

## **BVI<sup>1</sup> position paper on the FSB's consultation report on liquidity preparedness for margin and collateral calls**

### **Section 1: Introduction**

1. *Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?*

In general, we welcome a global discussion on liquidity preparedness for margin and collateral calls during times of stress. However, we do not agree with the result of the analysis laid out in the consultation report that – based on individual cases – the fund sector as part of the NBFIs sector is not adequately prepared with respect to spikes in margin and collateral calls and therefore new and strict rules are necessary.

The European legislator has already provided a highly regulated framework for investment funds and their liquidity management including margin calls and collateral management. In fact, strict rules and practises on liquidity management of margin and collateral have been in place for many years for European investment funds, and notably,

- In the UCITS Directive<sup>2</sup> and the Eligible Asset Directive<sup>3</sup> with requirements on a risk management process which enables the management company to monitor and measure at any time the risk of the positions (including derivatives) and their contribution to the overall risk profile of the portfolio. This involves also obligations to employ a process for the accurate and independent assessment of the value of over-the-counter (OTC) derivatives.
- In Directive 2010/43/EU<sup>4</sup> implementing the UCITS Directive with specific requirements on the liquidity of collateral and on considering collateral in the calculation of exposures to counterparty risks. In particular, collateral received shall be sufficiently liquid so that it can be sold quickly at a price that is close to its pre-sale valuation.
- In the AIFMD<sup>5</sup> and its Delegated Regulation<sup>6</sup> with requirements on risk and liquidity management processes and conducting regular stress tests which cover market risks and any resulting impact, including on margin calls, collateral requirements or credit lines, and specific requirements on setting a maximum level of the extent of any right of re-use of collateral and its disclosure to investors.
- In ESMA's Guidelines on liquidity stress testing for UCITS and AIFs<sup>7</sup> with examples of factors which may affect liquidity risk such as liquidity of collateral and potential events which may be simulated such as simulation of cash collateral reinvestment risk.

---

<sup>1</sup> BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 115 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit [www.bvi.de/en](http://www.bvi.de/en).

<sup>2</sup> Cf. Article 51 of the [UCITS Directive](#).

<sup>3</sup> Cf. Article 8 of the [Directive 2007/16/EC](#) on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions.

<sup>4</sup> Cf. Article 43(3) and (4) of the [Directive 2010/43/EU](#) implementing the UCITS Directive

<sup>5</sup> Cf. Article 15, 16 and 23 of the [AIFMD](#).

<sup>6</sup> Cf. Article 48(2)(c) of the [Delegated Regulation \(EU\) No. 231/2013](#)

<sup>7</sup> ESMA, [Guidelines on liquidity stress testing in UCITS and AIFs](#), July 2020.



- In ESMA's Guidelines on ETFs and other UCITS issues<sup>8</sup> with specific requirements on the management of collateral for OTC financial derivative transactions and efficient portfolio management techniques including stress tests, implemented in a German Derivatives Regulation<sup>9</sup> applicable to all investment funds using derivatives.
- In CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS<sup>10</sup>, and
- In CESR's Guidelines concerning eligible assets for investment by UCITS.<sup>11</sup>

In addition, with the updated European Market Infrastructure Regulation (EMIR)<sup>12</sup>, the European legislator has established strict cross-sector rules to curb systemic risks in the European derivatives market. This results in further comprehensive obligations for certain parties, including investment funds, relating to derivatives transactions.

Moreover, the fund industry's share of derivatives transactions in the European market is not very large and did not have a significant impact even in times of crisis. According to the latest report on derivatives published by ESMA, banks continue to dominate the derivatives holdings in the European market<sup>13</sup>:

*“Credit institutions hold by far the largest amount of overall notional (62% in 4Q22, +7ppt since 4Q20) with over 80% of their notional amount in interest rate derivatives and just under 15% in currency derivatives in 4Q22. In terms of non-banks, their overall share of notional amount fell over the reporting period (48%, -7ppt) with a shift away from non-banks in all assets except commodities, and away from alternative investment funds and non-financial firms to banks in particular[...]. Non-financial firm exposures, which account for 4% of total notional amounts had half of their exposures in interest rate derivatives, a third in currency derivatives and 10% in commodities in 4Q22. **For undertakings for collective investment in transferable securities (UCITS), which account for 2% of total notional**, 43% of exposures were in currency derivatives, 35% in interest rate, 12% in equity and 10% in credit. **Alternative investment funds (AIFs), also 2% of total notional**, had almost two thirds of their notional in interest rate derivatives, a fifth in currency, and 8% and 7% in credit and equity respectively in 4Q22.”*

ESAMA has also provided an overview of the **impact of the COVID-19 crises** in its report on EU derivatives markets<sup>14</sup> for the whole European Market. Here, too, the proportion of derivatives used via funds was very low compared to other market participants. **Moreover, German ‘Spezialfonds’ (alternative investment funds for institutional investors, about 28 per cent of the European fund market) did not propagate market stress through their investment decisions during the COVID-19 crisis.** A potential way in which ‘Spezialfonds’ may be interconnected (thus having the potential for the propagation of market stress) is through their investment (or rather lack of divestment) decisions during periods of financial stress. Even in March 2020, when volatility was particularly high due to widespread fears related to the COVID-19 pandemic, **open-ended ‘Spezialfonds’ reached net inflows of more than EUR 9 billion.** This equated to 0.5 percent of total assets at that time (EUR 1.9 trillion). Against the background of the unfolding crisis, fund managers altered the asset allocation of ‘Spezialfonds’ – but only moderately. According to figures collected by Deutsche Bundesbank, **they built up cash holdings by EUR 26 billion (increasing their share in the asset mix from 3.8 to 5.6 percent).** Bonds accounted for 52.7 percent at the end of March 2020, which is exactly the same share as in the previous

<sup>8</sup> ESMA, [Guidelines on ETFs and other UCITS issues](#), August 2014, pages 9 – 12.

<sup>9</sup> [Derivatives Regulation](#) with [justification](#) and further [explanations](#) provided by BaFin (available in German only)

<sup>10</sup> Cf., Box 9, [CESR's Guidelines](#) on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, July 2010.

<sup>11</sup> [CESR's guidelines](#) concerning eligible assets for investment by UCITS, March 2007, page 12.

<sup>12</sup> [Regulation \(EU\) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.](#)

<sup>13</sup> Cf., [ESMA's Market Report](#), EU Derivatives Markets 2023.

<sup>14</sup> [ESMA Annual Statistical Report 2021](#), EU Derivatives Markets.



month. However, the value of equity held fell by EUR 40 billion (equating to a reduction in total AuM from 13.1 to 11.7 percent). A large part of this effect can be explained by declining asset prices rather than actual divestments, though. After all, the MSCI World IMI fell by more than 14 percent in March 2020. The available data on investment decisions of ‘Spezialfonds’ managers therefore indicate pro-cyclical, but moderate changes in the asset mix.

**Based on the current strict European regulation and the market impact of the use of derivatives by investment funds, we see no inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress. The well-functioning European regulatory system should not be overloaded with new and different rules just because jurisdictions outside the EU are maybe not able to establish adequate rules or monitor compliance with these rules and therefore individual cases may arise (such as the Archegos debacle) that have an impact on the financial market in certain countries.**

In particular, German funds were not affected by the problems of GBP Liability-Driven Investment (LDI) strategies. Irrespective of this, we also see no need for stricter or further regulations at this point, as there are already measures in place (e.g. Article 25 of the AIFMD) that are intended to contain any systemic risks. ESMA has already made extensive use of this.<sup>15</sup> In particular, ESMA has issued some advice to the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier (CSSF) on investment restrictions for GBP LDI funds to ensure their resilience. In this context, ESMA also invites other competent authorities of AIFMs managing such funds to adopt similar measures.

## Section 2: Overview

### 2. *Is the scope of the proposed policy recommendations appropriate?*

In view of the importance of the use of derivatives by banks, we can certainly understand that their impact and requirements should be assessed separately. Nevertheless, in our view it would be entirely appropriate to adopt recommendations for all affected market participants (including banks), which should then be subject to the principle of proportionality, differentiated according to their market impact and influence, and on the sector-specific requirements and risks. Otherwise, we see a risk of competitive disadvantages for individual market participants and of regulatory arbitrage. For example, the EU legislator has already adopted cross-sector regulation with EMIR.

Regarding the sector-specific requirements, we miss detailed explanations of the rules for investment funds laid down at EU level in Annexes 1 - 2 of the consultation report. We therefore refer to our overview in the answer to question 1 and ask that these requirements also be included in further considerations.

### 3. *Is the focus of the FSB's policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?*

Given the low use of derivatives by investment funds in the EU market, we consider the proposed recommendations for investment funds to be too detailed and too far-reaching. In addition, the EU legislator has already established concrete and principle-based requirements for the liquidity management of funds with regard to margin calls and collateral management, which have not yet been taken into

<sup>15</sup> Cf. [Information](#) provided by ESMA, 29/04/2024.



account in the current proposals. We would therefore very much welcome it if the FSB were to adapt its recommendations accordingly in order to avoid changes to existing and effective requirements in this sector.

It is also important to consider the particularities of the individual countries in the distribution of funds and their investor structure (such as retail or institutional investors). This can vary from country to country and therefore require different measures.

*4. Is the approach to proportionality and materiality clear for all non-bank market participants?*

The FSB's consultation report prescribes the processes to be maintained in detail, which are intended to provide a semblance of security. In Germany and the EU, the potential margin payments of most funds (also in a worst-case scenario) are very manageable. It is therefore incomprehensible why such highly complex processes would be necessary. We would therefore be grateful if the principle of proportionality could be emphasised more clearly and would apply to different sectors.

In particular, we would like to emphasise that it is important that the rules for investment funds should apply at fund level and not at management company level because each fund is a separate vehicle with its own investment strategy, use of derivatives, (liquidity) risk policy and governance framework. This distinction is important because it has important implications for the way the proposed recommendations should be transposed to investment funds.

### Section 3.1 – Liquidity risk management practices and governance

*5. Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?*

It should be clarified that the systems and processes for the liquidity management of margin calls and collateral can be included in the general liquidity management processes and risk assessments of investment funds as it is already required under the AIFMD and the UCITS Directive. These requirements should also be based on the principle of proportionality. In particular, we miss the proportion of the derivative used and the collateral received in relation to the total (fund) portfolio as a criterion of the principle of proportionality.

Due to a high level of automation of collateral practices in the asset management sector we do not see an operational risk for the operational collateral management system, if due to crises the collateral calls increase significantly.

### Section 3.2 – Liquidity stress testing and scenario design

*6. Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?*

The proposed recommendations for liquidity stress tests and contingency funding plans are not appropriate and too far-reaching for investment funds because they presuppose that such stress tests and funding plans must be carried out in every case. Further criteria and sector-specific requirements for liquidity management should be considered here.



Managers of investment funds are required to have appropriate and effective liquidity management policies and procedures in place. That requires due consideration to be given to the nature of the investment fund, including the type of underlying assets and the amount of liquidity risk to which the investment fund is exposed, the scale and complexity of the investment fund or the complexity of the process to liquidate or sell assets. Therefore, the liquidity risk facing investment funds is difficult to determine as these funds hold assets with different liquidity levels while at the same time offering investors redemption. Therefore, stress tests are an important tool for measuring and controlling this risk. According to the European investment fund regulation, managers of investment funds shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each investment funds under their management. This also requires conduction stress tests which cover market risks and any resulting impact, including on margin calls, collateral requirements, or credit lines.

However, the liquidity risks of margin calls and collateral only account for a very small proportion of the fund's overall liquidity risks. For this reason, ESMA has also decided that only UCITS (with retail investors) receiving collateral for at least 30 % of its assets should have an appropriate stress testing policy in place to ensure regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS fund to assess the liquidity risk attached to the collateral. All other investment funds are not required to conduct such special stress tests.

Moreover, individual risk management practices of the counterparties are not known by asset managers and therefore cannot be part of a stress test scenario. Given the low volume of collateral and derivative investments, collecting such data is disproportionate to the outcome. However, due to the sector-specific regulations for fund managers, there are already requirements in the EU<sup>16</sup> that when selecting a counterparty (such as prime brokers, counterparties of OTC derivatives transactions, securities lending or a repurchase agreement) as part of the due diligence processes, it must be ensured that they are subject to proper supervision, are financially sound and have an organisational structure and resources that they need for the services to be provided.

We also do not agree with the proposed process to estimate the increase in initial margin requirements and haircuts under extreme but plausible stress scenarios, including separate estimates for types of exposures. In general, generous estimates should be sufficient. If, for example, potential margin calls are generously estimated, then it is irrelevant whether these arise from the initial margin or the variation margin. The same applies to the requirement for estimates for different time horizons. If the liquidity requirement has already been estimated for two weeks, for example, then we see no added value in an estimate for one week or one day.

*7. Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?*

Yes. The European legislator has already provided a highly regulated framework for investment funds and their liquidity management including margin calls and collateral management. We refer to our answers to questions 1 and 6.

Moreover, as stated multiple times and with regard to various legislative procedures (e.g. EMIR, SFTR, UCITS Directive), we would like to take the opportunity to strongly reiterate that UCITS have substantial difficulties to provide cash collateral in cases of centrally and bilaterally cleared OTC derivative

<sup>16</sup> Cf. Article 20 of the Delegated Regulation (EU) No. 231/2031; Article 23 of the Directive 2010/43/EU.



transactions under EMIR. The ESMA Guidelines on ETFs and other UCITS issues restrict the re-use of cash obtained from UCITS repo transactions for such purpose. In practice, paragraph 43 letter (j) of the Guidelines hampers UCITS' ability to access CCP clearing. The mentioned guideline considers the obtained purchase price under a repurchase agreement as collateral. Such artificial construct (e.g. the purchase price) breaches with EU law as it creates a new legal obligation on the level of an ESA guideline rather than interpreting existing rules. It is also in contrast to any and all known master agreements worldwide. The consequence of the artificial re-classification of a purchase price to collateral is a very restrictive prohibition. The mentioned guideline restricts the use of collateral. In particular, it prohibits posting the purchase prices (e.g. cash) received in a repo transaction as collateral to a CCP, respectively the clearing member. Since UCITS' borrowing is restricted to 10% of the net asset value (NAV), it is obvious that UCITS will be hampered to use OTC derivatives subject to a clearing obligation. Therefore, UCITS are forced to generate liquidity by switching from physical into synthetic investments. This generates additional costs which have to be borne by the investors without creating any regulatory benefit. Therefore, the FSB should encourage ESMA to amend paragraph 43 letter (j) of the Guidelines in order to clarify that the purchase price should not be considered under a repurchase agreement as collateral. The EU Commission should also clarify this in EMIR in order to overrule ESMA. Functioning EU Capital markets and access to liquidity during a financial crisis should be prioritised over legal interpretations.

### Section 3.3 – Collateral management

8. *Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?*

We refer to our answers to question 1. Collateral management is already covered by European legislation and ESMA guidelines in the investment fund sector. Additional requirements apply due to the EMIR. The well-functioning European regulatory system should not be overloaded with new and different rules.

9. *Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?*

No. It should be considered that collateral management is usual uncritical due to a high level of automation.

\*\*\*\*\*