Feedback statement of
Bundesverband Alternative Investments (BAI e.V.)
to the European Commission ("EC") targeted consultation document
ASSESSING THE ADEQUACY OF MACROPRUDENTIAL POLICIES FOR NON-BANK FINANCIAL INTERMEDIATION

I. General comments

Bundesverband Alternative Investments e.V. (**BAI**) welcomes the opportunity to respond to this consultation paper on NBFI. As an industry association we represent more than 300 national and international members active in the institutional alternative investments sector (i.a. infrastructure, private equity, private debt, liquid alternatives). Our responses therefore primarily focus on sections and questions related to (alternative) investment funds.

Before commenting on the various questions of the CP we would like to make some general remarks on the concept of NBFI, the role of funds in this context and the regulatory framework for funds in the EU.

As already pointed out in the workshop in May, we have strong reservations against the framing "bank" vs. "non-bank" within the NBFI debate. In the industry sector no one would contrast for example the "automotive industry" with the "non-automotive industry". Business models and related risks are too different to apply a "one size fits all" approach to the very wide range of institutions covered currently by the term NBFI. Thus, we support the initial finding of DG FISAM that such an approach is inappropriate. However, especially with regard to activities of funds and their manager we still see incorrect assumptions and conclusions as that this industry in only lightly or less regulated compared with banks and that non-bank regulation is in some way inferior to that for banks.

We therefore ask the Commission to acknowledge both: the different business models and related risks on the one hand and the proper and prudential regulation of funds in the EU on the other hand. Both banks and investment funds are highly regulated players on the financial markets; however, they differ fundamentally in terms of their business activities. There are <u>regular interactions between banks and investment funds, which vary greatly in detail, and in some areas they compete with each other</u>. This is one of the reasons why investment funds - alongside other players - have become subject of the NBFI debate.

Traditional banking activities are the deposit business (i.e. the acceptance of other people's money as a deposit), the lending business (i.e. the granting of loans), the provision of guarantees or the issuing business. <u>The activity of an investment fund, on the other hand, consists of collecting capital from a number of investors in order to invest it in accordance with a defined investment strategy for the benefit of these – predominantly long-term - investors</u>. In return, the investors receive shares in the fund, which they may or may <u>not</u> be able to redeem before the liquidation or expiry phase, possibly with restrictions depending on the structure of the fund (open or closed). Investment funds are generally <u>not</u> permitted to engage in other activities.

When comparing the two business models, it is noticeable on the one hand that the provision of capital in investment funds is always subject to a - sometimes very detailed - earmarking, namely in accordance with the fund's defined investment strategy. Fund units are therefore usually acquired with a medium or long-term investment horizon, e.g. for retirement provision. The assets in which investments are made are selected accordingly. For this reason, there is typically **no so-called maturity transformation** and there is a strong alignment of interest between the investors and the fund management. **And in addition, there are strict provisions as well for liquidity management, especially now under the amended AIFMD framework.**

Furthermore, an investment fund is a pool of segregated assets that is protected against access by the asset management unit, but also against access by creditors - even in the event of the management company's insolvency.

In contrast to conventional bank deposits, there are no - capped - guarantees for the capital contributions of fund investors, such as those provided by the statutory or voluntary deposit protection schemes of the banking industry, **i.e. investors must be prepared and have to bear potential losses**! The value of the share in a fund can therefore fluctuate due to fluctuations in the value of the invested assets, but a total loss is almost unlikely due to asset and risk diversification. Even in loss scenarios, however, no contagion effects on other market participants are to be expected, unless the fund has financed the assets to a considerable extent through leverage, which is only possible for certain types of funds and only under strict regulatory requirements like AIFMD (including leverage limit, disclosure of the largest lenders, etc.). And of course leverage providers (i.e. bank) are themselves subject to a strict risk management regime.

For the sake of completeness we would like to highlight as well dedicated findings in papers of e.g. FSB[1], ESRB[2], ECB[3] in which they acknowledge the different business models of the NBFI sector, especially funds, which is the main reason to treat/regulate them different than banks. But it is not just the business model itself which justifies different treatment and regulation, it's as well the investor base and also the balance sheet of funds and other NBFIs which justify a very different regulatory approach. The ECB in the abovementioned strategy review focussed on the balance sheet i.a. of funds compared to banks, which are obviously quite different and in combination with the investor base of typical AIFs in the EU (i.e. professional, long-term investors) we believe that **right now, especially as the revised AIFMD framework entered into force including sound and comprehensive provisions for liquidity management tools, leverage limits, etc., the EU should clearly emphasize not just the great importance of the fund industry financing the energy transition and the European economy, but also the effectiveness and robustness of the regulation for this sector.**

The aforementioned structural differences between funds and banks (limited scope for activity, asset and liability segregation, medium or long-term investment horizon of investors, liquidity management tools, no or only low leverage) have been obvious since the beginning of the NBFI debate. The fact that investment funds were nevertheless included in this debate and the regulatory evaluation was nevertheless correct and consistent in order to work out the connections between the various players and their activities on the one hand, but also to recognize where players carry out activities that have nothing to do with conventional banking business, especially credit intermediation, or only in narrow sub-areas, on the other hand. Now, after so much work has been undertaken and after a comprehensive and balanced regulatory framework for (alternative) investment funds is in place, **it is now the time to have a more distinct view and approach**

[1] Global Monitoring Report on Non-Bank Financial Intermediation, 2023
[2] NBFI Monitor No 9 / June 2024
[3] ECB Strategy review, No 270 / September 2021, Non-bank financial intermediation in the euro area: implications for monetary policy transmission and key vulnerabilities, Occasional Paper Series, revised December 2021

regarding investment funds and not to introduce new/further regulation for that industry. It would be detrimental to undermine right now the (new) regime, which is obviously the result of a very detailed and thoroughful legislatory process, by imposing new/further requirements in the course of a very broad NBFI discussion, compared to the very focussed debate on AIFs and LMTs as it was made i.a. within the AIFMD review.

Thus, it is absolutely crucial that the Commission acknowledges and emphasizes that there is comprehensive and appropriate regulation of collective investment schemes – especially here in Europe (UCITS, AIFMD, etc.) – in place which allows not only appropriate authorisation and ongoing supervision of these entities (including capital/own funds requirements, risk and liquidity management requirements, organisational requirements, transparency requirements), but which also grants in addition comprehensive rights toward competent authorities, including for example collection of all type of information regarding alternative investment funds, their managers and also counterparties, the setting of leverage limits for alternative investment funds under AIFMD, etc.

II. BAI answers to the CP questions

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?

In our function as industry association for the alternative investments sector our comments refer predominantly to (alternative) investment funds. They are - especially here in the EU - highly regulated themselves and furthermore operate in highly regulated markets and - to a very large extent - have highly regulated institutional investors as insurance undertakings, pension funds, occupational pension schemes, etc. We therefore aks also the EU Commission to relativize the assessment of potential systemic risks stemming from our industry and thus we do not see other sources of systemic risks related to our industry. One outcome of the CP should be to reframe the terms of this debate to recognise that the European funds industry does not pose a distinct or unique set of risks to credit institutions' balance sheets.

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

With our focus on (alternative) investment funds we do not see that they pose significant risks to credit institutions. Especially with regard to the business model of funds and their - institutional - investor base they act within a robust envirionment and are able to absorbe potential shocks.

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?

1 - To a very low extent

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:

We do not see that the failure of (alternative) investment funds could significantly affect the provision of critical functions to the real economy or the financial system. Investment funds can go out of business or become insolvent without any impact on markets.Their investors would have to bear any potential losses. Credit institutions as potential counter parties have to manage relevant risks and this is addressed by the complex banking regulation.

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?

We do not see that a particular NBFI sector is the one source for the materialisation of (new) systemic risk. Especially our industry within the modernised and extended AIFMD regime operates in a robust framework.

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:

We do not believe there is a sound definition or concept of 'excessive leverage', 'hidden leverage', etc. The use of these terms is very misleading. We do not recognise either of these terms as valid descriptions or meaningful measures for asset managers, or the regulatory bodies or academics promulgating them, to use or refer to. In the context of investment funds, our understanding of the term "excessive" is that it should be applied to any situation where there are greater than normally expected levels of leverage or of redemption requests. We are confident that the modified regulatory requirements that apply under the AIFMD or the UCITS Directive and related legislation are appropriate and now should be applied and tested first, before new regulation etc is introduced.

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:

The unrelenting focus on perceived risks in NBFIs, especially asset managers and funds, despite many rounds of rulemaking is a major threat to their ability to provide funding to the real economy. NBFIs such as asset managers and the funds they manage are subject to extensive prudential, conduct, financial stability and reporting rules. The continued search for risks they might pose, despite any compelling evidence to prove those risks actually exist, is undermining confidence in this key sector. The continual negative focus by international, EU-wide and national central banks on possible risks from NBFIs only serves unnecessarily and irrationally to undermine confidence in a key element of the EU's financial architecture which serves the needs of the EU's real economy.

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?

As stated above the EU Commission should acknowledge the recent changes to the AIFMD and UCITS Directive which have so recently been approved by the co-legislators who had the opportunity to take into account various topics around NBFI from regulatory bodies as the FSB, the ECB, ESMA and the ESRB. On this basis no further measures or initiatives should be initiated in a legislatory frame which just entered into force and now should stand the test of time. ESMA's current work developing the level 2 requirements must also respect these recently revised directives.

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?

OEFs and their managers already have extensive ex-ante tools available to ensure no unmitigated liquidity risks are built into OEFs. There are thorough-going rules on how OEFs must be designed so that dealing frequency and redemptions are coherent with the liquidity profile of the underlying assets as well as the needs of the target investors. They also have access to a very wide range of LMTs to manage any liquidity stresses that might emerge. As we allude to in our response to question 11, this access to such tools has recently been strengthened by the AIFMD Review Directive.

NCAs should also use the tools they have, be they when authorising OEFs or supervising these on-going requirements, rather than assuming further tools or interventions are necessary. For example, NCAs should make use of the twice yearly UCITS risk reporting and the Annex IV reporting of AIFs.

Question 17. : What is the supervisory Only for NCAs and EU bodies 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?

Typically managers will:

• Determine asset liquidity by simulating the time it would take to liquidate each asset in full in both stressed and normal conditions;

• Assess fund liabilities such as redemption scenarios, investor types and concentrations and likelihood and magnitude of possible margin calls; and

• Combine those to determine the redemption coverage ratio which is the extent to which portfolio positions could be converted to cash to cover redemptions over a range of time horizons.

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?

LMTs are applied on a fund-by-fund basis by managers who have a full understanding of their underlying characteristics and the investors in them. Given this, uniformity in the use of LMTs should not be a regulatory goal as it may lead to LMTs being applied unnecessarily in some funds and provide more sophisticated investors with the ability to anticipate redemptions to the detriment of others.

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

Stress testing represents an important tool within the liquidity risk management framework, allowing risk managers to ensure that a fund can meet redemptions in a range of environments. To analyse the impact stressed markets on the liquidity of a portfolio, risk managers should consider the liquidity in light of redemptions in both normal and stressed market conditions. Stresses can be applied to assets, fund redemptions, other fund liabilities or a combination of these, depending on the intended scenario. The outcome will provide the liquidity risk managers with insights on how different liquidity stress scenarios may impact the funds and hence will contribute operational readiness to mitigate these. In stressed markets, some data can become misleading or unsuitable for decision-making, especially during periods of extreme volatility. When previous data is no longer reliable, a back-to-basics approach is essential for managing fund flows and redemption requests. Simple, time-tested data becomes invaluable when new liquidity data lacks a proven track record, and trading volumes are unreliable. The following data becomes particularly important:

• Historical redemption requests in stressed periods (if available);

• Unencumbered cash;

• Pro rata liquidation;

• Redemption coverage ratio.

Stress testing involves simulating various adverse scenarios to assess the impact on an institution's liquidity position. This can help identify potential vulnerabilities and ensures preparedness for different stress conditions.

Question 21. : What difficulties Only for asset managers 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?

Average daily trading volumes are a central input to market participants' liquidity risk stress testing. They give a sense of the volume of instruments that can be traded without the need to sell below the market price. One challenge market participants face is that the ability to carry out a similar assessment for fixed income securities is constrained by the poor quality of post-trade fixed income market data. It is fragmented and inconsistent, making it difficult to utilise and of limited use to our stress testing models.

We therefore welcome efforts to implement a consolidated tape for the EU. Once operational, the tape will help to improve the simulation of liquidity risk through greater transparency in OTC bond and derivatives markets. Having the most up to date market data is central to liquidity stress testing. Importantly, the tape should also help to avoid instances of broker pricing becoming stale where the price data on screen differs from the prices of actual trades (as happened in March for example).

A second challenge relates to limited visibility into omnibus accounts for OEFs. Fully liquidity stress testing a fund requires understanding of how its underlying investors might behave. For institutional investors, it is possible for asset managers to open a dialogue and anticipate their liquidity needs. For retail funds, or those that are intermediated by distribution networks, modelling investor behaviour is more complicated, as the aggregation of flows limits managers' visibility of the end-investor. Therefore, policymakers should consider convening a working group of all actors involved in the fund distribution chain, with a view to determining the viability of improving the flow of critical information on underlying investors. The group should also consider any potential unintended consequences for the competitiveness of European funds that rely on ex-EU distribution. Specifically, data on the types of investors transacting in omnibus accounts, the size and concentration of investor holdings, and industry-wide data on historical worst-case redemptions would all help better inform manager assessments of potential redemption patterns.

Nevertheless, as regards liquidity mismatches, we hope that the ongoing revisions to the Regulatory Technical Standards and guidelines regarding LMTs called for under the AIFMD Review Directive will result in the consistent availability of the nine listed LMTs to address any liquidity mismatches in OEFs. These revisions should be allowed sufficient time to take effect before considering whether any additional measures might be required. We also hope that ex ante liquidity management tools that do not meet the four corners of those RTS and guidelines will continue to be permitted where managers choose to employ them.

Accurate and timely data is essential for effective liquidity risk management. However, obtaining high-quality data in real-time can be difficult, leading to potential gaps in monitoring. Designing stress tests that accurately reflect potential market conditions is complex. It requires sophisticated models and assumptions, which can be challenging to validate and calibrate.

The EU has implemented several tools and regulations to address liquidity mismatches:

• The EU has frameworks in place, such as the UCITS Directive and AIFMD, which include provisions for liquidity management and risk monitoring, and now under the AIFMD Review Directive, will mandate the availability of nine types of LMTs such as swing pricing, redemption fees, dilution levies, in-kind redemptions, and suspension of dealings to manage liquidity risks in investment funds and the selection of at least two LMTs from those nine types by the fund manager for each AIF/UCITS with limited exceptions.

• EU regulations mandate regular liquidity stress testing for investment funds to ensure they can withstand adverse market conditions.

• Authorities require detailed reporting on the liquidity profiles of funds and enhanced disclosure to investors about liquidity risks and the use of LMTs.

• The ESRB recommends a diverse set of macroprudential liquidity tools to address systemic risks, including guidelines for stress testing and the use of anti-dilution tools.

• We understand that while these tools and regulations provide a robust framework for managing funds' liquidity risks, their effectiveness depends on proper implementation and continuous adaptation to evolving market conditions.

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

Data availability is the main challenge. As noted in response to Q. 21, better data would improve estimates of end-investor behaviour and redemption patterns. The limitations of market data also impact estimates of margin calls, where it can constrain managers' ability to assess market dynamics that drive margin calls.

However, beside this, a major challenge market participants face in calibrating worst-case and stress-case scenarios related to redemptions and margin calls, is the limited information made available to them by intermediaries, especially CCPs.

We welcome the changes introduced in the recent review of the European Market Infrastructure Regulation ("EMIR") which provide that CCPs will provide information to clearing members in order to allow their clients receive required levels of transparency on margin calls and CCP margin models. We note that ESMA, in consultation with European Banking Authority and the European System of Central Banks, will develop regulatory technical standards specifying the scope and format of the exchange of information between CCPs and clearing members and between clearing members and their clients. We welcome the fact that the new rules will enable firms to get a better understanding of their future potential liquidity needs when clearing centrally by requiring margin models to be more transparent. We agree that it is easier for a firm to plan liquidity needs if it can understand what sort of margin calls it may face, particularly in a situation of stress.

We continue to call for standardisation of CCP disclosures and implementation of audit requirements to ensure those disclosures are accurate, consistent, and timely. Improving the quality of the data in these feedback loops will be central to enhancing the sophistication and accuracy of market participants' stress testing models. We also note behavioural factors as a challenge: predicting investor behaviour during stress events is complex. Panic selling or herd behaviour can exacerbate liquidity issues and are difficult to model accurately.

As already noted, model assumptions used in stress testing models, such as correlations and volatilities, may not hold true in extreme market conditions. Different jurisdictions may have varying regulatory requirements for stress testing, making it challenging for global institutions to comply uniformly.

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:

Our response relates to AIFs (and UCITS) and their managers. However, all types of relevant financial institutions should have in place robust governance for managing margin and collateral calls, thorough-going stress-testing, in depth reviews of their collateral management arrangements to ensure its availability and regular engagement with counterparties.

AIFs and UCITS often use some combination of the following:

• Redemption Coverage Ratio: Measures the ability of funds to meet redemptions.

• Stress Testing: Simulates adverse market conditions to assess the impact on liquidity and margin requirements.

• Liquidity Gap Reports: Analyse mismatches between asset liquidity and liability maturities.

• Redemption Gates and Suspension Policies: Tools to manage liquidity by limiting redemptions during periods of stress.

• Value at Risk (VaR): Estimates the potential loss in value of the fund's assets over a defined period for a given confidence interval.

• Leverage Ratios: Monitors the extent of borrowing and its impact on liquidity and margin calls.

• Property Valuation Frequency: Regularly updating property valuations to reflect current market conditions and liquidity

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?

As we have noted in our response to question 5, we question the concept of "excessive" leverage. For OEFs there are already extensive tools available both in terms of governance, counterparties and, where deemed necessary, caps. Information on who the main counterparties are is also readily available to securities regulators via Annex IV reporting. We do not see the need for further tools to be made available.

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 arenot sufficiently addressed?

Please elaborate with concrete examples:

No we do not think there are pockets of excessive leverage. And we also do not see that leverage topics are not adequately addressed. Please see our responses to questions 5 and 43.

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

As we have already discussed, the EU already has extensive reporting requirements for funds on the leverage they use and their counterparties. However, we do recognise the challenges involved in data sharing across global jurisdictions. More consideration could be given to sharing data with non-EU jurisdictions making use of the existing IOSCO memoranda of mutual understanding which already provides a framework.

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

We believe that all relevant topics addressed in respecitve fund regulation and we do not believe - further - macroprudential tools for fund managers or funds are necessary or appropriate in this field.

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?

As we note in our response to 46, macroprudential measures are neither necessary or appropriate for investment funds and investment fund managers. As we discuss in the response to question 53, we do see merit in jurisdictions carrying out system-wide stress testing.

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?

Please see our response to question 57.

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

Please see our response to question 57.

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?

We have not been presented with any evidence to suggest that this is an issue. The existing cooperation mechanisms are more than sufficient to supervise such firms

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)?

Please see our response to question 62.

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?

Please see our response to question 62.

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

Please provide examples:

No. We are concerned that the FSB workplan for NBFIs has a high potential for being counterproductive as it undermines confidence in NBFIs. We explain this issue in detail in our covering letter.

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