CONSULTATION RESPONSE

Brussels, 4 September 2023

EFAMA's RESPONSE TO THE FSB CONSULTATION REPORT ON ADDRESSING VULNERABILITIES FROM LIQUIDITY MISMATCH IN OPEN-ENDED FUNDS

Introduction

EFAMA welcomes the opportunity of this consultation report to share views on how regulators could foster greater consistency in the management of liquidity risks in the Open-Ended Funds (OEFs) sector and on how the FSB should proceed in the future to evaluate any potential build-up of systemic risks in capital markets.

As a starting point, we welcome in this consultation the recognition that it is the primary responsibility of management companies to select the appropriate LMTs for the funds under their management and that funds investing in less liquid, or illiquid, assets should have the possibility to offer daily redemptions to their end-investors, provided their liquidity management policy is suitable and robust enough. We also welcome the FSB's commitment to promote the availability and the consistent use of a broad set of anti-dilution and quantity-based LMTs.

However, in our view, the FSB Non-Bank Financial Intermediation (NBFI) methodology remains fundamentally flawed and results in an excessive focus on OEFs. This methodology unduly equates credit intermediation performed by banks with that performed by funds, while grossly overestimating the propensity of end-investors to redeem from OEFs under volatile market conditions. Furthermore, it does not encompass other market participants that play an important role in driving capital markets (i.e., broker-dealers, insurance companies, pension funds, and other financial institutions). Lastly, it insufficiently recognises the multiple layers of regulation already at play, applicable not only to asset management companies, but also to their institutional clients (e.g., insurance companies and pension funds).

Consequently, we consider that a number of the revised recommendations that the FSB has outlined in its consultation report (i.e., liquidity bucketing, mandatory LMTs for certain OEFs, quantitative disclosures on LMTs, and system-wide stress testing) remain ill-suited. Besides the fact that these recommendations attempt to solve a perceived problem that has not been accurately defined, we believe they would only result in additional operational costs without any meaningful benefits for end-investors, nor for the broader financial system. Indeed, as acknowledged by IOSCO, management companies across all the major fund jurisdictions are complying with the current *IOSCO Recommendations for Liquidity Risk Management for*

Collective Investment Schemes.[1] Leading fund jurisdictions such as the European Union are moreover already in the process of reviewing their regulatory frameworks in response to the market events sparked by COVID-19 pandemic.[2] The revised FSB recommendations are inconsistent with these new regimes and would introduce a number of new and unnecessary challenges for management companies and investors alike.

EFAMA recommends that the FSB take a holistic approach when reviewing potential systemic risks in market-based finance. Our recent position paper *Open-Ended Funds & Resilient Capital Markets* provides a number of constructive indications on how the FSB could proceed in this respect. We would also recommend a number of targeted policy measures that, we believe, would contribute to a more transparent and consistent approach to liquidity management in the OEF sector. These policy measures should include the full availability of LMTs across jurisdictions, as well as supervisory guidance on the use of these LMTs. Finally, the FSB should also consider market-wide reforms including 1) supporting the development of a consolidated tape for fixed-income securities in jurisdictions where such a tape is not available, 2) improving CCP margin transparency and predictability, 3) facilitating the use of liquidity buffers in the banking sector, and 4) consolidating supervisory reporting across all financial sectors.

Lastly, on the timing of this consultation (in parallel to the accompanying IOSCO consultation on anti-dilution liquidity management tools), and while mindful of the broader G20 agenda, we regret that these consultations are (again) poorly-timed (i.e. in the middle of a holiday season), which inevitably goes at the expense of deeper insights that our industry's practitioners could have had offered to global standard-setters.

Questionable analytical foundations

Although we believe that macroprudential supervision should be a core feature of any developed capital market, it is our impression that these types of analyses are not yet sufficiently advanced and are often predicated on inaccurate assumptions.

In the current case, **the whole rationale for greater scrutiny of OEF liquidity management stems from the questionable assumption that the very structure of OEFs encourages pro-cyclical redemptions by end-investors, which in turn would result in so-called 'excess' sales.** The FSB, for instance, states in its consultation that *"Unmitigated structural liquidity mismatch may amplify shocks by driving 'excess' redemptions that require managers to engage in asset sales larger than in the absence of liquidity mismatch, especially in times of stress. Shock amplification can occur through different channels: 1) Liquidity mismatch may produce a first-mover advantage at the fund level, 2) In the presence of liquidity mismatch, some investors may misunderstand the liquidity of the underlying assets held by OEFs and may not expect the additional cost or difficulty associated with funds exiting their positions, especially in a stressed environment"*.[3]

In our recent position paper *Open-Ended Funds & Resilient Capital Markets*, we have extensively demonstrated that **the focus on OEFs as part of the FSB's NBFI agenda is largely misguided**.

[1] IOSCO, Thematic Review on Liquidity Risk Management Recommendations, November 2022.

[2] As the EU co-legislators have found a political agreement in July 2023, the new UCITS/AIMFD legislation is expected to be published towards the end of 2023. In the meantime, please refer to the Council's position and the European Parliament's Report for an overview: Council of the European Union, Position on the AIFMD/UCITS Review, June 2022; European Parliament, Report on the AIFMD/UCITS Review, May 2023. At the same time, the SEC is reviewing its fund liquidity management rules as well: SEC, Proposal on Open-Ended Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT, November 2022.

[3] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 6.

According to the FSB, OEFs would account for more than 70% of the so-called 'narrow NBFI measure'.[4] Such estimate is nevertheless derived from simplistic assumptions and risk measures that repeatedly fail to grasp the fundamental difference between OEFs and bank deposit accounts.[5] The measure that is used to justify the claim that there is a 'structural liquidity mismatch' in the OEF sector is moreover inappropriate because it overestimates the propensity of investors to redeem. What many academics have called a 'first-mover advantage' in OEFs investing in less liquid assets (e.g., corporate bonds) is rather the reflection of a market-wide first-mover advantage in less liquid markets.[6] As regards whether there is such a first-mover advantage in the OEF sector, there is ample evidence to demonstrate that the level of dilution in OEFs invested in equity and fixed-income securities is relatively low, even during periods of market stress.[7] While March 2020 is often cited as a case study demonstrating the potentially destabilising effects of OEFs on capital markets, it appears that even the fund category that saw the largest outflows in Europe during this period (i.e., corporate bond funds) showed high levels of resilience and ability to meet outflows using existing LMTs. In contrast to what is often assumed, many European corporate bond funds experienced limited outflows during the period and, moreover, these flows occurred in small and incremental sizes over the course of the month. This evidence invalidates the narrative according to which OEFs would engage in fire sales due to large and unforeseen redemptions.[8]

In spite of these shortcomings, the FSB is nonetheless proposing a significant departure from the 2017 FSB Recommendations. The consultation notes that *"the FSB sought to measure the development of structural liquidity mismatch in OEFs based on available data. This analysis was subject to a number of limitations and assumptions and therefore the results should be interpreted cautiously. Nevertheless, the FSB's analysis suggested that there had been no measurable reduction in the degree of structural liquidity mismatch across the OEF sector. Moreover, as the OEF sector has grown in absolute terms, […] the potential impact of vulnerabilities that can arise from OEFs' structural liquidity mismatch has also grown"*.[9] In its 2017 Recommendations, the FSB recognised that *"funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behaviour during normal and stressed market conditions"*.[10] Conversely, it appears that the revised recommendations depart from this sensible approach by assuming that certain types of funds would have 'structural liquidity mismatches' based solely on the liquidity of their underlying assets, while ignoring end-investor profiles and their relative propensity to redeem.

In light of the above, **EFAMA would strongly recommend that the FSB broaden the scope of its NBFI methodology to ensure that it captures other activities apart from asset management. In the meantime, and for as long as its analysis is incomplete, it should refrain from formulating any new recommendations which appear to be based on a number of questionable assumptions on the workings of the asset management industry**. First, we recommend moving beyond the 'in or out' approach characterising the macroprudential analysis in the FSB's 'narrow NBFI' measure this far, while neglecting other institutions that arguably play an equally, if not more, important role in capital markets (i.e., broker-dealers, insurance companies, and other financial institutions). As an example, the March 2021 failure of Archegos Capital Management demonstrated that there are institutions in some jurisdictions that

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[4] FSB, Global NBFI Monitoring Report, December 2022, p. 3.
[5] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 18-19.
[6] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 34-38.
[7] ICI, Setting the Record Straight on Dilution, First-Mover Advantage, and Financial Stability Risk, June 2023.
[8] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 38-41.
[9] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 7.
[10] FSB, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, January 2017, p. 17.

still largely operate outside the regulatory perimeter and take significant risks without being subject to any (macroprudential) supervision.

Second, the FSB should be more careful with the conclusions that it appears to draw mostly from academic studies, based on questionable assumptions and on limited empirical evidence. For instance, while the concerns around the possibility of a 'first-mover advantage' are theoretically legitimate, the conclusion of the academic studies on this phenomenon are predicated on the assumption that the relationship between performance and flows in OEFs depends wholly on there being a 'structural liquidity mismatch' which would be unique to funds. In reality, competition for liquidity occurs far more broadly in a given underlying asset market (e.g. corporate bonds) and on par with other financial institutions having the same asset market exposures. Were such market to experience turbulence at a certain moment, non-OEF financial actors will also take advantage of an opportunity to possibly scale back their corporate bond exposures by relying on the limited liquidity available. With prices in these markets becoming more sensitive to volume variations, the correlation between performance and flows in corporate bond OEFs should therefore be better explained with references to broader market dynamics which may equally involve selling.

Third, we recommend having a more holistic and granular evaluation of stressed market events to develop a more accurate idea of where vulnerabilities may lie in the market. For example, we consider that this was not sufficiently done in the case of the COVID-19 crisis, where the FSB rushed to conclude that most of the outflows from investment funds during March 2020 were the result of 'excess redemptions' due to inherent vulnerabilities in the OEF sector. In response, our aforementioned paper *Open-Ended Funds & Resilient Capital Markets* shows that, at the beginning of 2019, investment funds accounted for 22% of the euro corporate bond market and that their net sales during the first quarter of 2020 only accounted for 16% of the total sales.[11] This excessive focus on OEFs has thus only offered the FSB a very partial representation of the broader market dynamics.

Fourth, the FSB must finally recognise the large diversity that exists in the asset management industry and the fact that the majority of investment funds pursues simple investment strategies. The usual broad brush treatment of equities, fixed-income securities and real assets as single asset classes fails to take into the account the multiple asset sub-categories within these same asset classes, asset level liquidity profiles and market structures in relation to each of these asset types. Macroprudential analyses in the OEF sector should conversely focus on specific funds that may contribute to the build-up of systemic risks rather than on broader fund categories.

In this respect, we note that while financial risks have recently materialised with multiple bank failures in March 2023, preceded by the UK Liability-Driven Investment (LDI) crisis in September 2022, as well as the by earlier Archegos debacle in March 2021, there have been no failures of similar magnitude in the European investment fund industry. While investment funds did experience large outflows during March 2020, these reflected the 'risk-off' sentiment of end-investors during the exceptional circumstance of a stalling global economy.

EFAMA views on the revised FSB policy recommendations

Structural liquidity mismatch

EFAMA does not agree with the claim that there is a 'structural liquidity mismatch' in the OEF sector and objects to the revised recommendations that were presented in the consultation to bridge this alleged gap.

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[11] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, p. 41.

It is important to stress that, **in contrast to banks, investment funds can engage in liquidity transformation without having to match the liquidity of their assets and liabilities** due to the fact that most fund investors have a longer term investment perspective compared to bank depositors, who conversely choose to hold cash in bank accounts to access liquidity on short notice.

As outlined in the previous section, **the FSB uses an indicator that grossly overstates the propensity of end-investors to redeem to measure this alleged mismatch**. Moreover, this measure does not take into consideration the current liquidity management practices (incl. the availability and use of LMTs) that asset managers have developed to manage the liquidity transformation of their funds. In the *2022 Global NBFI Monitoring Report*, the FSB for instance notes, when speaking about the narrow NBFI measure, that *"this classification is done on a conservative and inclusive basis, reflecting the assumption that policy measures and/or risk management tools have not been exercised"* and that consequently *"the […] measure may overestimate the degree to which NBFI currently gives rise to post-mitigant financial stability risks given that existing policy measures, risk management tools or structural features may have significantly reduced or addressed financial stability risks"*.[12] As a consequence of this methodology, no regulatory measure short of mandating minimum liquidity buffers or stricter redemption periods, including those proposed by the FSB in this consultation, would result in bridging this alleged mismatch.

EFAMA agrees that certain funds should have specific LMTs available to deal with their respective liquidity risks. Management companies should continue to retain the discretion to select, in discussion with their national supervisors, the LMTs that are the most relevant for the funds under their management. We welcome that the FSB acknowledges this principle in the consultation by stating that *"The revised FSB Recommendations […] do not imply a 'one-size-fits-all' approach across all OEFs or all jurisdictions. There is significant variation in the types of assets that OEFs invest in and investment strategies that OEFs adopt. The FSB believes that managers of OEFs have the primary responsibility and are best placed to manage the liquidity of their portfolios"*.[13]

While there is no absolute rule for determining when a fund should use a given LMT, we would expect that most **corporate bond funds** would either have a price-based or quantity-based LMT available and that most **real estate funds** would have a notice/settlement period that is consistent with the liquidity of the underlying assets. In line with the above principle, regulators should not impose a single notice/settlement period for these real estate funds considering that these funds may have different liquidity and investor profiles.

We thus believe that maintaining the current regulatory approach would be more appropriate than relying on the introduction of a strict and formal liquidity bucketing requirement that would seek to 'pigeonhole' OEFs into different fund categories based on the liquidity of their underlying assets and impose the use of certain LMTs for funds that invest in less liquid/illiquid assets.

First, **the liquidity bucketing approach is not compatible with the European approach to liquidity management**, which is instead predicated on the UCITS 'eligible assets' rule and a robust liquidity management framework that applies to both retail and alternative funds. In Europe, the legislation does not define what is a 'liquid asset', recognising the fluid nature of liquidity as illustrated by the fact that even highly liquid assets such as U.S. T-bills may face bouts of illiquidity. EU legislation rather refers to 'liquidity risks' to account for situations where a position cannot be sold, liquidated or closed at limited cost and in a sufficient timeframe. In addition, the UCITS Directive only allows UCITS funds to invest in 'transferable securities' and/or 'money market instruments' that satisfy a number of conditions. For an instrument to be

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[12] FSB, Global NBFI Monitoring Report, December 2022, p. 4.

[13] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 10.

considered an eligible 'transferable security' under the UCITS Directive, its liquidity has to be sufficient to ensure the UCITS' ability to honour redemption requests and in such a way that liquidity considerations already form part of the initial eligibility assessment. This ensures that the fund's underlying portfolio is sufficiently liquid to comply with the regulatory obligation to repurchase units or shares on demand.[14] Finally, management companies have the obligation to develop effective liquidity risk management processes and ensure that the funds under their management can meet redemptions in most – if not all – market conditions.[15] While European management companies do assess the liquidity of their funds' underlying assets, these data points are only used for the purpose of supervisory reporting, and not to meet minimum liquidity requirements. In this context, the practice of stress testing is particularly important to ensure that management companies are prepared to face large redemptions were market conditions to deteriorate. In 2020, ESMA adopted the *Guidelines on liquidity stress testing (LST) in UCITS and AIFs* to ensure that every European management company complies with a minimum set of requirements (e.g., the development of LST models, understanding of liquidity risks, LST governance, LST policy, frequency of LST, and use of LST outcomes).[16] Finally, in terms of LMTs, the European legislation does not mandate the use of a specific tool. The recently concluded review of the EU AIFMD/UCITS legislation requires each fund to not only have the right to suspend redemptions, but to also have recourse to at least two more LMTs that management companies can select from an exhaustive list of quantity- and price-based LMTs.

Second, **a regulatory approach based on liquidity bucketing would only represent additional operational costs for the end-investors and may ultimately result in a false sense of security for funds investing in liquid assets, as well as in counterproductive outcomes for funds investing in less liquid, or illiquid, assets**. **There is furthermore the risk that a regime shift in capital markets may require OEFs to change their liquidity management toolbox, which may create confusion among end-investors.**

Liquidity bucketing is, first and foremost, problematic because it provides a static measure of a fund's liquidity profile given the fluid nature of liquidity. Market liquidity indeed depends on a number of factors (including trade sizes, market depth, market resilience, and settlement period) that may vary across time and situations. There is therefore no guarantee that past levels of liquidity will reflect those in the future, even for securities deemed to be the most liquid (as the March 2020 market shock correctly demonstrated, where even U.S. Treasury bills suffered in this respect). This is particularly true in Europe where capital markets remain more fragmented than in the United States. While under normal market circumstances, it would be possible to derive fair estimations on the number of days to liquidate a given portion of the portfolio, market conditions can deal asymmetric blows to securities within a single asset class. For example, in the broad equity and corporate credit space, the COVID-19 crisis affected mostly those sectors exposed to airlines, travel, hotels, leisure, etc. This proves that assets in a same bucket can be impacted very differently and in ways that are impossible to foresee *ex-ante*.

This regulatory approach could moreover result in OEFs having to adopt LMTs for which they have limited use. For instance, should regulators adopt a stringent definition of liquidity, like the one currently under consideration in the United States[17], OEFs that invest in less liquid transferable securities could be

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[14] Articles 50 of Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and 2(1)(b) of Commission Directive 2007/16/EC implementing Council Directive 85/611/EEC as regards the clarification of certain definitions.

[15] AMIC/EFAMA, Managing fund liquidity risk in Europe, January 2020; AMIC/EFAMA, Response to the IOSCO Consultation on Open-Ended Funds, April 2021, p. 2.

[16] ESMA, Guidelines on liquidity stress testing in UCITS and AIFs, July 2020.

[17] The SEC is asking U.S. management companies to calculate the liquidity of their funds' portfolio on the assumption that their funds would have to sell one-tenth of their portfolios within a very short period of time, which is a very unlikely

considered as OEFs investing in illiquid assets from that point forward. Under the envisaged FSB recommendations, this could mean that, even though they invest in transferable securities, these funds would need to implement longer notice periods. Yet, these would be of limited added value for these funds. As an LMT, notice periods give visibility to the management company regarding upcoming redemptions and allow the company to sell assets in advance to meet these redemptions. While a very useful tool for funds investing in illiquid assets, it is less so for funds investing in transferable securities, where management companies seek to minimise the time between the order to sell the underlying assets and the NAV calculation, as this could result in a profit or a loss for the funds. For instance, should the management company sell the assets at a lower price compared to the price used to calculate the NAV on the day of the redemption, this would result in a dilution for the remaining investors because the value of the sale would be insufficient to cover the value of the redemption. A similar concern could be expressed as regards OEFs investing in liquid assets which, as a result of a strict definition of liquidity, could then be considered as OEFs investing in less liquid assets and would be required to use anti-dilution tools (ADTs). As outlined in our response to the IOSCO consultation on anti-dilution LMTs, there are funds that, in the aggregate, face consistently low levels of dilution. It is thus questionable whether requiring the use of ADTs for these funds would have sufficient investor protection and/or financial stability benefits to justify the additional costs incurred by these funds.[18]

Lastly, we can expect that **management companies may have to update their liquidity management toolbox when the liquidity in some market segments decreases, which may in turn create confusion among (retail) investors**. When such market shifts occur, management companies would have to inform the board of the funds under their management. Should these market shifts persist over the medium- to long-term, management companies could then have to update their liquidity management toolbox by adopting the LMT corresponding to the new liquid bucket of the OEF under their management. Beyond the fact outlined above that this change may not be compatible with the characteristics of the given fund (e.g., were a fund investing in transferable securities to introduce a notice period), these would also require an amendment to the fund's prospectus and/or rules, the preliminary agreement of the local supervisor, and, where necessary, the prior consent of existing end-investors. This is likely to be a particular problem for mixed asset (or 'hybrid') funds, which, given their underlying asset mix, are more likely to find themselves switching between the 'liquid' and 'less liquid' buckets as market circumstances changes creating operational complexity and significant confusion among end-investors.

Liquidity management tools

EFAMA agrees that public authorities should continue to strive to ensure that management companies have access to all LMTs and would welcome further guidance from IOSCO to promote greater incorporation, use, and consistent disclosure of LMTs. This guidance would serve several purposes: 1) help management companies with less sophisticated liquidity management practices to learn from others' best practices, 2) ensure greater consistency in the disclosure of LMTs, and 3) help public authorities to supervise the liquid risk management practices of their local industry.

This guidance should be principle-based to ensure that management companies can select the tools that are the most appropriate for the funds under their management. As we have outlined in our response to the IOSCO consultation on anti-dilution LMTs, even within a single fund category, there may be differences among funds which call for the use of different LMTs. While we understand the concerns around 'material variations' in the use of LMTs, these are better explained by the sheer diversity of the asset

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scenario. Please refer to the SEC proposal for more details: SEC, [Proposal on Open-Ended Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT](), November 2022.

[18] EFAMA, Response to the IOSCO Consultation on Anti-Dilution Liquidity Management Tools, September 2023.

management sector. Seeking consistency in the use of these tools for the pure sake of consistency would only be counterproductive.

As regards the **use of LMTs**, and in particular ADTs, we reiterate that management companies should continue to retain the discretion to select, in discussion with their national supervisors, the LMTs that are the most appropriate for the funds under their management. When selecting a LMT, it is important to consider the fund's liquidity profile and broader liquidity risk management framework to ensure their consistency. Echoing our response to the IOSCO consultation on anti-dilution LMTs, it is not necessary for every OEFs to use an ADT (especially where they already use other LMTs), as some funds face low dilution levels (e.g., large cap equity funds, single-investor funds, or funds using appropriate quantity-based LMTs), while others might face dilution levels that are too low to warrant a full-fledged anti-dilution arrangement (where the latter can be quite costly for the fund to set up and manage). Similarly, OEFs that use ADTs should not be required to factor in implicit transaction costs when the management company has sufficient assurances that the funds under their management are not subject to such costs. It would therefore be counterproductive to develop prescriptive rules, especially considering that there are a number of barriers and disincentives that may prevent management companies from complying with these rules (e.g., market structures, investor sentiment, and scrutiny from supervisors).[19] In addition, it is important to stress that quantity-based LMTs, such as gates and certain *ex-ante* quantitative redemption limits (e.g. 5 to 8% *per annum* as in the recently-reviewed EU ELTIF regime), are as important to the OEF sector as ADTs. These LMTs ensure that OEFs do not face large redemptions and, by extension, limit the (implicit) transaction costs that these funds bear when meeting their redemptions.

Regarding the **disclosure of LMTs**, it is crucial to find the **appropriate balance between transparency and effectiveness**. End-investors should have sufficient confidence that the management companies of the funds in which they invest will take all the precautions necessary to protect their best interests. Management companies in fact already provide a lot of information about their liquidity management practices in their funds' prospectus, annual reports, and/or on their websites. This being said, we understand from this consultation and the one from IOSCO that additional disclosures would be welcome (e.g., by providing the transaction costs that are considered by the management company in the calibration of the ADTs). In our opinion, it would however be excessive to provide quantitative information to end-investors – regardless of whether these disclosures are *ex-ante* or *ex-post* – with the objective to allow these to incorporate the cost of liquidity into their own investment decisions. It should be enough that investors know that, for funds where dilution is probable, the respective management companies will pass the cost of liquidity onto the subscribing or redeeming investors. While it is unlikely that retail investors will make use of these additional disclosures, professional investors are already sufficiently sophisticated to estimate transaction costs and, in some cases, already have access to more detailed information. **These additional disclosures should therefore not extend to quantitative information, such as threshold ranges and/or adjustment factors used in the calibration of ADTs.** These disclosures may in fact be used by opportunistic investors to exit a fund before the activation of the LMT, thereby defeating the very purpose of these disclosures.

Other FSB recommendations

EFAMA also wishes to share its views on the prospect of additional supervisory reporting and the development of system-wide liquidity stress testing.

First, as regards **supervisory reporting**, we believe that **management companies should only report on a regular basis data points that supervisors intend to consistently use in their (macro-)prudential**

[19] EFAMA, Response to the IOSCO Consultation on Anti-Dilution Liquidity Management Tools, September 2023.

analyses. European management companies already provide extensive information to supervisors. Before introducing any additional requirements, these authorities should thus closely review whether they make full use of all the data points currently provided to them.

While we do believe that more consistent reporting as regards the inclusion and use of LMTs would be useful, it would probably be more efficient for supervisors to conduct *ad hoc* supervisory reviews to evaluate the consistent use of these tools. We indeed note that the FSB believes that *"with the exception of suspensions, data are not available on a consistent basis on the use of LMTs by managers in normal or stressed market conditions. Managers in various jurisdictions do not consistently have to disclose or inform regulators when they use an LMT (apart from suspensions). Lack of consistent data about the use of LMTs is more pronounced than lack of data about the inclusion of LMTs in OEFs' constitutional documents".*[20]

In our view, and in line with the regulatory changes made under the EU UCITS/AIFMD regime, management companies should report to supervisors the LMTs that are available to their funds. As regards the use of LMTs, we believe that management companies should only notify their local authority when they activate a quantity-based LMT (i.e., suspension and gates). Because other LMTs may be used on a more frequent basis, notifying the activation of these tools would be burdensome for management companies. Management companies could moreover also provide information about the use of LMTs in *ex-post* disclosures (e.g., in the funds' annual accounts). This being said, nothing would prevent supervisors from reviewing on an *ad hoc* basis liquidity management practices in the OEF sector. ESMA for instance conducted such an exercise in 2020 with the *Common Supervisory Action (CSA) on UCITS Liquidity Risk Management*.[21]

Second, as regards **system-wide liquidity stress testing**, we do not believe that this practice is possible for the simple reason that this methodology was initially developed to monitor the risk of contagion within the banking sector. The objective of such system-wide testing is to see whether the failure of a systemically important bank would result in a 'domino effect' among other banks. In the OEF sector, system-wide stress testing would not work, as it is not the solvency of funds that would be tested, but their liquidity. A system-wide exercise would have to rely on multiple extreme assumptions (for example, the assumption that all investors behave in the same way, which is simply not confirmed by the analysis of investor flows under stressed market conditions) and on piecemeal data, which we consider insufficiently robust to provide actionable insights. The recent Bank of England's System-Wide Exploratory Scenario (SWES) exercise has confirmed the conceptual challenges with designing a system which can effectively reflect the operation of investment funds within the wider market-finance ecosystem.

Additional considerations

EFAMA does not believe that **the envisaged recommendations will significantly solve the market-wide imbalance between liquidity demand and supply** identified by the FSB in its *Progress report on NBFI resilience* and which has built-up over the course of the last decade in global capital markets due to an increasingly opportunistic liquidity supply.[22]

As outlined above, we do believe that **some targeted reforms in the OEF sector may be conducive to more resilient capital markets**. To reiterate the recommendations we have made throughout this

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[20] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 8.

[21] ESMA, Public Statement – CSA on UCITS Liquidity Risk Management, March 2021.

[22] FSB, Progress report on enhancing the resilience of non-bank financial intermediation, November 2021, p. 1.

response, we would be supportive of 1) full availability of LMTs across all jurisdictions, as well as 2) IOSCO guidance on the inclusion, use, and disclosures of LMTs.

However, **the aforementioned imbalance will require more ambitious reforms than the ones outlined above**. We agree with the FSB that *"OEFs are only one part of a broader market eco-system"* and that therefore *"a holistic and proportionate approach to addressing […] vulnerabilities"* will be necessary.[23] To this end, we would recommend **four distinct market-wide reforms**:

1. **Create a consolidated tape for fixed-income securities in Europe:** Providing greater transparency during times of market volatility would help market participants identify liquid markets and allow supervisors to monitor concerning market developments. We welcome the conclusion of recent EU reforms (i.e. the EU MiFIR review) in this regard;

2. **Improve CCP margin transparency and predictability:** Central counterparties (CCPs) could size initial margin requirements more conservatively by using appropriate model assumptions to mitigate the potential for future procyclical initial margin moves. This would avoid any excessive flow of liquidity away from markets during periods of stress;

3. **Facilitate the use of liquidity buffers by banks during periods of stress:** Banks have liquidity buffers to act counter-cyclically during periods of stress by providing the necessary liquidity. Yet, during March 2020, banks were unwilling to dip into these buffers. Greater guidance from banking regulators on when and how banks can deploy these buffers would contribute significantly to the resilience of capital markets; and

4. **Consolidate supervisory reporting across all financial sectors:** In order to conduct comprehensive systemic risk analyses, supervisors should have data on how all types of market participants, intermediaries and product types behave under normal and stressed market conditions. In sectors where market participants already provide extensive supervisory information, regulators should ensure that supervisors exchange the data that they collect among themselves. For example, in the case of European investment funds, central banks should share their fund inventories with market supervisors.

[23] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 7.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book.

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