 'money market instruments' (Art. 3 of Directive 2007/16/EC – in particular, this definition includes instruments that have a maturity up to 397 days and are not traded on a regulated venue). MMFs do not necessarily distinguish between instruments that are traded or not on a regulated venue. Instruments traded on a regulated venue, in particular, are subject to greater transparency and organisational requirements for secondary trading and may be potentially more resilient and liquid in case of a systemic event. Moreover, the potential availability of a venue where to match interests to liquidate short-term assets may facilitate liquidity management of MMFs during crises, even if in normal times secondary trading activity remains low.

Questions 8 to 15

Supervisory powers

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

Question 8.1 Please explain what are the pros?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street does not support the macroprudential activation of liquidity buffers.

Question 8.2 Please explain what are the cons?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We believe that this policy tool would be very challenging for competent authorities to implement and unlikely to reach the intended goal of enhancing the resiliency of the system. More specifically, we do not support extending the existing art.25 AIFMD powers to include liquidity buffers as well.

NCAs would have to clearly define stress periods and choose relevant parameters which are not observable, and they will have to act swiftly in a stress scenario, which is likely to be challenging. In addition, it may not be appropriate to apply a blanket approach across all funds or multiple funds given the different underlying investor bases, flow patterns and portfolio positioning.

Particularly for MMFs, dynamically adjusted or countercyclical liquidity requirements, whereby requirements would be adjusted upwards in response to a specific stress event, would be counterproductive and would actually add to liquidity strains precisely at a moment when MMFs would be required to perform their role as cash provider. Managers and investors require transparency at all times on the applicable requirements in order to factor them into their investment decisions. On the contrary, adjusting requirements at times of stress is likely to create stigma effects and exacerbate first-mover advantage pressures, with shareholders incentivized to redeem earlier.

More generally, it is important when setting liquidity buffers at fund level that regulators are mindful of appropriately calibrating liquidity requirements to avoid potential unintended consequences which would reduce managers' flexibility and "trap" liquidity within MMFs. Disproportionally high requirements lead to declining yields and reduced investor appetite and demand, and paradoxically can also increase the overall stress on the system if the market is not able to absorb the additional higher amounts of liquidity.

We do not view the current regulatory minimum liquidity requirements as the key factor in MMF stress during March 2020 or the LDI stress event. Rather it was the regulatory-imposed inability of MMFs to use liquidity buffers when needed that caused stress in the market, especially during March 2020. The problem was not a lack of liquidity but the fact that the liquidity was rendered effectively unusable by the 'bright line' of regulatory thresholds, i.e. as funds approached minimum liquidity levels, investors felt incentivized to redeem to avoid the activation of liquidity management tools.

In practical terms, this resulted in the counterintuitive scenario whereby MMFs had a substantial portion of their portfolio invested in Weekly Liquid Assets ("WLA") that was unusable. MMFs became forced sellers in a deteriorating market, in order to hold additional liquidity over and above the regulatory thresholds, as a means to further assuage investor concerns. One way to resolve this, and thus increase the liquidity available at times of stress, is to remove the link between the possible imposition of gates and fees and the breach of the liquidity thresholds. This measure alone should already increase available liquidity, and so MMFs resilience, without the need for an additional radical increase in WLA.

In other words, the whole purpose of liquidity requirements should be to create buffers that can and should be available for use by MMFs to meet redemptions in times of stress, rather than act as a floor. For this reason, "delinking" will help in increasing managers' flexibility in managing their liquidity buffers, but work should continue to make sure that buffers are effectively used as intended in stress situations.

Question 9. How can ESMA and ESRB ensure coordination and the proper use of this power and what could be their individual roles?
Please provide specific examples or scenarios to support your view:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As outlined in our answer to the previous question, State Street does not support introducing the power by NCAs, ESMA or ESRB to dynamically adjust liquidity buffers, which should instead be transparent and pre-determined in the relevant regulation. So we do not see a need to change the current authorities' roles.

Reporting requirements

Question 10. In view of the new UCITS supervisory reporting obligations and improvements to AIFMD reporting, how could reporting requirements under the MMFR be aligned, simplified and improved to identify stability risks (such as liquidity risks) and to ensure more efficient data sharing?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We would like to point out that MMFs reporting requirements are currently more detailed and specific than the equivalent rules under AIFMD/UCITS. The current framework, which State Street fully supports, not only requires quarterly reporting by the MMF, but also gives national competent authorities (NCAs) the power to request data ad hoc more frequently. Such requests were in fact frequently made during the March/April 2020 market turmoil.

Based on the existing requirements and reporting powers for NCAs, we do not see a need for additional reporting requirements and do not believe that they would further enhance fund resilience and/or add value for end investors.

From a policy perspective, what we believe is needed is instead a better coordination between NCAs and ESMA on data reported by MMFs. MMFs reporting is currently submitted and handled at the national level by NCAs – the priority should be to ensure consistency across jurisdictions and the effective use of the existing data between NCAs to facilitate a more comprehensive overview of MMFs risks and activities across the EU.

State Street would be happy to contribute to a more aligned and simple reporting regime across the EU, striking the right balance between uniform and informative data that can be produced by individual entities in a timely fashion and at a reduced compliance cost.

Stress testing framework

Question 11. Do you believe that the proposed enhancements to the stress testing framework listed above are sufficient to identify and mitigate liquidity risks effectively?

If not, what specific elements would you suggest including in the strengthened supervision and remediation actions for detecting liquidity risks?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As a starting point, we would like to point out that the current ESMA stress testing calibrations are extremely severe and updated frequently based on ESMA guidance. Moreover, as a general remark, regulators should note that given the short maturity profile of MMF portfolios, there is a natural limit as to how meaningful and informative more frequent stress testing can be for MMFs.

At State Street, we run monthly stress testing across all our MMFs and quarterly stress tests for our in-scope MMFs based on the ESMA methodology. It is important for the stress testing framework to remain principled-based, meaning that regulators define the risks that fund managers should test against, while managers set the "inputs" and parameters for the specific scenarios. This allows managers to be able to adapt the scenarios to the risk profile of their funds leading to the most meaningful results.

With respect to the additional elements listed in the EU Commission's consultation paper, we would like to note the following:

o On knowledge of the investor base, we already perform stress tests with reference to investor type, and we generally track large client flows over time and study them for cyclicality or identifiable patterns to the money movement. This is a valuable input in constructing portfolio maturity schedules and appropriate liquidity buffers. Investor concentration is also something that rating agencies consider and monitor closely when rating MMFs.

o On strengthened remediation actions by ESMA/NCAs, MMFR already provides for a set of corrective measures that can be taken if liquidity thresholds are crossed, to ensure that liquidity is replenished as soon as feasible (see art.24 MMFR). We would like to add however, that the most important limitation of a stress testing approach remains the fact that a liquidity assessment is never a black or white exercise, and in the fund context stress tests should not be constructed as a pass/fail exercise. Rather, stress-tests should remain an important tool for portfolio/risk managers to assist in the management of a fund's liquidity.

o On reporting requirements, we would like to refer to our response to Question 10.

o On a EU-wide stress tests for MMFs, please refer to our response to Question 12.

Question 12. What are the costs and benefits of introducing an EU-wide stress test on MMFs?

Should this stress test focus mainly on liquidity risks?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street is in principle open to the idea of a EU-wide stress test exercise across the NBFI and bank sectors. If calibrated correctly, and minimizing as much as possible the compliance burden on firms, it could be a tool to articulate a system-wide approach to financial stability which doesn't look at the funds sector in a siloed way but takes into account the interconnectedness across the financial system. Such a EU exercise would be a positive addition to the current framework if:

i) Like the recent Bank of England System-Wide Stress Scenario (SWES), as starting point, it is based on a clear policy question or market that is critical from an EU perspective (as the case of the Gilt market resiliency in the SWES),
ii) It includes all relevant market actors in the given market that regulators want to test,
iii) It is based on a aggregated and shared data across NCAs, rather than been additive in terms of reporting requirements. If the challenges around design and data collection are addressed, a EU-wide stress test can be helpful in identifying where the actual risks lie within the system.

On the contrary, we are skeptical of the usefulness that a EU-wide stress testing framework would have if targeted solely at MMFs. Given the already existing and very rigorous ESMA stress testing, there would be significant costs for MMFs to comply with additional requirements, while the benefits of an additional layer of stress tests are unlikely to be meaningful considering the fast-changing nature of MMF portfolios.

Finally, as a general comment on stress tests at fund level, we don't believe that there should be any more prominence on liquidity stress testing compared to that of NAV stress testing. The two pieces of stress testing go together to show how the fund would behave under stressed market conditions, and therefore one should not be the main focus.

Reverse distribution mechanism

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

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including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As State Street we opposed the original ban on the reverse distribution mechanism (RDM) as we were convinced that RDM was a very useful method that allowed funds to address a negative interest rate environment, especially for fixed NAV MMFs. Under a RDM, negative yields and the associated decline in value of a MMF's portfolio, would be passed on to investors through pro rata reductions in their shareholdings. The NAV would remain fixed and investors' holdings in the fund would be reduced by an amount reflecting the negative yields of fund assets.

Given current interest rates are comfortably in positive territory, it is unlikely that RDM would be useful again in the foreseeable future but nonetheless we would support its reintroduction given that it could represent an additional option in the future were negative rates to return, and also considering the investor preference over alternative approaches.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

The benefits of using RDMs were evident in the EU after 2015 financial crisis, when Euro-denominated MMFs moved to a negative yield and RDM was used to effectively address the emerging negative interest rate environment. Negative income could be applied daily to reduce the number of shares held by the investor. RDM allowed boards to consider more effectively the time frame for negative yields, passing lower yields on to investors in discrete, transparent and planned events, rather than open-ended changes to the NAV approach with uncertain return to the fixed NAV. This method of accounting for fractional daily price changes provided stability and suited investors for operational and accounting reasons.

Liquidity and short-term instruments

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

Please explain your answer:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street would like to point out that many Money Market Instruments, especially Commercial Paper (“CP”) and Certificate of Deposits (“CD”), are over the counter instruments, traded bilaterally, and are not traded on an exchange or venue. This is primarily because given the costs of listing and the limited maximum maturity, the instruments are too short to make listing economically viable for the issuers.

More broadly, there is currently no one fits all platform that incorporates MMF trades, and even in the case of repo transactions, not all sell sides houses either want to use a platform (and prefer to trade bilaterally due to costs) or they all use different ones. Finally, even for the instruments that are listed, admission to a trading venue does not in any case guarantee liquidity.

3.2 Other open-ended funds (OEFs)

Liquidity risk in investment funds refers to the possibility that a fund may not be able to meet its financial obligations, such as payments or redemption requests, in accordance with the fund's rules. This risk is more enhanced in OEFs[25], especially when the OEF’s structural liquidity mismatch (i.e. difference between the liquidity of the fund's assets and its liabilities) is not managed using relevant tools (e.g. LMTs and liability management) in light of potential liquidity shocks. Liquidity risks are particularly important for OEFs that are either invested in illiquid assets or offer frequent redemption without adequate LMTs (to deal with a plausible redemption shock), such as sufficient notice period, gate mechanisms and/or liquidity buffers. Liquidity risk can also impact closed-ended funds, particularly in scenarios involving leverage, where significant market fluctuations may require sudden margin calls or deleveraging.

The recent AIFMD/UCITSD review has introduced a harmonised set of LMTs and laid down mandates for ESMA to further guide a uniform use of LMTs by managers across the EU. Those rules, which are adopted at fund level, will have to be operationalised by regulatory technical standards (RTSs) and ESMA guidelines on the characteristics, selection and activation of those LMTs. The expectation is that new provisions will enhance the resilience of all investment funds, including MMFs, when they become applicable in 2026. Furthermore, the AIFMD/UCITSD review includes a new reporting system for AIFs and UCITS, which will include an ESMA RTS on a new reporting template for AIFMs and a novel obligation for UCITS to report on their holdings.

Taking into account these developments, more could be done to improve the ability of macroprudential authorities to identify liquidity stresses in a timely manner or to monitor liquidity risk at systemic level (e.g. through EU-wide stress tests) and about the role of NCAs in the selection of LMTs.

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[25] 'Open-ended funds' (OEFs) in the EU can either take the legal form of UCITS funds (Art. 76, UCITSD) or of alternative investment funds (AIFs) whose shares or units can be redeemed at the request of any shareholder or unitholder, directly or indirectly from the AIF's assets, before the liquidation or wind-down phase begins and according to the AIF fund rule. (Article 1(2) of Regulation (EU) No 694/2014). This definition encompasses different realities, from highly liquid AIFs to AIFs offering infrequent liquidity, often referred to as semi-liquid AIFs.

3.2.1 Enhancing the supervisory framework on liquidity risks

As mentioned, investment fund managers are required to periodically conduct stress-testing. Nevertheless, NCAs' monitoring of liquidity risks and their evolution on a broad scale is currently hampered by the lack of accurate metrics. Specifically, metrics for liquidity risks require an accurate assessment of unmitigated liquidity mismatches, i.e. where a liquidity mismatch is not adequately mitigated by specific tools, such as liquidity management tools, to withstand a plausible redemption scenario. Additionally, these metrics depend on the precise calibration of worst-case and stress-case scenarios related to redemptions and margin calls, as well as evaluating the effectiveness of LMTs in mitigating risks.

Liquidity stress test data at fund level can help NCAs to verify whether the LMTs of a fund (or a cohort of funds) or the use of an OEF architecture are or remain appropriate. While ensuring that the activation of the LMT remains full responsibility of the manager, who is the one best placed to trigger it, NCAs should use the collected data and reporting to identify inconsistencies between the liquidity profile (assets/liabilities) of an investment fund and the use of specific LMTs and ask for remedial actions where needed. In addition, to ensure a level playing field and more effective coordination and implementation of macroprudential policies, the NCA or ESMA could have the power to require the asset management company, for financial stability reasons (independent from the appropriateness assessment abovementioned) and where certain conditions are met, to select a specific LMT for a fund or a cohort of funds, even if not previously selected by the manager.

Questions 16 to 25

Link between liquidity mismatch and liquidity risks

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

At State Street, strong liquidity management has always been part of our fiduciary duty and we have a wide range of recognized tools/best practices in place to manage fund liquidity and redemptions. This includes tools for managing day-to-day liquidity, as well as tools to cope with more extreme tail risk events and first-mover advantage risks. These tools range from ongoing monitoring of asset liquidity compared to expected redemptions, to more proactive measures in times of financial stress, such as swing pricing, redemption fees and gates. Not all such tools are necessary or appropriate in all markets, or for all fund types, nor is dilution always a material risk, and fund managers are able to assess this with the help of their liquidity management playbooks.

We recognize that, in specific circumstances, it can be hard to justify certain investment strategies/asset classes in daily dealing funds. We have no objection to more targeted means for NCAs of addressing extreme forms of liquidity mismatch in those funds, but this is a process that should start at inception through product design or through the appropriate deployment of Liquidity Management Tools ("LMTs"), it should not be done by means of a 'one-size fits-all' bucketing approach.

EU funds closely monitor their liquidity set-up and rely on fund stress testing to determine whether their liquidity profile would resist a redemption shock. Thresholds and buckets cannot substitute for this detailed liquidity assessment. Of course, we are prepared to justify our judgements to our local regulators, and the latest review of the AIFMD/UCITS Directives will bring additional reporting requirements and make the selection of LMTs mandatory and more harmonized across OEFs and EU jurisdictions.

As explained under Question 12, if there is a gap in the current monitoring framework for systemic risks it might reside in the ability of NCAs and EU authorities to join the available data to identify and detect risks at the systemic level.

State Street is in principle open to the idea of a EU-wide stress test exercise across the NBFI and bank sectors. If calibrated correctly, and minimizing as much as possible the compliance burden on firms, it could be a tool to articulate a system-wide approach to financial stability which doesn't look at the funds sector in a siloed way but takes into account the interconnectedness in the financial system.

Question 17. **Only for NCAs and EU bodies**: What is the supervisory practice and your experience with monitoring and detecting unmitigated liquidity mismatches during the lifetime of OEFs?

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

At State Street, the primary risk metric for our open-end funds is Liquidity Coverage Ratio (LCR), estimated for both normal and stressed market conditions and used to monitor mismatch between fund's assets and liabilities on an ex-ante basis. LCR measures if fund has adequate sources of liquidity (liquid assets that can be converted into cash) which are sufficient to cover liquidity needs (redemptions) under normal or stressed market environment.

In addition, Estimated Liquidation Cost / Market Impact, Time to Liquidate, Bid-Ask Spreads, % of the fund invested in securities with certain liquidity risk characteristics (market cap, issue size, traded volume, time to liquidate, etc.), and Investor Concentration Index (HHI) are all supplemental metrics included as part of Liquidity Risk Management framework.

Finally, State Street employs a variety of fund and market indicators a part of a broader market liquidity monitoring framework to ensure better insight into market liquidity conditions across different asset classes, regions and parts of investment process. Metrics include, but not limited to, ETF premiums/ discounts, Fund & ETF flows, index turnovers, volatility indexes, price index levels and spreads.

Question 18. **Only for NCAs and EU bodies**: What supervisory actions do you take when unmitigated liquidity mismatches are detected during the lifetime of an OEF?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 19. On the basis of the reporting and stress testing information being collected by competent authorities throughout the life of a fund, how can supervisory powers of competent authorities be enhanced to deal with potential inconsistencies or insufficient calibration between the LMTs selected by the manager for a fund or a cohort of funds and their assets and liabilities liquidity profile?

How can NCAs ensure that fund managers make adjustments to LMTs if they are unwilling to act? How could coordination be enhanced at the EU level?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

At State Street we support expanding the availability and use of LMTs and anti-dilution tools in accordance with jurisdictional specificities. Investment managers, in pursuing their fiduciary duty, remain best placed to activate and calibrate these tools on the basis of their fund’s investment strategy and portfolio liquidity.

The focus should remain on material dilution risks and the inclusion of implicit transaction costs should remain on a best effort basis, provided that the trade sizes of the fund are large enough to result in a market impact. Because implicit transaction costs are difficult to estimate (especially due to inconsistency of market impact data) we struggle to see how the inclusion of these implicit costs will be able to drive consistency among open-ended funds, and therefore the best interest of investors.

While the primary responsibility to deploy LMTs will remain with fund managers, given the ongoing work by

ESMA on guidance and technical standards for the operationalization of LMTs, EU fund managers will soon be assisted by standards and best practices on application of LMTs. ESMA will outline the characteristics of LMTs, the risks they intend to mitigate and the scenarios for their intended use.

From their perspective, regulators are responsible to make assessments on LMTs at the fund authorization stage and on an ongoing basis, ensuring that funds are operationally ready to use LMTs. We could also envisage enhanced guidance/engagement with fund managers in exceptional cases of particularly stressed market dislocation, in order to facilitate the application of LMTs, as opposed to mandate direct intervention by policy makers.

Question 20. Only for asset managers: What measures do you find particularly effective to measure and monitor liquidity risk in stressed market conditions?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response under question 17 for metrics that we find relevant for monitoring liquidity risks.

As a more general comment, policymakers should be mindful of the fact that there is no widely or industry-accepted approach to quantifying asset liquidity, whether in normal or stressed market conditions. The multi-faceted aspect of liquidity, including expected or assumed trading size, may lead to different outcomes across funds of similar size, assets and strategy. Liquidity always remains an ongoing and dynamic exercise and rigid definitions may compromise a fund’s ability to achieve its objectives and meet the expectations of its investors.

Judgments about asset liquidity are always based on observations and estimates, and the liquidity profile of a fund is always dynamic, with liquidity needs that ought to be assessed on an ongoing basis. The dynamic nature of liquidity suggests that it is preferable to focus regulation on fund managers’ preparedness to changing market conditions rather than trying to define what exactly constitutes “stressed” conditions.

The FSB report on “Addressing Structural vulnerabilities from liquidity mismatch in open-ended funds” from December 2023, correctly provides for a non-exhaustive list of factors that can concur to the determination of the liquidity of a particular asset class, even though some of the factors are difficult to estimate and quantify – i.e. valuation certainty, the efficiency and effectiveness of the pricing mechanism, operational features and potential frictions – so they shouldn’t always be considered all together.

Question 21. Only for 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?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response under Question 17 on the ways we currently measure and monitor liquidity risks.

As stated previously, a lot of work has been done in the past years at the international and European level to address any gaps in the regulatory framework related to potential liquidity mismatches in investment funds. As a result of this work, and in particular of the AIFMD and UCITS review which is still been implemented, the EU is very well placed compared to other jurisdictions in addressing any unmitigated liquidity mismatch and we do not see any gaps in the current EU regulations.

While our liquidity risk monitoring metrics are broadly effective in recognizing the increasing costs to liquidation, an area where we see room for improvement for liquidity models is determining the time to liquidation during extreme market stress that can result in excessive liquidation costs. We note that this is an industry-wide challenge, given the reliance of widely used liquidity classification metrics, tools and services based on historical data and assumptions.

Question 22. **Only for asset managers**: What are the challenges in calibrating worst-case and stress-case scenarios related to redemptions and margin calls?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street supports good practice around KYC requirements and we are confident that our current policies allow us to effectively manage investor concentration. The EU Regulation in fact requires managers to take into account the concentration and behavior of investors. As part of this, we track large client flows over time and study them for cyclicality or identifiable patterns to the money movement. This is a valuable input in constructing portfolio maturity schedules and appropriate liquidity buffers.

We also maintain communication with larger holders over time to better understand their cash flow needs, including their margin and collateral calls sensitivity, and position funds accordingly and perform stress tests with reference to investor type.

Calibrating extreme scenarios, such as six sigma events, poses inherent difficulties due to their rare and unprecedented nature. These events often fall outside the bounds of historical data and past behaviors, making it challenging to model their potential impact with accuracy. As a result, assumptions for such tail risks require careful consideration and are inherently subject to greater uncertainty.

State Street would like to highlight that the existing ESMA stress testing framework for MMFs already encapsulates a wide array of shocks and scenarios, including those relating to investor and issuer concentration. That said, we would support the incorporation of margin call risks into stress testing frameworks, provided it was implemented in a measured, principles-based fashion that enabled the investment manager to calibrate the analysis to the unique characteristics of the MMFs.

Besides MMFs, State Street has procedures in place which govern trading of FX, OTC derivatives, and other forward settling instruments, to ensure portfolios do not have undue counterparty concentration. We also review each counterparty annually, with forward settling counterparties subject to a fundamental review of their credit profiles. At the same time, we generate regular counterparty, exchange, and clearinghouse reporting, providing senior management with aggregated margin and exposure data. Reporting includes detailed data down to the individual portfolio level.

In terms of challenges, incorporating margin call risks into stress testing frameworks may add an additional operational and compliance burden, depending on how it was implemented and the scope of the analysis.

Furthermore, it could be challenging to compare margin call risks across the industry given proprietary way in which firms determine, set, and calibrate haircut levels. In addition, stress testing frameworks may not capture firm-specific nuances, such as intra-group indemnification for certain funds, products and transactions as well as how capital resources are apportioned internally.

Stress testing

Question 23. Only for NCAs and EU bodies: When monitoring or using results of liquidity stress tests, are you able to timely collect underlying fund data used by managers and the methodology used for the simulation?

Are there other aspects that you find very relevant when monitoring the stress tests run by managers?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 24. Only for NCAs and EU bodies: How do you use information collected from stress tests at fund level for other supervisory purposes and for monitoring systemic risks?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 25. Only for NCAs and EU bodies: What are the main benefits and costs of introducing a stress test requirement at the asset management company level and how could this be organised?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

3.3 Other NBFIs and markets

Other NBFIs, such as large commodity traders, and the functioning of large short-term funding markets, are increasingly playing an important role during stress scenarios. March 2020 events also raised flags about the resilience of some money markets, such as commercial paper (CP) and certificate of deposits (CD) markets. Improving their functioning could strengthen their resilience in crisis times.

Commodity derivatives are traded under various strategies by different types of counterparties, including financial and non-financial undertakings which hedge their commercial business (e.g. energy companies) or which contribute to the liquidity of the energy derivative markets. In case of large and unexpected price shocks, liquidity stress can be heightened by corresponding large and unexpected margin calls that traders, such as commodity trading companies, need to be prepared to address.

Another key feature of commodity derivatives is the dual presence of market participants who are active in both the spot /physical market and the futures markets. The respective regulatory and supervisory frameworks differ or are not aligned. The activities of energy traders that are active only or mainly on energy spot markets can also have repercussions on financial markets (energy derivatives). This is notably the case in situations of stressed energy supply or when energy spot market purchases serve as the principal tool for filling storage capacity. In such instances, volatility in spot markets can rapidly spill over into energy derivatives.

Finally, unexpected margin calls can also affect market participants in other derivatives markets. The UK Gilt crisis in September 2022 raised questions about the ability of pension funds to deal with large margin calls, especially when exposed to sizeable derivative exposures (directly or through LDI funds).

Questions 26 to 42

Other NBFIs

Question 26. What are your views on the preparedness of NBFIs operating in the EU in meeting margin calls, and on the ways to improve preparedness, taking into account existing or recently agreed EU measures aimed at addressing this issue?

Please specify the NBFI sector(s) you refer to in your answer:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As regards ways to improve preparedness in meeting margin calls, a crucial question is what constitute high quality collateral.

At State Street we see clear advantages in allowing the use of MMFs units as collateral for meeting margin requirements in both non-cleared and cleared derivatives transactions. Margin calls were in fact a clear driver of MMF redemptions in both March 2020 the dash for cash and LDI stress event, with investors redeeming from MMFs in order to meet increased collateral requirements. This drove a large part of the outflows observed in both periods, and reversed once markets stabilized.

This procyclical dynamic, where investors redeem from one form of liquidity (i.e. MMF share) just to re-invest it into another (i.e. similar money market instruments), could be avoided if investors were allowed to post and accept MMF units as collateral in both bilateral and clearing transactions. In turn, this would benefit overall financial stability by reducing redemption pressures on MMFs and improving collateral management across the system.

The use of MMFs as collateral in bilateral, uncleared, transactions is technically permitted under current regulation, but it is in practice restricted by the punitive haircuts which apply, given that MMFs are treated as equities, instead of “looking through” their actual underlying assets which would imply a cash-like treatment instead.

The use of MMFs as collateral in centrally cleared transactions is instead currently prohibited because CCPs are not permitted to hold MMFs in the EU under the EMIR framework. We would encourage a continuation of this discussion beyond the current Consultation Paper, as the potential benefits in terms of reduced volatility and preparedness for margin calls would be significant for the financial system as a whole.

Question 27. What are relevant risk metrics or tools that can be used to effectively monitor liquidity and margin preparedness across all NBFI entity types?

Please provide examples specifying the sector you refer to:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

At State Street we carry out a daily review of margin and exposures. This review takes place prior to the commencement of the trading day and encompasses an assessment of all funds' exposures for that day.

Exposures are automatically computed indicating whether they are favorable to the broker or the fund. This information is subsequently communicated to the relevant brokers to facilitate an agreement regarding margin calls based on these calculations.

In a similar manner, margin calls received from brokers are also reviewed and addressed, contingent upon mutual agreement on the specifics.

In terms of preparedness, should any issues arise, particularly in the rare instance where systems fail to auto-calculate exposures, the matter is escalated to internal teams for urgent investigation. In the interim, a comprehensive manual workaround is executed to address margin calls and provide instructions based on the exposure results. Pre-agreed margin calls will continue to be fulfilled as usual.

Pension Funds

Question 28. How can current reporting by pension funds be improved to improve the supervision of liquidity risks (e.g. stemming from exposure to LDI funds, other funds or derivatives), while minimising the reporting burden? What can be done to ensure effective look-through capability and the ability to measure the impact of unexpected margin calls?

Please provide examples also for other NBFI sectors.

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 29. What would be the benefits and costs of a regular EU-wide liquidity stress test for pension funds and with what frequency?

What should be the role of EU authorities in the preparation and execution of such liquidity stress tests?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As stated in our response to Question 12, we don’t think regular stress tests should be conducted on specific funds at the EU level given the already existing frameworks for stress testing across the sector. State Street is in principle open to the idea of a EU-wide stress test exercise across the NBFI and bank sectors. If calibrated correctly, and minimizing as much as possible the compliance burden on firms, it could be a tool to articulate a system-wide approach to financial stability which doesn't look at the funds sector (e.g. MMFs or Pension funds) in a siloed way but takes into account the interconnectedness in the financial system. Such a EU exercise would be a positive addition to the current framework if:

i) Like the recent Bank of England System-Wide Stress Scenario (SWES), as starting point it is based on a clear policy question or market that is critical from an EU perspective (as it is the case of the Gilt market resiliency in the SWES),
ii) It includes all relevant market actors in the given market that regulators want to test,
iii) It is based on a aggregated and shared data across NCAs, rather than been additive in terms of reporting requirements.

If the challenges around design and data collection are addressed, a EU-wide stress test can be helpful in identifying where the actual risks lie within the system.

Short-term funding markets

Question 30. What would be the benefits and costs of creating a framework or a label in EU legislation for certain money market instruments (such as commercial papers) to increase transparency and standardisation?

Should the scope of eligible instruments to such framework/label be aligned with Article 3 of Directive 2007/16/EC?

If not, please suggest what criteria would you consider for identification of eligible instruments:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street supports greater standardization in the short term funding markets on the basis that it would help optimize liquidity, support intermediation in those markets and improve transparency for the end investors. All high-quality CP and CD should be eligible for asset purchase programmes, so as to allow dealers to finance positions at times of stress, regardless of the specific type of paper. A label could be a helpful step in achieving this outcome and greater standardization would help avoid inconsistent outcomes in the treatment of paper with the same credit quality.

We would like to refer to the response submitted by the Institutional Money Market Funds Association ("IMMFA") for a more in depth analysis of the issues we see in short-term funding markets.

Question 31. Would the presence of a wider range of issuers (notably smaller issuers) to fund themselves on this market, and therefore diversify their funding sources, be beneficial or detrimental to financial stability?

5000 character(s) maximum
including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We believe that the market for CP and CD paper is already vast in terms of issuers diversification. We note that the presence of smaller issuers doesn’t necessarily add to liquidity or stability of these markets, given that they then to have lower credit scores, are less transparency and less likely to issue frequently and in large volumes.

We would like to refer to the response submitted by the IMMFA for a more in depth analysis of the issues we see in short-term funding markets.

Question 32. What are your views on why euro-denominated commercial papers are in large part issued in the ‘EUR-CP’ commercial paper market outside the EU?.

What risks do you identify?.

Please provide quantitative and qualitative evidence, if possible:

5000 character(s) maximum
including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street does not see the fact that a large part of the euro-denominated CP is issued outside the EU as a problem or a risk, rather it is a sign of the depth and success of the ECP market which serves a global investor base.

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

5000 character(s) maximum
including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

When considering the liquidity of secondary markets, we suggest distinguishing between normal and exceptional market conditions. While true that activity in secondary markets may be low, given the buy-to-hold nature of money market instruments and their short maturity, which could suggest low-liquidity when using turnover-based metrics, the fact remains that when MMFs look to sell assets in normal market conditions, they will usually find a willing buyer.

For MMFs reforms to be meaningful and effective from a financial stability perspective, State Street believes that it is crucial that policymakers consider addressing underlying structural issues in short-term funding markets at times of stressed market conditions.

Despite significant market developments, short-term funding markets remain highly intermediated and dependent on banks for the provision of secondary market liquidity. However, as seen in March 2020, broker-dealers were either unable or unwilling to engage in discretionary market-making, resulting in MMF managers being unable to utilise secondary market liquidity. The withdrawal of broker-dealers may have been an unintended consequence of post-2008 prudential reforms which, while undoubtedly have improved the resilience of the banking sector, may have altered incentives regarding their market-making activities.

We would like to refer to the response submitted by IMMFA for a more detailed consideration of potential measures to increase liquidity of short-term funding markets.

Question 34. Considering market practice today, is the maturity threshold for ‘money market instruments’ (up to 397 days) in the Eligible Asset Directive 2007/16 sufficiently calibrated for these short-term funding markets?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street does not see a need to extend the current maturity threshold for money market instruments.

Question 35. Do you think there is a risk with the high concentration of this market in a few investors (MMF and banks)?

Please elaborate:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We think that the market is large with mitigating rules in place to limit high levels of concentration in funds.

We would like to refer to the response submitted by the IMMFA for a more in depth analysis of the issues we see in short-term funding markets.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We would like to refer to our response to Question 33 on ways to help dealers intermediate at times of stress.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street would like to point out that many Money Market Instruments, especially CP and CD, are over the counter instruments, traded bilaterally, and are not traded on an exchange or venue. This is primarily because given the costs of listing and the limited maximum maturity, the instruments are too short dated to make listings economically viable for the issuers.

More broadly, there is currently no one fits all platform that incorporates MMFs trades and not all sell sides houses either want to use a platform (and prefer to trade bilaterally due to costs) or they all use different ones. Finally, even for the instruments that are listed, admission to a trading venue does not in any case guarantee liquidity, as platforms themselves would not substitute for the role of dealers intermediation.

Question 38. Can the possibility to trade on a regulated venue increase the chances of secondary market activities in a systemic event, for instance by acting as a safety valve for funds that need to trade these assets before maturity (especially when facing strong redemption pressures, like for MMFs)?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

As explained in our previous responses, State Street does not believe that trading on a regulated venue is the solution for enhancing the liquidity of short-term funding markets.

If the goal of policymakers is to introduce a safety valve for funds that need to trade CP/CD before maturity, we would strongly suggest that it should be made possible for MMFs to deposit cash with a public facility able to absorb cash around reporting periods. This is already possible in the U.S. via the Federal Reserve's RRP facility, which allows continuous access at an appropriate pricing level.

Commodities markets

Question 39. How would you assess the level of preparedness of commodity derivatives market participants for each of the following sectors in terms of meeting short-term liquidity needs or requests for collateral to meet margins?

	1 (very low level of preparedness)	2 (low level of preparedness)	3 (medium level of preparedness)	4 (high level of preparedness)	5 (very high level of preparedness)	Don't know - No opinion - Not applicable
Insurance companies	◯	◯	◯	◯	◯	◯
UCITS funds	◯	◯	◯	◯	◯	◯
AIFs	◯	◯	◯	◯	◯	◯
Commercial undertakings	◯	◯	◯	◯	◯	◯
Investment firms	◯	◯	◯	◯	◯	◯
Pension funds	◯	◯	◯	◯	◯	◯

Please explain your answers to question 39:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 40. In light of the potential risk of contagion from spot markets or off-exchange energy trading to futures markets, do you think that spot market participants should also meet a more comprehensive set of trading rules for market participation and risk management?

Please elaborate on your response:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 41. How can it be ensured that the functioning of underlying spot energy markets and off-exchange energy trading activity does not lead to the transmission of risks to financial markets?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Other markets

Question 42. To what extent do you see emerging liquidity risks or market functioning issues that can affect liquidity in other markets?

- 1 - To a very low extent
- 2 - To a low extent
- 3 - To a significant extent
- 4 - To a high extent
- 5 - To a very high extent
- Don’t know / no opinion / not applicable

Please explain your answer to question 42, providing concrete examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

4. Excessive leverage

Excessive leverage is a significant vulnerability because it can act as a (hidden) risk amplifier (through position liquidation and counterparty channel) of several risks, such as liquidity, counterparty and concentration risks. While financial leverage is generally reported and visible by most NBFIs, detecting synthetic leverage via derivatives positions in some instances (such as through the use of other legal vehicles) can be very difficult. Nonetheless, derivatives are key for the provision of financial products by several NBFIs, such as insurance companies and pension funds, in particular those offering products driven by long-term guaranteed liabilities (e.g. some life insurance products or defined benefit pension plans).

There are some tools to deal with leverage, such as leverage limits (like the one used under Art. 25 AIFMD) or restrictions targeting the use of specific leveraged products.

4.1 Open-ended funds (OEFs)

Both UCITSD and AIFMD have requirements that restrict the use of leverage. The AIFMD (Art. 25) gives the possibility to NCAs to introduce leverage limits or other restrictions to leverage (such as yield buffers) for an individual fund or groups of funds. To date, two authorities have made use of the Article 25 in AIFMD to impose leverage limits by means of a yield buffer to GDP-denominated LDI funds (see introduction). Furthermore, the recent AIFMD review has introduced a structural (absolute) limit on leverage for loan-originating funds that will be applicable from 2026. In addition, competent authorities have been granted powers to introduce leverage limits for specific alternative investment funds (AIFs) under AIFMD Article 25.

In order to identify pockets of synthetic leverage, AIFMD and EMIR have introduced reporting requirements at fund and transaction level respectively, which should allow for a comprehensive view of synthetic leverage. Investment funds and their management companies also interact with other NBFIs and banks, and they are large players in global funding markets. There should be better understanding on what is the ability to detect leverage when using complex investment strategies involving, for instance, synthetic leverage via investment in other funds.

Questions 43 to 46

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

It is State Street's view that the existing tools in the EU to manage leverage risks in the funds sector are sufficient and more advanced compared to other jurisdictions. UCITS and AIFs are subject to stringent regulations that impose limits on leverage and ensure comprehensive risk management practices, which will be further enhanced after the full implementation of the recent AIFMD and UCITS review.

UCITS and registered funds do not employ significant leverage. UCITS funds are highly restricted in their use of leverage, with limits on borrowing capped at 10% and stringent exposure limits on the use of derivatives. New stringent leverage limits are being introduced also for loan originating AIFs. For AIFs, with article 25 of the AIFMD, there is already in the EU a macroprudential tool in place through which national competent authorities can impose leverage limits. This tool was already activated in Ireland targeting the property funds sector. This also suggest the existence of a strong and very sophisticated leverage framework in the EU funds sector.

As noted in our response to Question 5, State Street has supported work in the past to address concerns on transparency and lack of data on leverage. Beyond the funds sector, regulators should consider the broader ecosystem to correctly identify the source(s) of the leverage. In this sense, addressing any discrepancies with regards to quality and consistency of data that NCAs currently receive could help regulators to identify areas in the system where there is an accumulation of risk. We therefore suggest a consolidation across borders and within ESMA of the data already provided in the context of the AIFMD reporting.

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

* The yield buffer is defined as the level of increase in yields that a fund can withstand before its net asset value (NAV) turns negative. See The Central Bank's macroprudential policy framework for Irish-authorised GBP-denominated LDI funds, p.3.

5000 character(s) maximum
including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

The advantages can be considered to include consistency and ease of understanding for all managers, clients, and consultants regarding the requirements. However, a notable disadvantage has been the limited flexibility to evaluate funds on an individual basis.

Question 45. While on average EU OEFs are not highly leveraged, are there, to your knowledge, pockets of excessive leverage in the OEF sector that are not sufficiently addressed?

Please elaborate with concrete examples:

5000 character(s) maximum
including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response to Question 43. We believe that in the EU there is already a strong leverage framework and a comprehensive toolkit in place which allow supervisors and regulators to detect any pockets of excessive leverage in the funds sector.

From a public policy perspective, regulators should look for sources of leverage outside the funds sector, considering the broader NBFI ecosystem. In this sense, addressing any discrepancies with regards to quality and consistency of data that NCAs currently receive could help regulators to identify areas in the system where there is an accumulation of risk.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

4.2 Other NBFIs and markets

Leverage of other NBFIs can also create issues if not properly monitored and eventually managed. Reporting mechanisms play a key role to identify pockets of leverage and reconcile with ultimate beneficiaries, as well as to understand the interconnections, also in terms of counterparty risk management. While there is already transaction-level (e.g. EMIR and MiFIR) and entity-level reporting (e.g. Solvency II), the question is whether reporting can be improved in order to provide entities and supervisors involved with a timely picture of leverage to act upon, while minimising reporting burden. The role of highly concentrated intraday positions in derivatives markets, in a general context of low market liquidity (such as the 2022 energy crisis), in amplifying the effects of leverage (taken through the contractual terms of the derivative instrument) on market liquidity and volatility should be further explored.

Questions 47 to 51

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

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

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 49. Only for NCAs and EU bodies: Are you able to timely identify (financial and synthetic) leverage pockets of other NBFIs (such as pension funds, insurance companies and so on), especially when they are taken via third parties or complex derivative transactions?

Please elaborate on how this timely detection of leverage could be obtained:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 50. How can it be ensured that competent authorities can effectively reconcile positions in leveraged products (such as derivatives) taken via various legal entities (e.g. other funds or funds of funds) to the ultimate beneficiary?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Commodities markets

Question 51. What role do concentrated intraday positions have in triggering high volatility and heightening risks of liquidity dry-ups?

Please justify your response and suggest how the regulatory framework and the functioning of these markets could be further improved?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

5. Monitoring interconnectedness

While there are significant synergies in the interaction between various sectors of the financial system (with positive spillover effects on financial stability through more private risk sharing), more work is needed to identify and understand vulnerabilities stemming from (hidden) links between different NBFIs, and between banks and NBFIs, including in relation to risk of amplification and herding behaviours embedded in large portfolio overlaps[26]. This could be achieved through, for example, the conduct of an EU-wide stress tests across NBFI sectors and between NBFIs and banks. Other jurisdictions have also been cognisant of the risks that interconnection may bear to financial stability in certain cases and are trying to get a better understanding of related vulnerabilities with system-wide stress tests. For instance, the UK has recently launched the idea of a System-Wide Exploratory Scenario (SWES), which aims to improve understanding of how banks and NBFIs react to stressed financial market conditions and how those behaviours amplify shocks in financial markets and instability[27].

In the EU, a system-wide EU stress test could simulate the impact of different scenarios on various NBFI sectors: funds, asset management companies, insurance, pension funds, large investment firms and key market infrastructures. The stress test could be done on a periodic basis (e.g. annually) and possibly use also stress test data on banks regularly run by EBA to simulate stress scenarios across all the sectors of the financial system. The stress test could include the impact of margin calls based on existing methodologies, in particular those of the EU CCP supervisory stress test conducted by ESMA. Moreover, the recent EMIR review introduced the Joint Monitoring Mechanism (JMM), which is, among other things, tasked with contributing to the development of Union-wide stress tests for the resilience of CCPs[28]. A broader EU-wide stress test could be based on a similar model, while exploring a greater role for horizontal bodies, such as the Joint Committee of the ESAs, as the stress test would cut across all NBFI sectors. The

ESRB could provide support on defining methodologies and stress scenarios, as it currently does for OEFs. The ESAs could be also in charge of data collection from NCAs. This exercise could follow some governance principles already laid out in existing system-wide exercises in the EU, such as the one-off Fit-for-55 climate risk scenario analysis[29].

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[26] Large and systematic portfolio overlaps among banks and non-banks can lead to co-movement in prices and even fire sales of assets when entities react in the same way during a systemic event. Moreover, portfolio overlaps are not generally visible, unless data is cross-checked between sectors to estimate the influence that indirect exposures can have on systemic risk.

[27] There are just over 50 participants in the SWES – including banks, insurers, central counterparties, funds managed by asset managers, hedge funds, and pension funds. The Bank of England works closely with the Financial Conduct Authority, the Pensions Regulator, and other domestic and international regulators on the SWES. See system-wide exploratory scenario, Bank of England.

[28] The JMM comprises representatives from ESMA, EBA, EIOPA, ESRB, ECB, SSM and central banks of issue other than the Euro and is chaired by ESMA. Amongst its tasks are monitoring of compliance with the active account requirement; monitoring of the cross-border implications of client clearing relationships, including interdependencies and interactions with other financial market infrastructures; contributing to the development of Union-wide assessments of the resilience of CCPs focussing on liquidity, credit and operational risks concerning CCPs, clearing members and clients; identification of concentration risks, in particular in client clearing. In order to perform its tasks, the JMM can request information from NCAs and financial market participants, where the NCA so agrees.

[29] The one-off fit-for-55 climate risk scenario analysis aims to assess the resilience of the financial sector in line with the Fit-for-55 package, and to gain insights into the capacity of the financial system to support the transition to a lower carbon economy under conditions of stress. The one-off exercise is part of the new mandates received by the EBA in the scope of the European Commission's Renewed Sustainable Finance Strategy. Given its cross-sectoral and system-wide, this exercise is conducted with the collaboration and coordination of the other European Supervisory Authorities (ESAs), the European Central Bank (ECB), and the European Systemic Risk Board (ESRB). One-off Fit-for-55 climate risk scenario analysis, European Banking Authority

Questions 52 to 56

Question 52. Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We do not have concrete examples of potential risks and generally we consider that the existing counterparty risk framework in the EU adequately captures exposure risks from banks to non-banks.

As noted to our response to Question 2, we would like to point out that the EBA has been tasked in the CRR III to submit by 31 December 2027 a report to the EU Commission on the relative contribution of non-bank entities to the credit exposures of banks, including the appropriateness of potential aggregate limits or tighter limits to individual exposures. We consider that this question should be addressed in that context, with the recognition that different bank business models vary significantly in their risk profiles.

Question 53. What are the benefits and costs of a regular EU system-wide stress test across NBFI and banking sectors?

Are current reporting and data sharing arrangements sufficient to perform this task?

Would it be possible to combine available NBFI data with banking data? If so, how?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

We believe that the concept of interconnectedness of the funds sector to other parts of the financial system deserves more scrutiny and will need to be substantiated by a more detailed analysis before moving to policy considerations.

State Street is in principle open to the idea of a EU-wide stress test exercise across the NBFI and bank sectors. If calibrated correctly, and minimizing as much as possible the compliance burden on firms, it could be a tool to articulate a system-wide approach to financial stability which doesn’t look at the funds sector in a siloed way but takes into account the interconnectedness in the financial system.

Such a EU exercise would be a positive addition to the current framework if:
i) Like the recent Bank of England System-Wide Stress Scenario (SWES), as starting point it is based on a clear policy question or market that is critical from an EU perspective (as it is the case of the Gilt market resiliency in the SWES),
ii) It includes all relevant market actors in the given market that regulators want to test,
iii) It is based on a aggregated and shared data across NCAs, rather than been additive in terms of reporting requirements.

If the challenges around design and data collection are addressed, a EU-wide stress test can be helpful in identifying where the actual risks lie within the system.

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

Please elaborate:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 55. What governance principles already laid out in existing system-wide exercises in the EU, such as the one-off Fit-for-55 climate risk scenario analysis or the CCP stress tests conducted by ESMA, could be adopted in such system-wide stress test scenario?

Please elaborate:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 56. Only for NBFIs and banks: In your risk management practices, do you run stress tests at group level, and do you monitor the level of interconnectedness with (other) NBFIs (within and beyond your own sector; e.g. portfolio overlaps)?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street Global Advisors periodically reviews and performs enterprise level scenario analysis to determine and assess the firm's overall assets sensitivities to different market environments as well as individual factor shocks (increase in volatility, widening spreads etc). In addition, a variety of stress tests, encompassing both historical and theoretical market and economic scenarios, are conducted regularly by the Investment Risk team at each investment level and are reported to the portfolio management teams, where outliers are discussed.

For individual Money Market Funds stress testing, the rigorous scenarios that we run the funds through involve a variety of input factors that do depend on interconnectedness as well as those that are market driven. Rating migration as well as default and respective recovery rate are inputs that are stressed to the fund before market shocks are applied. Securities are stressed as if they were to be downgraded as well as if they were to default. The interconnectedness of migration and default/recovery applies to all funds in every scenario. We then apply market shocks of credit spreads and interest rate shocks which provide a final NAV output.

6. Supervisory coordination and consistency at EU level

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. This raises important questions on how to ensure effective coordination among Member States, especially during systemic events affecting more than one Member State, while ensuring autonomy to competent authorities. Sharing data among authorities in charge of macroprudential supervision under the current reporting frameworks is also key, as well as monitoring links with unregulated entities (e.g. family offices, supply chain or real estate finance companies). For instance, supervisory coordination could include more timely use of macroprudential tools to reduce the level of exposure or the excessive leverage.

6.1 Open-ended funds (OEFs)

Considering that asset managers operate in multiple countries, often by passporting the same fund or creating funds with similar characteristics in different EU Member States, coordination in the supervisory action and in the use of micro and macroprudential tools is key.

ESMA, together with the ESRB, receive information about NCAs' actions under its remit to monitor, assess and measure systemic risk. For instance, during the COVID-19 crisis, ESMA held bi-weekly meetings and received data voluntarily shared by NCAs to monitor the suspensions, availability, and activation of LMTs, including sharing information on cases with cross-border elements.

Moreover, coordination is crucial for the application of macroprudential tools during crises to prevent additional spillover effects across multiple markets. However, this coordination, engagement with stakeholders and use of macroprudential tools should be agile and of high quality, as fund managers may be fully occupied during times of crisis with managing liquidity under redemption pressures.

6.1.1 An enhanced coordination mechanism (ECM) for adoption of macroprudential measures and conflict resolution

Building on the mechanism provided for by Article 25 AIFMD for limits on leverage, 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. While NCAs could remain responsible for their adoption (this list could include the power to suspend redemption rights, additional liquidity buffers for MMFs, leverage restrictions and so on), they would need to obtain beforehand the opinion of ESMA (after consulting the ESRB) and explain any deviation therefrom. This ESMA opinion could also be addressed to NCAs of other Member States, if the measure would be relevant for more than one Member State. Moreover, ESMA, after consulting the ESRB, could also be given the power to initiate an opinion to a single or multiple NCAs in one or more Member States in relation to the adoption or lack of adoption of a given NMM.

On implementation and conflict resolution in relation to a given macroprudential measure, a better coordination system could include a mechanism whereby the host NCA (on the ground of financial stability risks in a given EU Member State) or ESMA (where financial stability risks may arise for a large number of Member States), after consulting the ESRB, could initiate a procedure to request the home NCA to rectify a potentially inadequate, or introduce a missing macroprudential measure (a similar mechanism like this exists today, under Article 50 AIFMD, but it is limited to the power to suspend redemption rights). ESMA, after consulting the ESRB, could issue an opinion in case the home NCA does not act satisfactorily.

6.1.2 Supervisory coordination powers for large asset management companies

ESMA could be given specific coordination powers over large asset management companies, with the day-to-day support and supervision left to NCAs under ESMA guidance. In particular, ESMA could be given enhanced coordination role over the supervision conducted by competent authorities (similar to the ESMA CCP Supervisory Committee model[31]). This means that NCAs would remain responsible for the supervision of investment funds authorised in their jurisdiction. However, amongst others, they would need to obtain the opinion of ESMA prior to the adoption of certain decisions and explain any deviation therefrom. ESMA, among other, would be competent to initiate and coordinate Union-wide stress tests, to initiate and conduct peer review analyses of NCAs.

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[30] EMIR 2.2 established the CCP Supervisory Committee within ESMA to prepare draft decisions for adoption by the Board of Supervisors, where ESMA is required to take a decision in relation to EU and third-country CCPs. It is composed of the Chair and the two independent members of the CCP Supervisory Committee, NCAs that supervise CCPs (i.e. not from all Member States) and central banks of issue (the latter non-voting). The supervision of EU CCPs remains with the national supervisors. However, NCAs need to submit their draft decisions (e.g. on authorisation) for an opinion to ESMA, and explain any deviation therefrom. ESMA conducts peer reviews, can initiate and coordinate Union-wide stress tests, etc.

Questions 57 to 64

Question 57. How can we ensure a more coordinated and effective macroprudential supervision of NBFIs and markets?

How could the role of EU bodies (including ESAs, ESRB, ESAs Joint Committee) be enhanced, if at all?

Please explain:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street believes that to achieve the broader objective of assessing financial stability risks related to liquidity mismatches, the use of leverage and interconnectedness beyond the funds sector, regulators should give priority to solving any discrepancies with regards to quality and consistency of data.

The goal should be to consolidate data that NCAs currently receive into a single database for capital markets administered by ESMA and accessible to the ECB/ESRB. Through this data hub regulators could more easily identify areas in the system where there is an accumulation of risk, or where gaps in the existing reporting necessitate enhancements. We therefore suggest a consolidation across borders and within ESMA of the data already provided in the context of the AIFMD/UCITS reporting.

Enhanced coordination mechanism (implementation and adoption of NMMs)

Question 58. How could the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs by NCAs or ESAs (such as leverage restrictions or powers to suspend redemption on financial stability grounds) be improved?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street would like to point to the example of the coordinated actions taken by the Central Bank of Ireland (CBI) and the Luxembourg’s CSSF in April 2024 to introduce an aligned set of measures to address excessive leverage in GBP-denominated LDI funds authorized in the two countries. These actions were justified by the cross-border nature of these funds and the impact that they caused during the LDI stress in the UK. These coordinated measures suggest to us that the current framework already allows for the implementation of macroprudential measures on leverage in a coordinated way across Europe.

Question 59. What are the benefits and costs of introducing an Enhanced Coordination Mechanism (ECM), as described above, for macroprudential measures adopted by NCAs?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 60. How can ESMA and the ESRB ensure that appropriate National Macroprudential Measures (NMMs) are also adopted in other relevant EU countries for the same (or similar) fund, if needed?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 61. Are there other ways of seeking coordination on macroprudential measures and possibly of reciprocation?

What could this system look like?

Please provide concrete examples/scenarios, and explain if it could apply to all NBFI sectors or only for a specific one:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our answer to Question 57.State Street does not support an entity-based supervision of asset management companies.

Entity-based supervision has its origins and rationale in the banking sector, where banks' own balance sheets, if poorly managed, could generate negative impacts on the sector and the wider economy. On the contrary, asset management is by definition an agency business, where the manager invest the assets on behalf of its investors and following a clear investment strategy. Any loss or profit generated belongs to the investor and doesn't impact the management company's balance sheet, which tends to be small and uncorrelated with the many investment funds it manages, each with its own investment policy. Size, as expressed in terms of asset under management (AUM), is also uncorrelated with the potential risk that an asset manager may pose to financial stability. Even in the event that one of the investment funds would have to be liquidated, this would not impact the resiliency of the remaining funds under management.

Overall, State Street believes that activity and product-based regulation remains the best approach for monitoring and addressing risks that may arise in the asset management industry.

Moreover, management companies in the EU are already currently authorized and supervised by a home supervisor, and for groups that operate across the EU through subsidiaries, these are also locally supervised. We understand that in certain situations this may result in fragmentation, and we would therefore be supportive of considering ways and options to enhance the cooperation and coordination amongst supervisors with the goal to streamline supervision over management companies and ease cross border marketing, product, and conduct supervision.

Supervisory powers of EU bodies

Question 62. What are the benefits and costs of improving supervisory coordination over large (to be defined) asset management companies to address systemic risk and coordination issues among national supervisors?

What could be ESMA's role in ensuring coordination and guidance, including with daily supervision at fund level?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response to Question 62. Overall, State Street believes that activity and product-based regulation remains the best approach for monitoring and addressing risks that may arise in the asset management industry.

Question 63. What powers would be necessary for EU bodies to properly supervise large asset management companies in terms of flexibility and ability to react fast?

Please provide concrete examples and justifications.

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response to Question 62. Overall, State Street believes that activity and product-based regulation remains the best approach for monitoring and addressing risks that may arise in the asset management industry.

Question 64. What are the benefits and costs of having targeted coordinated direct intervention powers to manage a crisis of large asset management companies?

What could such intervention powers look like (e.g. similar to those in Article 24 of EMIR)?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Please refer to our response to Question 62. Overall, we consider that NCAs already have intervention powers.

6.2 Other NBFIs and markets

Fostering coordination among EU authorities (ESRB, ESMA, EIOPA and EBA, as well as ECB and the Single Supervisory Mechanism) and between EU authorities and national macroprudential authorities in macroprudential oversight is important due to the complexity of NBFIs and the markets in which they operate, as well as the involvement of multiple supervisors across sectors. More coordination may imply mechanisms to coordinate and provide guidance for the adoption and implementation of macroprudential measures, but also executing and overseeing stress tests, and guiding national macroprudential authorities in data collection. The mechanism could be designed as the enhanced coordination mechanism (ECM) described in section 6.1 (for insurance and pension funds that mechanism could be managed by EIOPA). Alternatively, NMMs could be also subject to an ex-ante objection procedure by the European Commission, based on the opinions of the ESRB and ESMA/EIOPA.

In commodities markets, moreover, there is the additional complexity due to the interlinkages between spot and derivatives markets. This consultation paper wants to explore whether a more integrated system of supervision that is able to supervise both physical and financial infrastructure of the commodity futures exchange is needed. For instance, the delivery rules of commodities exchanges are key for physical-futures price convergence of benchmark front-month forward contract prices (and so for the price of futures contracts) in a large number of (storable) commodities markets.

Questions 65 to 68

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

Question 65.1 Please explain what are the pros?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 65.2 Please explain what are the cons?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

ESAs and ESRB's powers during emergency situations

Question 66. What are the benefits and costs of gradually giving ESAs greater intervention powers to be triggered by systemic events, such as the possibility to introduce EU-wide trade halts or direct power to collect data from regulated entities?

Please justify your answer and provide examples of powers that could be given to the ESAs during a systemic crisis:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street believes that investment managers, in pursuing their fiduciary duty, remain best placed to activate and calibrate LMTs on the basis of their fund's investment strategy and portfolio liquidity.

As recommended by the FSB in its 2023 report on "Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds", at times of major market dislocation and stress, rather than mandating direct intervention, it is preferable that authorities adopt an approach based on enhanced guidance /engagement with fund managers. We note in fact that ESMA is currently working on a set of technical standards and guidance on LMTs which will clarify and help NCAs determine when to suspend funds in exceptional circumstances.

It is important to remember, however, that the power of NCAs to impose suspension of a fund will by definition impact only investors in that specific funds, and not other investors in the same asset class, with the risk that the intervention will always be perceived as unfair and ineffective.

Integrated supervision for commodities markets

Question 67. What are the benefits and costs of a more integrated system of supervision for commodities markets where the financial markets supervisor bears responsibility for both the financial and physical infrastructure of the commodity futures exchange, including the system of rules and contractual terms of the exchange that regulate both futures and (cash/physical) forward contracts?

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

International coordination

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

Please provide examples:

5000 character(s) maximum

including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

State Street would like to suggest that EU prioritizes work at the FSB level on:

- completing the data pilot project to enhance authorities' and the FSB's ability to monitor vulnerabilities associated with open-ended fund liquidity mismatch;
- work on the functioning and resilience of repo markets, and
- address vulnerabilities identified in short-term funding markets at the EU level.

Annex: Overview of tools for NBFI with a macroprudential function in EU legislation

You will find a preliminary list of macroprudential tools for NBFI in the annex to the consultation document.

Additional information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) below. **Please make sure you do not include any personal data in the file you upload if you want to remain anonymous**.

The maximum file size is 1 MB.
You can upload several files.
Only files of the type pdf,txt,doc,docx,odt,rtf are allowed

Useful links

More on this consultation (https://finance.ec.europa.eu/regulation-and-supervision/consultations-0/targeted-consultation-assessing-adequacy-macroprudential-policies-non-bank-financial-intermediation_en)

Consultation document (https://finance.ec.europa.eu/document/download/ddd6c515-3796-4db3-b91d-88a1a64acf07_en?filename=2024-non-bank-financial-intermediation-consultation-document_en.pdf)

More on macroprudential policies for non-bank financial intermediation (NBFI) (https://finance.ec.europa.eu/capita markets-union-and-financial-markets/financial-markets/macroprudential-policy/macroprudential-policies-non-bank financial-intermediation-nbfi_en)

Specific privacy statement (https://finance.ec.europa.eu/document/download/9bc66a3b-2fb3-4340-a268-9d46aade55f7_en?filename=2024-non-bank-financial-intermediation-specific-privacy-statement_en.pdf)

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