BANCA D'ITALIA
EUROSISTEMA

EU Commission's Targeted consultation assessing the adequacy of macroprudential policies for Non-Bank Financial Intermediation (NBFI) (May-November 2024):

Banca d'Italia contribution

Foreword

With this document Banca d'Italia provides its contribution to the EU Commission Public Consultation on the "Targeted Consultation Document – Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation (NBFI)". This response must be understood as a complement to the response to the Consultation as provided jointly by the Eurosystem, as Banca d'Italia aims to provide its own views on selected topics not covered by the joint Eurosystem contribution, and without contradiction with that. Therefore, the provided answers should be considered in conjunction with the Eurosystem's joint answer to this consultation. Banca d'Italia contribution draws on its role as long standing supervision authority on Italian asset managers and funds, and focuses on two main topics: (A) how to address liquidity mismatches in open ended funds (OEFs) and (B) what steps may be taken to enhance the supervision on large asset managers. Section A addresses first the questions related to Banca d'Italia supervision experience and then the possible ways to enhance the monitoring of OEFs liquidity risk and the most useful data for that purpose, not necessarily in the same order the questions are asked in the EU consultation.

(A) Addressing liquidity mismatches in open ended funds

Banca d'Italia supervision experience

Question 16(a). What is the supervisory practice and your experience with monitoring and detecting unmitigated liquidity mismatches during the lifetime of OEFs?

As a preliminary remark, we would like to stress that the definition of 'unmitigated' liquidity mismatches used in the consultation paper should be preferably avoided as it may suggest that OEFs may increase their exposure to liquidity risk without limits as long as they are able to adopt liquidity management tools (LMTs) to withstand a plausible redemption scenario. Therefore, we suggest to focus more broadly on monitoring the overall liquidity risks of OEFs.

The monitoring of OEFs' liquidity risk is framed in the more general approach to the prudential supervision of asset managers which is based on the Supervisory Review and Examination Process (SREP) performed on a regular basis on all Italian asset managers. The SREP includes the analysis of data coming from dedicated off-site monitoring tools based on extensive supervisory reporting, on-site inspections, meetings with representatives of supervised entities; gathering of documents and other relevant information in order to produce ratings for each risk profile considered (business model and profitability; governance and internal controls, including funds' liquidity risk management; operational risk and capital adequacy) and for the overall situation of the managers. The SREP results determine the subsequent supervisory action.

Following the market turmoil of March 2020, Banca d'Italia developed specific supervision initiatives aimed at strengthening the monitoring system on liquidity and leverage risk of OEFs. These initiatives are: (1) Introducing an ad hoc dedicated weekly reporting system for open-ended funds (in addition to the regular monthly reporting); (2) performing monthly top-down stress tests based on the high quality liquid assets (HQLA) approach; (3) monitoring funds' exposure to synthetic leverage and related margin calls (see also answer to Q27 below).

Under the second initiative, the aim is to measure the ability of funds to cope with high redemption requests using the most liquid component of their assets. The HQLA approach is then used to assess the degree of liquidity of the assets, and a liquidity risk indicator is calculated as the proportion of liquid assets (calculated according to the HQLA framework) to net redemptions under a stress scenario. Where the liquidity risk indicator is lower than one, the fund is considered "vulnerable" and the information is assessed in the context of ongoing supervision and could lead to requests of risk mitigation (see below).

The third line of analysis is aimed at identifying funds that would not be able to cope with particularly large increases in collateral margins on derivatives contracts using the most liquid component of their portfolios and it is based on the calculation of a monthly vulnerability indicator, which is equal to the ratio of available liquidity to changes in collateral margins in a stress scenario. Available liquidity includes cash, the value of government securities of euro area countries and other countries with ratings greater than or equal to AA. A more comprehensive exercise is described in the answer to Q27 below.

Going forward the two shocks (the redemption shock and the margin shock) will be combined in a unified scenario.

Based on the regular monitoring of the liquidity risk of open-end funds, we single out the funds that have been labelled as "vulnerable" on a continuous basis for the last twelve months. On this set of funds, we deep-dive on the liquidity stress tests that the managers are required to perform based on the 2020 ESMA Guidelines, through a questionnaire covering the following areas of inquiry: formalization of the stress testing policy, adequacy of the model of stress tests adopted and examination of portfolios on the basis of the time to liquidate criterion.

Against the background of substantial compliance with ESMA Guidelines, areas for improvement emerged on certain management practices. Therefore, individual intermediaries under scrutiny are being requested to improve their own internal processes, building on the evidence of the analysis, in order to effectively prepare for liquidity stress scenarios.

The in-depth analysis based on the collection of qualitative and quantitative information on managers' internal stress test is resource and time consuming. The activity has benefited, as indicated above, from the ex-ante identification of a limited sample of relevant funds based on the supervisor's top-down analysis. The large scale adoption of this type of supervisory engagement requires, especially for jurisdictions with a large number of managers/funds, a granular and regular reporting on managers' internal stress tests, which is currently missing.

Another lesson which emerged from our experience relates to the **absence of a regulatory metric of liquidity for OEFs other than MMFs**. This provides managers with a large degree of discretion and, in some cases, can lead to results that are not sufficiently conservative in terms of risk management.

Question 18. What supervisory actions do you take when unmitigated liquidity mismatches are detected during the lifetime of an OEF?

Italian OEFs are mainly UCITS funds that are subject to a wide range of strictly-enforced rules about asset eligibility. As far as alternative investment funds (AIFs) are concerned, Italian regulation requires that funds investing more than 20% in illiquid assets must be closed-end. Therefore, the Italian

regulatory environment severely constrains the possibility of liquidity mismatches. Nevertheless, Banca d'Italia monitors regularly the evolution of OEFs' liquidity indicators (see answer to Q16(a)) and the adequacy of asset managers' internal risk management within the yearly SREP cycle. The analysis of liquidity risk indicators, together with other evidence from off- and on-site supervision (such as deficiencies detected in the system of internal controls or high shareholders' redemption rate), is useful for enacting/undertaking supervisory actions. The latter include letters to or meetings with asset managers – aimed at verifying the adequacy of the governance and risk management and requesting reinforcement actions – or deep-dives as part of on-site supervision.

Enhancing the supervision on OEFs liquidity mismatches

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?

In order to lay down the foundations of an effective liquidity monitoring system it is necessary first to enhance the current European regulatory framework by **introducing a shared regulatory metric of liquidity for open-ended funds other than money market funds**. This harmonised definition could form the basis for a 'common language' for managers and competent authorities, thus fostering the development of accurate and internationally shared metrics.

An effective monitoring of the liquidity profile of OEFs should rely on the measurement of the portfolio liquidity (i.e. the average time it takes to orderly liquidate assets) and on the investor liquidity (i.e. the shortest period where investors are allowed to redeem); the liquidity mismatch is the combination of these two metrics.

For monitoring OEFs' liquidity risks, NCAs may then rely either on a top-down or on a bottom-up approach. In several jurisdictions, a top-down approach (whereby the NCAs estimate the liquidity mismatch for each fund) is hindered by data gaps on the portfolio composition, the redemption frequency, and the use of LMTs. In particular, recent FSB works suggest that in many jurisdictions NCAs face significant challenges with data coverage, granularity and sharing.

Therefore, the second action to strengthen OEFs' liquidity monitoring should be **implementing a harmonized reporting system on liquidity metrics and on the results of fund liquidity stress test for OEFs**; such information would enable competent authorities to improve their ability to assess the consistency between the liquidity profile and the repayment terms of the funds.

In more ambitious terms, this framework should be complemented by setting liquidity targets either in terms of the chosen liquidity metric (for example a certain measure of overall mismatch) or in terms of resilience to shocks defined by stress test scenarios, as defined by NCAs.

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?

The monitoring system described in the answer to Q16 **should be complemented by a comprehensive reporting about the selection and calibration of LMTs**. Asset managers should report to NCAs the LMTs selected and the triggering thresholds at the establishment of each fund and at every modification. Based on this structural information, NCAs would be able to perform cross-section analysis linking fund type, investment policy, liquidity mismatches, stress test weaknesses, type and calibration of LMTs, in order to detect outliers and inconsistencies and to define benchmarks informing the supervisory dialogue with asset managers.

With regard to the actions NCAs can take to ensure compliance by asset managers, the selection, calibration and activation of LMTs are subject to an extensive set of rules both on general liquidity risk management and on the specific use of LMTs under the AIFMD/UCITS framework: these rules ensure substantive powers to NCAs to check that internal controls and liquidity risk management ensure an investment strategy that is consistent with the redemption policy of each OEF. **The qualitative assessment of liquidity risk management, coupled with the quantitative benchmarking analysis**

derived from stress test and LMTs reporting, would enable NCAs to effectively challenge managers' choices and request remedial actions. This approach requires huge resources to manage the needed information and it is more effective the wider the sample of the funds analysed: an operational coordination by ESMA could therefore ensure the application of homogeneous methodologies across the EU, prevent an excessive fragmentation of the supervisory decisions and achieve a more efficient use of the available resources.

Question 17. What is the data that you find most relevant when monitoring liquidity risks of OEFs?

The most important data for monitoring liquidity risks of OEFs are:

- OEF holdings at ISIN level with information on the issuer (type, sector, activity, rating), the type of the instrument (bond, equity, derivative) and its features (maturity, callability, etc.). Usually this would require the availability of (or the possibility to access to) databases containing structural information on securities. Similar information should be provided for securities financing transactions (SFTs). Information on cash and cash equivalents is also key.
- A Liquidity measure for each portfolio holding, ideally the time to liquidate.
- Net Asset Value (NAV) broken down by type of investor (retail/ professional; sectoral breakdown of investor would be a plus).
- Financial liabilities (including SFTs) broken down by type, maturity and counterpart.
- Redemption frequency and length of the notice period.
- Weekly / monthly net inflows / outflows broken down by investor type (retail/professional; sectoral breakdown of investor would be a plus).
- The LMTs selected for each fund with information on their calibration (e.g. the trigger threshold).

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.

Liquidity risks may interact with those related to exposure to synthetic leverage and margin calls. Supervisors should therefore aim at jointly assessing such risks, in order to identify possible overlaps and interactions between different drivers of vulnerability.

Current regulatory approaches lack such a comprehensive view, as they tend to separately focus on specific sources of risk. Liquidity risk is typically addressed via the use of LMTs or other (e.g. anti-dilution) tools, which focus on specific aspects of liquidity risk, such as liquidity mismatch, first-mover advantage; leverage tends to be mitigated via the imposition of more or less stringent limits, as in the case of UCITS.

Banca d'Italia has developed an approach to consider vulnerabilities related to synthetic leverage, liquidity mismatch and margin preparedness in a unified manner, integrating EMIR data with supervisory reporting. It consists of a three-step assessment.

As a first step, the overall exposure to synthetic leverage and margin calls is assessed at sector level by aggregating fund-level data: i) consistent with the methodology employed in the IOSCO investment funds statistics, the ratio of funds' derivatives gross notional to its NAV is used to proxy synthetic leverage; ii) the exposure to margin calls is measured as the ratio of net margins over funds' liquidity holdings.

The second step consists in a risk-based analysis aimed at assessing funds' peak exposure in terms of both synthetic leverage and margin calls, measured consistently with the above. One of the key risks associated with leverage embedded in derivatives portfolios is the resulting procyclical margin calls during periods of market stress.

The third step addresses heterogeneity across funds through a fund-level perspective. In this stage we identify funds that are potentially vulnerable to margin calls and may pose risks to financial stability.

The results of our analysis show that gross notional exposure of Italian funds is fairly stable and well below NAV. Overall, margins posted by funds are not sizeable relative to NAV; however, some pockets of vulnerability

could arise. On average, margin-related liquidity absorption is only a fraction of the available fund liquidity.

Taking a more general perspective, margin models' transparency is one of the key aspects affecting margin preparedness of NBFI. Indeed, margin preparedness largely depends on the ability of market participants to predict margin calls and to understand the main factors leading to the margin spikes. A thorough awareness of the CCPs' margin models can enable market participants to incorporate the assessment of margin-related risks in their liquidity risk management and governance frameworks and to deploy contingency funding plans against liquidity needs arising from these calls. Transparency must be granted by both the CCP and the clearing members offering clearing services.

From this standpoint, **the disclosure obligations of CCPs and clearing members in terms of margin model information and simulation tools can play an important role**. The recent review of EMIR regulation will increase disclosure obligations, especially with respect to the clearing members that offer clearing services; the focus should now shift to the implementation and monitoring phase.

A powerful tool to monitor and improve margin preparedness of market participants could be to actively involve CCPs in their liquidity stress tests in order to integrate their framework with a robust analysis of a range of extreme but plausible liquidity stress scenarios caused by changes in margin calls; in turn, CCPs could promote and organize collective tests and simulations of margin calls with the market participants.

In general, CCPs, leveraging their role, should be more actively committed in improving the margin preparedness of market participants; the entire financial ecosystem would benefit from these exercises.

Since margin spikes possibly come from excessively concentrated positions, **NBFIs could include in their liquidity risk framework key risk indicators (KRIs) to identify excessive exposures**; such KRIs could be calibrated in terms of potential margin spikes.

(B) Enhancing supervision coordination on large cross border asset managers

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?

In the EU some asset management groups are large, complex and active on a cross-border basis within and outside the EU. Those entities, via the funds they manage, can pose risks to the financial system.

Most risks stem from the investment funds (e.g. liquidity and leverage risks, etc.), as highlighted in many analyses by the FSB, IOSCO, ESRB, and ECB. However, the investment strategies adopted by large asset managers at global level may also affect specific markets (e.g. sovereign bond markets). Therefore, in those cases, coordination and consistency in the supervisory activities carried out by home and host NCAs may be desirable. For example, it would prevent NCAs from adopting supervisory measures/actions that are conflicting or not proportionate.

Against this backdrop, we believe that there is room for improving supervisory coordination for large asset managers, with the following benefits and challenges.

Benefits: closer coordination in the supervisory activities would ensure a quicker, more efficient and more effective response by the home and host NCAs, both in normal and crisis times, leveraging swifter information exchange channels. Moreover, sharing the experiences of the home and host NCAs for a specific large asset manager would enrich the supervisory knowledge about the intermediary, the ability to timely identify weaknesses, and the readiness to deal with crisis when they occur.

Challenges:

<u>First</u>**, the legal basis is an essential aspect: a coordination mechanism for the supervision of large asset managers requires a harmonised legal framework**. At the moment, however, **the legal framework for asset managers is only partially harmonised**: there are common rules

for UCITS management companies and funds, as well as for AIFMs, certain categories of AIFs (EuVECAs, EuSEFs, ELTIFs and, forthcoming, loan-originating AIFs), money market funds, and the tasks and responsibilities of depositaries. Some of those common rules are directly applicable in Member States, while others require national transposition and include national discretions and derogations. Yet, several crucial aspects of the asset management framework are still regulated at the national level (e.g. retail AIFs, asset valuation rules, licensing and supervision of depositaries). In this respect, greater harmonisation of rules should be achieved, especially in the areas of the collective asset management framework that, so far, have been regulated at the national level. However, the development of harmonised rules at the EU level takes time; therefore, while we are working to achieve full harmonisation, coordination mechanisms should be activated with reference to those frameworks that are harmonised at EU level: therefore, they would work for UCITS and AIFMs, but not for AIFs other than those regulated at the EU level.

Second, a well-defined scope is crucial. A coordination mechanism for the supervision of large asset managers requires **that the role and responsibilities of NCAs (home and host) and of ESMA are clearly defined, and that the object of supervision is clearly identified**. In this respect, we see two major issues:

- at the moment, supervision on asset management companies is performed at single/solo level and a supervisory regime on a consolidated basis is missing (with the exception of "group structures" in the context of sub-threshold AIFs according to art. 3, par. 3, AIFMD, for the purposes of respecting the thresholds). As almost all the large cross border asset managers have very articulated group structures, a coordination mechanism for supervising them would require the introduction of a consolidated-like supervisory regime for those intermediaries, with a precise identification of the matters which are subject to the coordination mechanism. Of course, the extension and intensity of the consolidated approach and the arrangement and the division of roles among NCAs and ESMA (see also question 63) are closely connected: in principle, the benefits of a more centralized coordination model would be maximised if a larger scope of supervision is envisaged, encompassing both conduct of business (including the compliance with funds regulation)

and prudential rules (capital requirements, governance, organization, internal controls, risk management systems). However, the current regulatory framework allocates to the home NCA of the fund the supervision responsibilities for all harmonized products (UCITS, MMFs, ELTIFs): in case of material cross border activity this would imply the coordination of several NCA;

- most large asset managers belong to "significant" banking groups or to insurance groups and supervisory measures on governance, organization structure and internal controls adopted for those large asset managers' subgroups may have implications for their banking groups. Hence, we should ensure an effective cooperation and coordination of the home/host NCAs of large asset managers with the ECB/SSM, as well as with the relevant NCAs for large asset managers belonging to "less significant institutions", if any, or banking groups not supervised by the SSM. These considerations make more compelling the case for a coordinated approach to large cross-border NBFI (sub-) groups, that could mirror the already strongly coordinated/centralised approach to supervision for European banks.

<u>Third</u>, supervisory coordination should not translate into excessive burden in terms of regulatory costs and supervisory fees on large asset managers.

<u>Last, but not least</u>, common criteria should be developed to identify "large" asset management companies. Ideally, those criteria: i) may be developed by ESMA, together with the NCAs, and ii) should aim at capturing entities of large size and high complexity, active on a cross-border basis, and for which there could be merit in establishing a coordinated supervisory approach at supranational level given their market footprint and the externalities stemming from their combined market strategies.

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.

Considering the pending issues as highlighted in our answer to question 62 (lack of a fully harmonised framework, regulatory fragmentation in

certain areas, etc.), there could be merits in developing a gradual approach: while pursuing and preparing for a centralized model with a prominent role entrusted to ESMA, in the short term colleges of supervision for European large asset management companies could be established.

The setup of colleges is a well-known and tested experience that has proved to be extremely useful for the supervision of large banking and insurance groups and, more recently, central counterparties (CCP).

Colleges should have a formalised governance structure, with clear roles and responsibilities for the participating NCAs (e.g. host NCAs should be voting members, and the home NCA may chair the college).

In this context, ESMA should have a pivotal role to ensure the establishment and correct functioning of colleges, and take part in college meetings and activities (for organisational reasons, a co-chairmanship of the home NCA and ESMA may be also considered).

Of course, **the establishment and functioning of asset manager colleges should be regulated at the EU level**: this would require amendments to several legislative acts, such as the ESMA founding regulation, UCITS and AIFM directives, and possibly the development of binding regulatory standards specifying the functioning of colleges. Also, the possibility of introducing "common decisions" e.g. on the adoption of coordinated measures for tackling risks for the financial system could be explored and discussed.

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)?

The core function of an asset manager is managing assets as an agent on behalf of others in accordance with a specified investment mandate. Asset managers must follow investment guidelines set out in the agreement with each client or investment fund's governing documents as the client assumes the risk of investing. Asset managers generally use third-party custodians to hold investor assets, as required by regulation or as a best practice.

EU legislation restricts the activities that asset managers (UCITS Management companies and AIFMs) can perform in addition to asset management: in general asset managers are prohibited from assuming risk on their own account and capital requirement are aimed at addressing operational risk (legal, reputational, IT, outsourcing, etc.). Failures of asset managers due to business reasons or operational risks happen especially among smaller managers with concentrated businesses. The winding down of these managers may take several forms from the outright liquidation of the manager and its funds to the transfer of the funds to other managers, to mergers with other managers, etc. None of these solutions usually creates disturbances to the financial system as a whole. Large asset management groups are much more diversified and in the EU generally belong to even larger banking or insurance groups which can step in to support their financial needs. Although the probability of the failure of a large asset manager is quite low, it may nonetheless have some systemic implications if it is connected somehow to the crisis of its large investment funds with cross-border distribution or if the manager provides a critical function or service to market participants or clients for which substitution is difficult or if governance/reputation issues provoke a sudden massive reaction of investors across all the funds managed. However, as the assets under management are protected by the segregation rules, the orderly management of the crisis of a large asset manager is relatively simple and it is going to be definitely much less complex than that of a medium sized banking group. To this end it is essential to ensure the timely exchange of information among the NCAs involved, especially if cross-border distribution and management of funds are involved, and the necessary harmonisation of the powers necessary to take coordinated action in different jurisdictions.

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.

The role of ESAs as defined along the lines of the Enhanced Coordination Mechanism (ECM) described in the answer to Q57 (see Eurosystem’s answer) seems the most appropriate framework also for dealing with crisis situations, as the possible measures envisaged (i.e. redemptions suspension) are going

to be mostly the same as the national macroprudential measures (NMMs) listed under the ECM. With reference to the direct power to collect data from the regulated entities, it should be noted that it implies the availability of a direct operational channel for the collection of the information between the ESAs and the regulated entities, which ordinarily transmit their reporting through their NCAs. It appears more practical to empower ESAs to request certain data in crisis situation or also in ordinary business, but to maintain a role for NCAs as operational channel for the data.

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