FESE response to the Commission consultation on assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI)

Brussels, 22nd November 2024

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

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?

FESE would like to use this question to point out other unresolved issues in the MMFR and UCITS Directive framework to help NBFI unlock efficiencies by streamlining the regulatory requirements in funds regulation. For over 20 years, European financial institutions have voluntarily cleared securities financing transactions (SFTs such as repurchase agreements (repo)). The continuous level of debt issuance and subsequent growth of repo markets in Europe puts pressure on the intermediation capacities of banks, which have to operate and serve their clients with a limited balance sheet. When facing such constraints, there is a risk that certain types of clients could struggle to find adequate intermediation capacity from banks in a tense market, and banks themselves struggle to serve the entirety of their client base. In response to these constraints, CCPs have designed new membership models for the voluntary clearing of SFTs.

Whilst banking regulation has enshrined clear rules on the treatment of exposures of a bank towards the CCP in a traditional clearing model, funds regulation has not applied similar rules for other types of market participants when facing a CCP. As a result, there are inconsistencies between banking, clearing and EU funds regulation, unintentionally disincentivizing buy-side entities to make use of central clearing. While EMIR 3.0 provides some welcomed reliefs to counterparty and cash limits in the MMFR and UCITS Directive, more holistic changes were deferred to the review of the UCITS framework.

Further targeted amendments to the UCITS and MMF frameworks could be helpful. In particular, ensuring access to central clearing for a broad range of participants.

Risk-adequate collateral concentration and diversification rules for centrally cleared repos.

The strict collateral concentration and diversification rules applied to UCITS could be further adapted risk-adequately for CCP-cleared (reverse) repos. While those rules have been put in place to address funds' vulnerabilities, the CCP guarantees the fulfilment of the contract. MMFs and UCITS currently need to receive at least 6 bond issues per issuer or can only own a certain percentage of a given issuer. However, there are no such regulatory requirements for OTC IRS.

In the context of CCP-cleared transactions, it might be instructive to also look at the banking regulation (CRR) which explicitly provides certain relief with regard to the "Large

Exposure" limits applicable for CCP-cleared securities financing and derivatives transactions.

Despite the welcomed changes to the MMFR and UCITS Directive via EMIR 3.0, the funds regulation still unintentionally disincentivises central clearing concerning counterparty limits for centrally cleared SFTs. To ensure consistency with the recent changes that exempt centrally cleared derivatives transactions from counterparty limits in both MMFR and UCITS Directive and reflect repos in the MMFR cash limits, targeted additions to Art. 17 MMFR and Art. 52 UCITS Directive could exclude all centrally cleared transactions, including SFTs, from relevant concentration and diversification requirements. Such an exclusion should apply to both direct and indirect clearing models.

Easing constraints on the re-use of received collateral through SFTs for margin efficiencies.

To facilitate more voluntary clearing and efficiencies for the buy-side for stronger EU capital markets, targeted changes to the UCITS Directive, the MMFR and ESMA Level 3 measures could be considered as well to ease the constraints on the re-use of received collateral through SFTs to meet CCP margin requirements:

Specifically, to protect funds from risks associated with non-centrally cleared repos, they are currently restricted to pledge collateral received in a reverse repo transaction to meet CCP margin requirements, even if this collateral would be held bankruptcy remote from the pledge. Consequently, for CCP-cleared transactions, additional assets would need to be sourced by the fund to meet the mandatory CCP margin requirements, making central clearing economically less attractive. Through a targeted amendment to Art. 15(2) MMFR and the related provisions in UCITS Guidelines, UCITS funds could be explicitly allowed to pledge securities to a CCP if received by the fund by way of a transfer of title in a cleared reverse repo transaction with that CCP.

Also, according to Article 14(b) MMFR, funds cannot raise or re-use cash collateral received through a repo transaction to meet mandatory CCP margin requirements. Through a targeted amendment to Art. 14(b) MMFR as well as Art. 52 UCITS Directive, it could be added that cash collateral received from centrally cleared securities financing transactions may be used by UCITS to meet CCP margin requirements.

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?

We support the ongoing policy work to enhance the liquidity preparedness for margin and collateral calls of non-bank market participants on both EU and international levels to ensure that all non-bank market participants taking part in clearing are as well prepared as possible to deal with liquidity needs in times of market stress.

It is therefore the right way that through recent changes to EMIR non-bank market participants, including non-financial counterparties, can benefit from the possibility of providing non-cash collateral, such as uncollateralized bank guarantees, and thus reduce potential liquidity pressures in times of crisis.

Further, both EU and international measures aim at enhancing the level of transparency into margin developments to support the liquidity preparedness of market participants. While related transparency provisions for CCPs towards their market participants are a necessary condition, they are not sufficient to ensure that Clearing Members and clients incorporate the information provided by the CCP into their liquidity preparedness. Generally, the introduction of new transparency tools should follow the principle of proportionality, i.e., a cost-benefit analysis to ensure that the costs borne by CCPs developing the tools are balanced with the added value for the market and be mirrored

by the mandated use of such tools in liquidity preparedness programmes. There is a risk that very high transparency on CCP's margin models could have a destabilizing effect during market stress events. Information without any context for margin calls that are likely to be met can lead to speculation due to irrational behaviour during a crisis event. High-margin payments are not necessarily a cause for concern as they could simply reflect increased volatility or significant price changes in the market. Any additional disclosure requirement should therefore rather enhance transparency on CCP margin models and foster comparability of margin model design choices and key parameters.

Margin simulators are a key transparency measure promoted by the EU as well as global policy work. EU CCPs already provide such simulators and allow access to those tools not only to their Clearing Members but also to clients and the broader market. Despite the accessibility, the usage of the simulators is very low. CMs typically have their own tools and less sophisticated clients prefer to use simple approximations than analyse in detail for each CCP. Against this background, such tools should remain flexible and practical, and any legislative guidance should ensure that any definitions of the scope of simulators remain high-level. A one-size-fits-all prescriptive approach would only generate unnecessary costs to CCPs – likely increasing the cost of clearing to clearing members and their clients, with little to no increase in benefits for any party (also considering that, in markets where they operate, such as cash equities and equity derivatives, clearing members are highly sophisticated and develop their own simulator tools in-house).

CCPs should provide margin simulations based on current market conditions and should also aim to provide margin simulators for historical market conditions which should ideally aim to cover periods of stress. However, the mandatory provision of hypothetical forward-looking or backwards-looking scenarios should not be part of the simulations. The usefulness of backwards-looking scenarios (for example in case of stock splits or in case of changes over the lifetime of a company) is questionable. Most importantly, the results of simulation tools should not hinder a CCP from taking the actions it deems appropriate during periods of stressed market conditions. The scenarios provided in the simulation tool should be the same as the ones used by the CCP's actual margin model, to ensure consistency between simulation tool results and the requested margin.

Generally, margin transparency requires a holistic approach. Enhancing transparency by the CCP to the CM is not the silver bullet. Transparency from CMs to clients and vice versa is essential, too. Since the link between CM and client is quite different from the CCP-to-CM link, we believe that a higher level of transparency on that front would in particular be justified and beneficial. CCPs only have contractual relationships with the CMs but have no insights into clients' positions that are not disclosed to the CCP – hence, certain information is only available to the CMs and the clients themselves, but not to the CCP. Notwithstanding, clients may also have unknown positions with other CMs. Equally, it is important that clients understand how and to what extent CMs' actions alter the margin responsiveness of CCPs vis-à-vis end-clients.

Question 39. How would you assess the level of preparedness of commodity derivatives market participants in terms of meeting short-term liquidity needs or requests for collateral to meet margins? Please rank from 1 to 5 (lowest to highest) the level of preparedness for the following participants by sector: insurance companies, UCITS funds, AIFs, commercial undertakings, investment firms, pension funds.

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.

FESE believes that imposing a more comprehensive set of trading rules for spot market participants is not the most effective approach and will be counterproductive. While the potential risk of contagion from spot markets to futures markets is a valid concern, FESE believes that the current regulatory framework is sufficient to address these risks. We advocate for a balanced approach that promotes market integrity and stability without imposing undue burdens on market participants.

The existing regulatory framework, including MiFID II, EMIR, REMIT, and the Transparency Directive already addresses many of the concerns related to market integrity and risk management. Furthermore, it should also be recognised the role specific aspects of these regulations can play in limiting possible contagion from off-exchange markets. For example, the ancillary activity exemption under MiFID II is an important regulatory instrument which is appropriately calibrated to ensure proper market functioning and efficient risk management by market participants and should be retained. Together, this regulatory framework ensures market participants adhere to high standards of conduct and transparency. Further rules may lead to regulatory overlap and unnecessary complexity. They will also drive away small and medium participants, whose participation in the spot power markets is key to the success of the energy transition – and one of the key objectives of the recent market design reform (EMD). Imposing a one-size-fits-all regulatory approach may not be suitable for the diverse nature of spot markets.

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?

4. Excessive leverage

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?

6. Supervisory coordination and consistency at EU level

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.

FESE acknowledges that the ESAs should ensure that legislations are implemented EU-wide as intended especially in cases of systemic events where risks have contagious potentials on the whole EU financial ecosystem. There is however a difference between granting more intervention powers to ESAs and improving EU-wide consistency and convergence. In our view, NCAs and trading venues might have divergent views and hands-on practices in various circumstances. Different market structures in different Member States are more prone to "local" effects, rather than "EU-wide or "global" effects. Taking this into consideration, ESAs' intervention with the "one size fits all" principle, where necessary, may not always be efficient.

We advocate against granting ESAs powers to introduce EU-wide trade halts given the manyfold academic evidence existing on current market-wide trade halt experiences available in the U.S. and the Chinese markets. Arguably the most prominent among these measures is the market-wide circuit breaker, which was first introduced in the U.S. in 1988 after the 1987 Black Monday stock market crash. The U.S. market-wide circuit

breaker was first triggered on October 27, 1997, which led to its redesign. Following the turbulent stock market declines in 2015, China introduced its market-wide circuit breaker in January 2016. After being triggered on the first day of its instalment and again in the same week, it was immediately abolished. These events have revived the debate about general market-wide interventions and the appropriateness of such coordinated measures. A vast body of academic literature is available today indicating the risks associated with such coordinated halts. Results demonstrate some of the negative impacts of market-wide trading halts even without any other market frictions. Among others, such coordinated measures are found to lead to lower price-dividend ratios, and reduce daily price ranges, but increased conditional and realised volatility.

Alongside the academic evidence, it is more important to mention the real-life impact seen on financial markets. When markets go down severely i.e., as during Covid crisis, it is crucial to allow financial market players continue to trade at the fair value. Rather than cutting off access to trading by halting the market, trading at a relatively lower fair value can provide market participants with a chance to protect themselves against downturns by hedging their investment risks and managing their cash flows. To produce fair value, counterparties are needed in the market. If this does not exist, market players would start trading among themselves in black markets/off-venue platforms, which would have a negative implication on price discovery and transparency, ultimately to the disadvantage of the end investor. In the Covid crisis, many market participants were concerned with, especially after short selling bans were introduced, the rising trust issues in the market due to uncertainty in the ability to trade in financial markets. In these kinds of systemic events, trading venues should have the responsibility to provide transparency in the market and decide if a trade halt is necessary.

We do also not support granting direct power to ESAs to collect data from regulated entities. NCAs should have the key responsibility in data collection. For critical subjects in terms of market-wide stability, trading venues already provide data to ESAs i.e., trading venues send detailed information regarding the triggering of circuit breakers directly to ESMA on an annual basis. However, if the ESAs had greater powers in data collection, it would not be clear to see the borderline between ESAs and NCAs. On the other hand, reporting data directly to ESAs might cause fragmentation of oversight. If trading venues report directly to ESAs, it may lead to a lack of coordination and fragmented oversight, complicating the regulatory landscape and potentially restraining a harmonized response to the crisis. Thus, we think that information should be exchanged only between NCAs and trading venues.

Nevertheless, we do not deny that ensuring consistency across NCAs is key to contributing to a well-functioning financial system. Convergence is the key pillar of the ESAs' tasks and the reason for the authorities' creation in the first place. The right way forward in our view is to further improve the existing supervisory structures towards better coordination and cooperation of NCAs and ESAs while ensuring the adequate reflection of the diversity of the EU financial ecosystem and, where necessary, granting discretion power to trading venues i.e., deciding triggering of trade halts. This would enable the ESAs to best pursue their current tasks of achieving stability and harmonization in national interpretation and application of EU legislation in cases of systemic events.

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?

FESE understands that policymakers may be exploring further integration of supervision in commodities markets for both financial and spot due to the identified interlinkages. The

assumption is that this proposal, in theory, should enhance visibility for public authorities and deliver better supervisory results.

FESE would first like to remark that the rules underpinning the functioning of financial commodities markets in MiFID II were recently amended and implemented following the MiFID "quick fix". Markets have, since then, benefitted from better-tailored provisions that have enhanced market efficiency. Thus, we would not favour changing a regime that has proven to work. The heightened volatility registered during the recent energy crisis was due to a supply crisis that naturally affected financial markets as well. In FESE's view, a separate supervisory regime for the financial and physical infrastructure of the commodity futures exchanges did not contribute to such volatility, nor the establishment of a unique entity would have marginally made a difference in market practices. There is a risk that an integrated supervisory system may lead to overregulation, which could stifle innovation and market development.

FESE suggests exercising caution in integrating the supervisory regime for two markets that are fundamentally different. Policymakers should consult on a concrete list of evidence-based proposals for amending the current supervisory regime.