

AFM Position Paper

Mitigating systemic risk in investment funds

Views on macroprudential policy for
investment funds

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1 Introduction

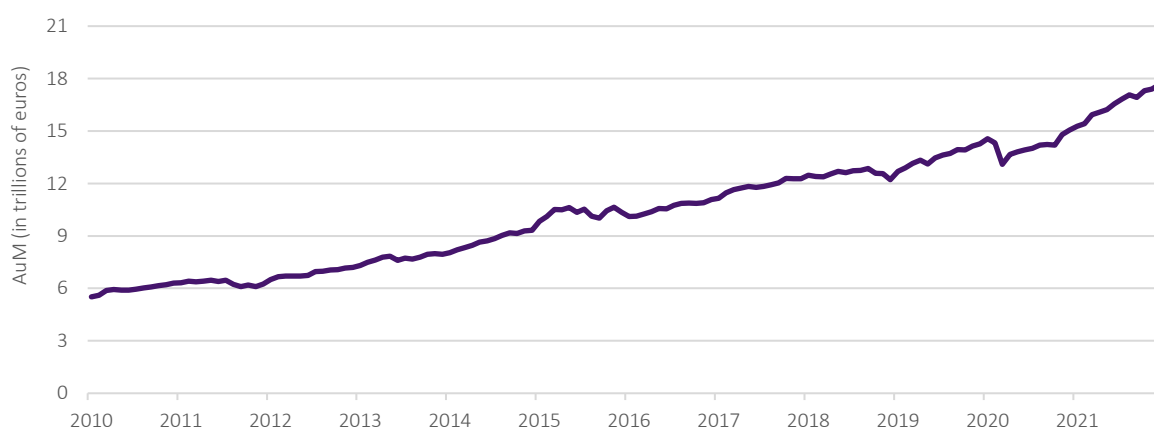
The question of how to mitigate potential financial stability risks in and emanating from the asset management sector is an ongoing topic of debate internationally. As a conduct of business and capital markets supervisor, the AFM contributes to this debate by sharing its view on macroprudential policy for the asset management sector. In this discussion paper, we will first set out the AFM's view on the principles behind the policies we endorse. We will then present our views on specific policies that would help to limit systemic risk.

In our view, enhancements can be made in three areas within the asset management sector: (i) prudent design of the funds, (ii) proactive ongoing risk management, and (iii) macroprudential tools at the discretion of National Competent Authorities (NCAs). In addition, improvements can also be made outside the sector that would help reduce the systemic risk faced by investment funds.

2 Systemic risk in investment funds

The investment fund industry has been growing over the past decade. In Q1 2022, Assets under Management (AuM) in the euro area totalled EUR 17.6 trillion or 132% of the euro area's GDP (Figure 1). Since the end of 2010, these activities have on average increased by 10% per year. Approximately 90% of asset management activities in the euro area takes place in five countries: Luxembourg, Ireland, Germany, France and the Netherlands, based on fund domicile.¹

Figure 1: Total AuM of investment fund industry in the euro area



Source: ECB

The asset management sector and investment funds play an important role in the allocation of resources to the real economy and in the diversification of those resources. They contribute to the resilience of the financial system by providing an alternative source of funding, next to bank finance, and they offer investors alternative ways to invest. In this intermediary role, investment funds pool resources, perform liquidity transformation, redistribute risks and attract a wide variety of investor types with very heterogeneous investment goals.

Most investment funds are mainly equity-financed and thus able to withstand valuation shocks. Compared to banks, investment funds are less dependent on debt financing, which means they are not exposed to the same type of solvency risks as banks. In addition, investors take an equity stake in a fund, meaning that they are the owners of the underlying assets and not the fund manager, who is the fiduciary agent. Investors are generally aware that the value of their investments will vary according to the market and risk profile of the fund. Nevertheless, due to their increased size, concerns about systemic risks of the investment fund sector, and open-end investment funds in particular, have increased in recent years.^{2,3}

Historically there have been some episodes of systemic risks arising from investment funds. Examples are the collapse of the Long-Term Capital Management (LTCM) hedge fund in 1998⁴ and the contribution of the money

¹ ECB statistical Data Warehouse

² Financial Stability Board (2017), "[Policy Recommendation to Address Structural Vulnerabilities from Asset Management Activities](#)".

³ IMF (2021), "[Investment Funds and Financial Stability: Policy Considerations](#)", Departmental Paper No 2021/018.

⁴ Where the use of large amounts of derivative contracts led to large liquidity needs to fulfil margin calls, see US Department of the Treasury (1999), "[Hedge funds, leverage, and the lessons of Long-Term Capital Management](#)".

market fund (MMF) sector to the global financial crisis of 2007-08.⁵ Most recently, the COVID-19 financial markets shocks show how investment funds, and specifically MMFs, can contribute to market stress and systemic risk.⁶ Some funds had trouble meeting redemption requests of their investors, which may have increased market stress. Other funds found it difficult to meet the margin calls on their derivatives portfolios. And the invasion of Ukraine by Russia causes valuation issues for certain investment funds and strategies.

In the context of investment funds, systemic risk can be defined as those risks that originate from liquidity risk or the use of leverage by the fund and that threaten the functioning of the financial system. In our view, the functioning of the financial system is compromised when a large, systemically relevant fund or a group of funds: (i) cannot fulfil the liquidity needs of their investors, (ii) pose a risk to the functioning of (systemically) relevant markets, or (iii) pose a risk to systemically relevant institutions outside the investment fund sector, such as CCPs or banks. Liquidity risks originate from liquidity mismatches between the assets and liabilities of a fund and from margin calls resulting from the use of derivatives. Liquidity stress can spread to the wider financial market through several transmission channels, including illiquidity of markets and the inability to meet investor demand for redemptions.⁷

Liquidity mismatches can trigger systemic risk if they lead to fire sales. Especially in times of severe or sudden market stress, mismatches between the liquidity of the assets and the fund's redemption profile can lead to fire sales to meet redemption requests. This potentially affects prices and liquidity in affected markets and thus also other market participants holding the same or correlated assets. Lower asset prices may give investors further incentives to redeem investments in the fund, or trigger automated trading algorithms, resulting in additional selloffs that amplify the impact of the initial shock. The initial outflow can be triggered by negative market returns. Larger liquidity mismatches may increase negative externalities for investors, resulting in greater procyclicality and a risk of investor runs. The expectation that some investors will redeem can cause investors to front run this, resulting in first-mover advantages which can lead to investor runs. Liquidity risk is particularly pronounced during periods of crisis, as the collective behaviour of funds and their investors can amplify market-wide shocks. The likelihood of fire sales increases due to: (i) highly correlated holdings across funds, (ii) the use of similar risk models and monitoring frameworks, (iii) the reduction in dealers' intermediation capacity relative to the size of the market, and (iv) leverage.⁸

The presence of leverage in an investment fund increases the risk of fire sales and can amplify the magnitude of the shock that funds transmit to other parts of the system. In addition, leverage impacts systemic risk because it has the potential to increase solvency risk, particularly through the use of derivatives. The collapse of LTCM and the recent example of Archegos⁹ demonstrate this risk. Leverage can lead to concerted spikes in margin calls and hence cash needs in periods of high market volatility.¹⁰ The larger the leveraged fund is or the use within the sector as a whole, the larger the potential impact it has on the market and on other financial institutions and thus the more systemically relevant the fund and investment fund sector becomes.

⁵ A run on MMFs led to large liquidity demand from MMFs and eventually led to funds 'breaking of the buck', see Baba, N., McCauley, R.N., Ramaswamy, S. (2009), "[US dollar money market funds and non-US banks](#)".

⁶ Financial Stability Board (2020), "[Holistic Review of the March Market Turmoil](#)".

⁷ See for instance: European Systemic Risk Board (2016), "[Macroprudential policy beyond banking: an ESRB strategy paper](#)", Financial Stability Board (2017), "[Policy Recommendation to Address Structural Vulnerabilities from Asset Management Activities](#)", European Systemic Risk Board (2018), "[Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds \(ESRB/2017/6\)](#)", and International Monetary Fund (2021), "[Investment Funds and Financial Stability: Policy Considerations](#)", *Departmental Paper No 2021/018*.

⁸ Claessens, S., and Lewrick, U. (2021), "[Open-ended bond funds: systemic risks and policy implications](#)", *BIS Quarterly Review*, December 2021.

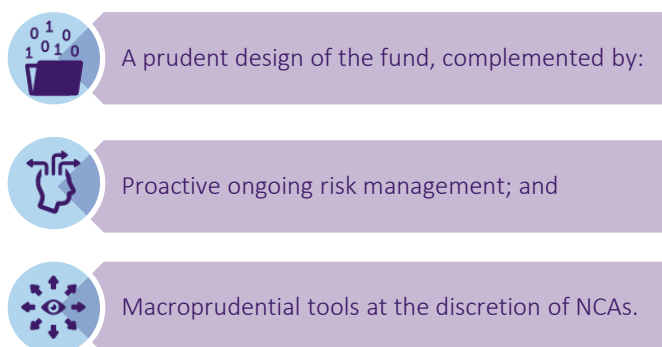
⁹ ESMA (2022), "Leverage and derivatives – the case of Archegos", May 2022.

¹⁰ This was demonstrated during the COVID-19 market turmoil when margin calls rose fivefold. Especially large institutional investors, such as pension funds that hedge interest rate risk via interest rate swaps, were faced with these margin calls. During that period, funds were generally able to meet the margin calls by raising cash by engaging in repo transactions, selling assets (e.g. money market fund shares) or drawing on credit lines, thereby amplifying market dynamics. See ECB (2020), "[Financial Stability Review](#)", May 2020.

3 Macprudential policy for investment funds

3.1 Policy principles

To address systemic risks emanating from investment funds, both a microprudential and macroprudential approach are needed. Microprudential rules are regulatory requirements that individual funds must comply with. These are mainly aimed at investor protection, but also help to reduce systemic risk. On top of this microprudential approach, one could define a macroprudential approach, consisting of measures purely aimed at reducing systemic risk. These could include measures that: (i) limit the build-up of risks in the sector as a whole, (ii) are aimed at systemically important investment funds, or (iii) are aimed at vulnerabilities resulting from the collective activities of investment funds. Depending on the objective, these macroprudential measures can be temporary or permanent. In designing macroprudential policy, one should weigh up the potential benefits to financial stability against the costs it imposes on the funds and thus also on their investors. In our view, policies to reduce systemic risk consist of three building blocks, comprising a microprudential approach complemented by macroprudential tools. In each of these building blocks improvements can be made. The building blocks are:



Some of the vulnerabilities and risks affecting investment funds should be addressed outside the investment fund sector. Vulnerabilities and risks can best be mitigated at the root of the problem, which may be located outside of the investment fund sector. In our view, macroprudential policy for investment funds should not repair vulnerabilities that are present in the wider financial market or at other financial institutions. It must only focus on risks and vulnerabilities that emanate from investment funds, or should aim to increase the resilience of investment funds so that the investment fund sector does not spread and/or amplify risks.

Current microprudential regulation can be improved to further reduce systemic risk. The EU regulatory framework comprises of the Directive for Undertakings for Collective Investments in Transferable Securities (UCITS), the Alternative Investment Fund Managers Directive (AIFMD) and the Money Market Fund Regulation (MMFR). This legislation set out governance and conduct rules for investment funds. This regulatory framework includes requirements on and tools for robust risk management for funds throughout their lifecycle, which can be separated into: 1) the design phase; 2) the ongoing management of the fund; and 3) emergency situations (see Box 1 for an overview). While the main objective of conduct rules and appropriate risk management is to protect investors, these rules also contribute to financial stability by reducing vulnerabilities at the investment fund level and thus preventing the build-up of risks on a system-wide level. In our view, improvements to these micro-level risk management rules are an effective way to reduce, at least partially, systemic risk.

Box 1 – The risk management framework for funds

The current risk management framework of funds can be broken down into different phases. First, in the ‘inception/design’ phase, the fund manager decides on the types of assets to invest in, the (potential) use of leverage and the fund’s overall liquidity profile, see figure 2. Based on these design features, the fund manager should develop a risk management strategy that includes liquidity stress tests, position limits and liquidity management tools (LMTs).¹¹ The existence of robust risk management strategies within the asset management sector has macroprudential relevance, even though the requirements and tools are microprudential in nature, because it enhances the robustness of investment funds and thereby prevents risks from becoming systemic. The AFM is of the opinion that fund managers should consider the design of their risk management framework and tools in multiple phases of the fund’s lifecycle.

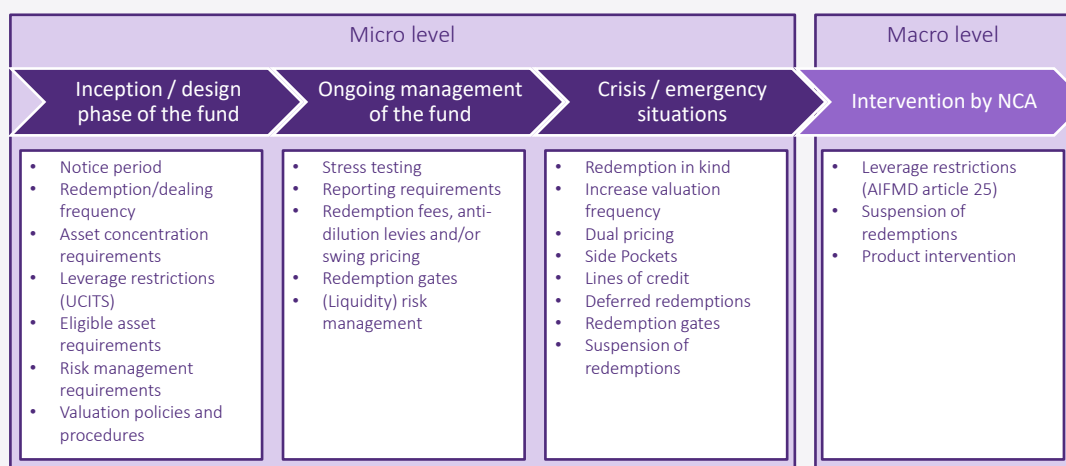
Under the current regulatory requirements, the fund manager must ensure that the redemption profile is consistent with the liquidity of the underlying assets. A fund manager has the responsibility to set a redemption frequency that matches the liquidity of the underlying assets and can include a notice period to anticipate and manage redemption requests. A notice period is beneficial in relieving the immediate pressure to sell and it directly addresses liquidity risk. The fund manager can design limits on exposure, asset concentration and eligible assets beyond regulatory requirements to improve the portfolio’s liquidity. In addition, it is important that a fund manager also takes into account the liquidity needs stemming from the use of derivatives, as these can give rise to margin calls.

In the ‘ongoing management of the fund’ phase, the fund manager should apply the conditions set in the ‘inception/design’ phase and employ its risk management framework, including liquidity management tools. If this is done early enough, fund managers can anticipate vulnerabilities and pre-emptively mitigate risks. In this phase, the fund manager uses liquidity stress testing for individual funds as a tool to test liquidity management practices against outcomes that appear unlikely but are possible. Furthermore, the fund manager can apply pricing tools, such as swing pricing, redemption fees or anti-dilution levies, to effectively pass on to investors the transaction costs stemming from inflows into and outflows from the fund effected by the relevant investors. Using pricing tools ensures fair and equal treatment of investors and reduces first-mover advantages in funds. In addition, the fund manager can apply a permanent redemption gate to restrict outflows. In this phase, supervisors can reduce risk by limiting investment funds’ use of leverage.

In the ‘crisis/emergency situations’ phase, the fund manager and supervisory authorities have tools available to immediately intervene in the fund if the situation requires it. These crisis/emergency tools are complementary to the standard risk measures and can only be used by the fund manager if these tools are included in the prospectus. Emergency tools are aimed at immediately addressing the liquidity risk that can emerge in a crisis. In these situations, the fund manager can apply redemption gates, switch to in-kind redemptions, dual pricing or side pockets, or even suspend all subscriptions and redemptions to mitigate pressing liquidity risk. Tools that limit the outflow are best suited for situations where a deterioration in the liquidity conditions cannot be managed by means of redemption terms. During a crisis, not only the fund manager can intervene, but also the supervisory authority, which can suspend redemption of individual funds or a group of funds when this is in the public interest.

¹¹ IOSCO (2018), “[Recommendations for liquidity risk management for collective investment schemes](#)”; IOSCO (2018), “[Open-ended fund liquidity and risk management – Good practices and issues for consideration](#)”.

Figure 2: Overview of relevant risk management requirements and tools by operating phase



Source: AFM

Sound risk management is first and foremost the responsibility of the fund manager. This consists of having a measured redemption profile relative to the composition of the portfolio of assets and a targeted use of liquidity management tools (LMTs). In using LMTs, there is no ‘one size fits-all’ solution and responsible entities are expected to exercise their sound professional judgement in the best interest of investors. Due to the heterogeneous nature of the investment fund sector, there is no standard rule whereby specific types of LMTs should be available and/or implemented for certain types of funds. The relative liquidity of assets can vary over time, affecting the cost or time it takes to liquidate the position held in the portfolio. In times of liquidity stress in the market, liquidity can occasionally disappear in market segments. The selection of available LMTs and timely use of LMTs should take into account the dynamic and relative nature of liquidity. Fund managers have the responsibility to assess the risks, consider their funds’ size relative to the market and the types of investors, select the appropriate LMTs for their funds, and include these LMTs in the prospectus to ensure they can be used. Table 1 below illustrates well-known vulnerabilities faced by investment funds related to systemic risk transmission and useful tools to address these. Fund managers should analyse the vulnerabilities affecting their funds and how their funds transmit risks to the wider financial markets and determine which tools they need. For instance, if a fund manager is running an equity fund, swing pricing may be sufficient to reduce first-mover advantage. But if it is managing an emerging market corporate debt fund, adequate swing factors may be hard to define and fees and/or gates may work better.

Table 1: Illustration of vulnerabilities faced by investment funds and LMTs to address them

	Useful tools to address the vulnerability	Examples of fund types subject to the vulnerability
Run risk due to herd behaviour of investors or first-mover advantage	Swing pricing, redemption fees, anti-dilution levies, redemption gates	All types of funds
Assets for which the market can become less liquid or even illiquid in times of stress	Swing pricing, redemption fees, anti-dilution levies, redemption gates, side-pockets	Sovereign debt funds, corporate debt funds, emerging market funds
Inherently illiquid assets	Notice periods, redemption fees, anti-dilution levies, redemption gates, suspension of redemptions	Real estate funds, infrastructure funds
Margin calls due to the use of derivatives	Liquidity buffer	Hedge funds, overlay funds

The AFM sees the activation of ex-post macroprudential tools as a backstop and a measure of last resort. Fund managers have the responsibility to manage the liquidity of their funds. Their information position with respect to the liquidity risks in their funds is superior to that of supervisory authorities. However, in certain situations, a macro perspective is necessary. For example, when liquidity is scarce and individual fund managers do not take negative spill-over effects of their actions into account, or when many funds struggle to find liquidity at the same time and together pose a systemic risk to the financial system. In such circumstances, an intervention by supervisors is warranted, which may take the form of reducing the outflow of liquidity, for example.

Effective macroprudential policy also includes tools that can prevent a build-up of systemic risks or increase the resilience of the investment fund sector or systemically important institutions. Hence, NCAs have a responsibility to monitor the build-up of risks and activate tools accordingly. These tools are not ex-post crisis intervening tools, but ex-ante tools and preferably countercyclical. The leverage limit is one such tool, as is stress testing. The development of further ex-ante tools is needed, which will require additional research.

3.2 Prudent design of the fund

The reduction of systemic risk starts with a prudent design of the fund by the fund manager. This includes designing the right balance between underlying investments, redemption terms, the use of leverage and liquidity buffers. A conservative redemption profile becomes more relevant the less liquid the underlying assets are. Furthermore, the use of leverage and the accompanying margin calls can make it necessary for fund managers to set a liquidity buffer. As described in Box 1, the current microprudential regulation provides fund managers with the suitable tools for a prudent design of their funds. However, we believe that supervisory authorities can be more prescriptive when it comes to the use of these microprudential tools to mitigate systemic risks.

Redemption terms

Aligning redemption terms to the liquidity of the assets is an effective way to reduce liquidity risks; this will require further guidance by NCAs. The redemption terms consist of the notice period, the redemption frequency and the settlement period. These should be in line with the liquidity profile of the underlying assets to reduce liquidity mismatch. The notice period is especially effective in mitigating liquidity risks that originate from redemption requests, as it allows fund managers to plan for liquidity demand from investors and search for liquidity. A longer notice period creates a time buffer for the fund manager to sell underlying assets. Redemption terms become more effective the less liquid the underlying assets are. Funds investing in inherently illiquid assets should have a longer notice period. Examples of such inherently illiquid funds are real estate funds and infrastructure funds. The added use of a notice period is more effective than a lower redemption frequency alone, as a redemption term without a notice period still results in an immediate liquidity need to fulfil the redemption request, albeit on fewer days in a year. A prudent redemption term should take into account the liquidity of the underlying assets in stressed market circumstances. Current regulation is not very prescriptive on this point. Therefore, in our view, NCAs would develop additional guidance.¹²

Liquidity buffer

A macroprudential liquidity buffer for all funds to cover redemption requests would in our view not be effective. Some liquidity needs, specifically those arising from redemption requests, are simply not well addressed by adding a liquidity buffer. For example, for funds that invest in inherently illiquid assets, such as real estate funds, the use of liquidity buffers as the main instrument to cover redemption requests could trigger first-mover advantage situations. Selling illiquid assets takes time and may come at a cost. Therefore,

¹² See for example the recent proposals by the Central bank of Ireland. Central Bank of Ireland (2021), "[Macroprudential measures for the property fund sector](#)", *Consultation Paper 145*, November 2021.

the presence of a buffer could give rise to first-mover advantage, e.g. investors may want to redeem before others to make a claim on the buffer before the fund manager has to resort to the sale of the illiquid assets. Furthermore, a liquidity buffer comes at a cost of lost return, which is not in the interest of the investor, especially if LMTs or redemption terms are more effective. Therefore, if the fund manager wants to use a liquidity buffer to only cover redemptions, then in our opinion liquidity management is not fitting and not necessary in the interest of the investors. In our view, more conservative redemption terms, pricing mechanisms to remove the first-mover advantage and gating are better suited and more effective to manage higher than expected outflows.

The AFM does support a liquidity buffer for funds that are subject to margin calls. A liquidity buffer is only effective when a fund is at risk of being confronted with immediate liquidity needs that cannot be managed through redemption terms or the use of LMTs. Margin calls constitute such immediate liquidity needs for which redemption terms and LMTs are ineffective, as these can only manage liquidity demand from redemption requests. A liquidity buffer to cover margin calls has the advantage that it allows funds, at least initially, to manage margin calls without having to resort to immediate asset sales. This type of liquidity buffer, at the discretion of the fund managers, should be based on the liquidity risk they face. As discussed in section 2, leverage increases the likelihood of fire sales and amplifies them. Therefore, the size of the leveraged fund is a relevant aspect to consider when determining the size of a buffer. Consequently, a buffer to cover margin calls should be dynamically based on the potential impact the fund has on the transmission of liquidity risk to the market. This buffer would reduce the potential procyclical effect a fund can have on the market. The AFM would welcome further analysis as to the required size and the anticipated effectiveness of such buffers.

A liquidity stress test is a helpful instrument to measure liquidity risk and the related buffers. In our view, regulators should take responsibility for setting part of the parameters of the stress test, preferably at EU level, and thereby provide guidance to fund managers on how to calibrate the right size of a liquidity buffer. The size of the liquidity buffer should also take into account the cost of holding part of investors' equity as a buffer. Improvements in data availability and quality is very important for conducting stress tests to the assets and liabilities of funds.

3.3 Ongoing risk management of the fund

The AFM supports harmonising LMTs in the EU and introducing a mandatory minimum number of LMTs, as this would improve the resilience of individual funds and thus of the sector as a whole. Adequate risk management procedures and the use of appropriate LMTs by fund managers is a second important building block of policies that aim to reduce systemic risk. Fund managers should have robust risk management procedures that provide them with a range of LMTs that can be used when the fund experiences liquidity pressure. The presence of pricing tools limits the potential for first-mover advantages by treating all investors in a fair and equal manner.¹³ When pricing tools alone are not sufficiently effective, the fund manager should resort to tools that limit outflow, such as gating, in-kind redemptions or suspensions.

Although the current regulatory framework provides fund managers with some necessary tools to mitigate risk, the AFM sees that there is room for improvement in the application of the current regulatory framework. The COVID-19 stress period has shown that the availability and use of LMTs is key in mitigating stress in individual funds, but also in the wider market. However, not all funds have taken steps to ensure they can use LMTs. For a fund manager to be able to use a LMT, the LMT must be included in the prospectus. This is not always the case. Therefore, the AFM takes the view that one of the first steps in addressing systemic risk is for fund managers to ensure that LMTs are part of their risk management procedures. If these not already present, fund

¹³ See for example, Dunhong, J., Kacperczyk, M., Kahraman, B., and Suntheim, F. (2021), "[Swing pricing and fragility in open-end mutual funds](#)", *The review of financial studies*, 35, pp. 1-50 and Lewrick, U., Schanz, J., Carpentier, J.F., and Rasqué, S. (2022), "[An assessment of investment funds' liquidity management tools](#)", *CSSF Working Paper*, June 2022.

managers should review their risks management practices and incorporate additional LMTs in the constitutional documents and any other pre-contractual information for investors by going through the procedure of changing these documents. NCAs should monitor the adequacy of the risk management framework of fund managers and the LMTs included in this framework.

LMTs that transfer the costs of inflows (subscriptions) and outflows (redemptions) to the investors effecting these should be a standard tool in a fund manager’s toolkit. The AFM is of the opinion that the use of pricing tools, such as swing pricing, anti-dilution levies and fees, is most effective if these tools are part of the normal redemption and subscription procedure and if their availability and use is transparent to the investors. The general use of LMTs through the regulatory framework can be facilitated by ESMA guidelines or technical standards on the circumstances in which LMTs should be deployed, as well as criteria governing their use. However, this should not be too prescriptive, as this could otherwise lead to regulatory thresholds¹⁴ that may trigger a run on the fund. The harmonisation of the availability of LMTs in Europe and the requirement for fund managers to have at least one appropriate LMT included in the fund’s constitutional documents besides the suspension of redemptions, as recently proposed by the European Commission, is a good start. However, in our view, fund managers should not seek to fulfil only the minimum requirements but make all LMTs available that they deem effective for the fund they are managing.

3.4 Macprudential tools at the discretion of NCAs

The existing regulatory framework provides NCAs with three instruments that are essentially macroprudential tools. The AIFMD provides NCAs with the option to impose leverage limits or other restrictions to limit the use of leverage.¹⁵ This is an ex-ante tool that prevents the build-up of (systemic) risks associated with the use of leverage, such as liquidity risk or counterparty risk. The AIFMD and the UCITS Directive also provide NCAs with the possibility to suspend redemptions in the interest of the unit holders or in the public interest, and in our view, financial stability is part of the public interest.¹⁶ This is an ex-post crisis tool. Finally, MiFIR makes it possible for ESMA or the NCA to temporarily restrict or prohibit the marketing, distribution or sale of financial products if this poses a threat to the stability of the whole or part of the financial system.¹⁷ This is also an example of an ex-ante tool. These three instruments can be used for: (i) investor protection, and (ii) financial stability. For the first objective, the instrument is a microprudential tool that is part of the design and ongoing management of the fund. For the second objective, the instruments become a macroprudential tool at the discretion of NCAs.

As a measure of last resort during crises or to prevent the build-up of systemic risks, competent authorities should be able to direct the use macroprudential tools. As risks and vulnerabilities differ per situation and per type of funds, different types of macroprudential tools should be available to NCAs. In our view, additional tools would help NCAs to better intervene during periods of systemic stress or to prevent the build-up of systemic risk.

Liquidity management tools at the discretion of authorities

Granting authorities discretionary powers to intervene by using LMTs would be a valuable addition to the macroprudential toolkit available to intervene in the investment funds sector. LMTs can, ex-post, reduce fire-sale dynamics in such a way that the transmission of liquidity risk to the wider market is, at least partly, mitigated. Therefore, the AFM recognises that (coordinated) supervisory intervention is sometimes warranted. The initial proposal by the European Commission for the revised AIFMD to expand the powers of NCAs beyond their current authority to suspend fund redemption in the public interest, to enable them to require a fund

¹⁴ A regulatory threshold is a level that triggers the use of an LMT prescribed by regulation. If this threshold is predictable due to prescriptive regulation, investors may redeem in anticipation of the activation of an LMT and thereby trigger a run on the fund.

¹⁵ AIFMD art. 25

¹⁶ AIFMD art. 46; UCITS art. 84

¹⁷ MiFIR art. 40, 42

manager to activate or deactivate redemption gates, notice periods and/or redemption fees, would be an effective expansion of the macroprudential toolkit. We support these proposals by the Commission, but would like to emphasise that such activation by NCAs should be a measure of last resort.

Specifically, a redemption gate would allow supervisory authorities to mitigate the transmission of risk from the investment fund to the wider market by limiting the outflow. The current power to suspend redemption fully limits the outflow from a fund and restricts investors' access to the fund. Gating would not fully restrict the fund investments, as partial redemption is possible. The current tool to suspend all redemptions is an all-or-nothing tool that should only be used as a last resort and when the NCA is certain that no other actions could mitigate systemic risk. Redemption gates balance the interests better and would allow NCAs to intervene in a more subtle way, without having too large of an impact on the fund, its investors, and the wider market.

The activation by NCAs of LMTs that transfer costs to redeeming investors or that change redemption terms can only work if the fund manager has designed a predetermined fee and/or redemption structure and transparently communicated this to the investors. Supervisors should not set the fee or notice period for specific funds or in general, as these should be based on the specifics of the individual fund, such as the liquidity of the underlying assets and the availability of other LMTs. This should be determined by the fund manager in the design phase of the fund. The NCA does not have all the information necessary to determine the most effective notice period or fee for individual funds and should not have the responsibility to do so. The AFM is supportive of enabling authorities to activate redemption fees and/or notice periods, but in practice this should include the requirement for fund managers to determine in advance a fee and notice period that the authorities can activate.

Ex-ante tools at the discretion of authorities

Developing ex-ante macroprudential tools at the discretion of authorities would improve the resilience of the investment fund sector by limiting the build-up of systemic risks. At present, NCAs have limited tools at their discretion to prevent the build-up of risk. For AIFs, authorities have the power to impose leverage limits or other restrictions to limit the use of leverage. This can be effective for funds in which the use of leverage might lead to systemic risks, but is insufficient to target other (cyclical) systemic risks or to increase the resilience of the sector. In general, ex-ante tools can be used to limit the exuberance during upswings so as to reduce stress during downswings. The existing tool available to NCAs to prohibit the marketing, distribution or sale of financial products can be seen as an ex-ante tool, but this is not the most effective tool to use. In developing new ex-ante tools, consideration should be given to developing tools that specifically address the asset side of funds, such as a temporary exposure limit. The AFM suggests that policymakers explore which potential ex-ante tools could limit the build-up of risks.

The AFM also sees potential in a more dynamic (countercyclical) approach to liquidity risk management. In our view, a dynamic approach to risk management means that certain risk management requirements or redemption terms adjust automatically, depending on the external circumstances. This means the risk management framework acts as a countercyclical macroprudential instrument without the intervention of an authority. For instance, one could consider providing for an automatic adjustment of the notice period in times of stress, when liquidity is low and/or volatility is high. In normal times, it may be easy to raise liquidity in the market to meet redemption requests, but in times of stress, the liquidity of the underlying market may be severely affected. A longer notice period would allow the fund manager to find liquidity at the best possible price in the best possible time. The AFM advises policymakers to further explore whether – and if so, under which conditions – such changes would be feasible.

3.5 Policy considerations outside the investment fund sector

Part of the vulnerabilities and risks should also be addressed beyond the investment fund sector. If risks emanate from vulnerabilities in the wider financial markets and not from the behaviour of investment funds, then this should be addressed at the root of the problem, outside of the investment fund sector. In our view, macroprudential policy for investment funds should not repair vulnerabilities in the financial system that result from weaknesses in other parts of the financial system. For example, this means that if large derivative portfolios are managed outside the investment fund sector through individual mandates, a liquidity buffer should also be instituted by the client such that liquidity risks due to margin calls are addressed similarly as we recommend doing for funds.

Warehousing (market making) by banks

Part of the transmission of liquidity stress from investment funds to the wider markets is due to the fact that market makers may not provide sufficient liquidity to the market in times of stress. Several recent studies show that certain banking regulations reduce the capability of traditional market makers to provide liquidity, especially in fixed income markets.¹⁸ Liquidity demand among investment funds is amplified when the market does not provide liquidity. Where this is due to regulations that have the unintended effect of impeding the ability of financial institutions to provide liquidity, the solution to mitigate this risk should not only be sought in making the investment fund sector more robust, but also in improving banking and other regulations. An example of this is the repo market, which dries up at quarter and year-ends due to bank regulations that imply that banks only need to report a snapshot of their balance sheet rather than an average value. The UK switched to averaging in 2017 and it has been found that averaging helps to improve market liquidity. Other improvements that promote market liquidity and are potentially beneficial to financial stability relate to the development of the Capital Markets Union (CMU). For instance, the consolidated tape, standardisation in the capital markets and electronic trading of bonds could all improve liquidity.

Limiting the procyclicality of margins and haircuts

Liquidity stress in the financial system transmitted from investment funds that use derivatives can be mitigated by limiting the procyclicality of margins and haircuts. This procyclicality results from low margins and haircuts in ‘good times’ (when asset prices are stable or moderately rising and volatility is low) followed by large and sudden increases in margins and haircuts during ‘bad times’ (when asset prices are sharply falling and volatility is high). Low margins and haircuts in good times allow for the build-up of leverage, as the collateral of counterparties has a higher value to borrow against and reduces the resilience of market participants. If this is followed by abrupt increases to margins and haircuts during bad times, it may trigger systemic liquidity spirals in which funding and market liquidity interact. This may generate contagion and reinforce stress in financial markets.¹⁹

In the view of the AFM, procyclicality can be reduced through a combination of an initial margin floor and a cash or in-kind collateral buffer that results in a countercyclical margin buffer (CCyMB) to be used in times of stress. By using the CCyMB, the increase in initial margin will be less steep. Consequently, due to the availability of a buffer, the initial margin market participants need to post is lower than without such as buffer. Other solutions to address this procyclicality are a pass-through of intraday variation margin and an initial margin floor.²⁰ The AFM believes that a pass-through cannot be done continuously during the day and that this policy option would only work when the pass-through from the CCP to the clearing member reaches the end client. As timing and predictability in receiving variation margins are crucial for cash management, a pass-through

¹⁸ See for instance: Breckenfelder, J. & Ivashina, V. (2021), “[Bank balance sheet constraints and bond liquidity](#)”, *ECB Working Paper Series*, no. 2589, September 2021; ESRB (2016), “[Market liquidity and market-making](#)”, October 2016; Fender, I. & Lewrick, U. (2015), “[Shifting tides – market liquidity and market-making in fixed income instruments](#)”, *BIS Quarterly Review*, March 2015.

¹⁹ ESRB (2017), “[The macroprudential use of margins and haircuts](#)”, February 2017.

²⁰ ESRB (2020), “[Mitigating procyclicality of margins and haircuts in derivatives markets and security financing transactions](#)”, January 2020.

would have to be done in specific fixed timeslots during the day. Furthermore, an initial margin floor ensures that when vulnerabilities build up in good times, the margin requirements take part of the potential future risks into account when a floor is introduced. This increases buffers and reduces procyclicality, and thus increases the resilience of the entire financial system.

Another option to limit procyclical liquidity needs arising from margin calls is by allowing margins in kind.

Margins in kind could limit the transfer of liquidity need to the wider market where it causes stress. Margining in kind should be subject to eligibility requirements and haircuts to prevent risks shifting to CCPs. Margining in kind should potentially only be made available in times of stress. The AFM thinks that this option should be considered, but not without an analysis on the effects of this policy option on risks accumulating on the balance sheet of CCPs.

Access to central bank facilities

There could also be a role for central banks to step in as a dealer (or market maker) of last resort to mitigate the transmission of liquidity stress from investment funds to the wider system if the stress is large enough to result in systemic risk. Investment funds and other non-bank financial intermediaries have not been granted access to statutory public backstops, and have no or only limited access to the central bank facilities. The impairment of the liquidity and maturity transformation of funds can put pressure on prices, feeding a spiral that central banks could stem by using their balance sheets. These liquidity spirals can be especially volatile in case of a large margin requirement due to the use of derivatives by investment funds. The AFM believes that when all other potential tools and interventions have been exhausted, a central bank facility could be used as a backstop to effectively mitigate systemic risk emanating from investment fund behaviour, as is also proposed by several economists at the BIS.²¹

Granting access to central bank facilities for investment funds must be carefully designed to ensure this is an effective tool and not another source of market dysfunction. Easy and broad access could affect the market ecosystem through hysteresis, central banks acting as a substitute for markets, and weaker market discipline, with potential financial stability implications. To limit the central bank's risk exposures, the facility could be restricted to loans secured by high-quality collateral and should only be accessible in certain market conditions. A liquidity facility at the central bank should be backed by sufficient collateral held at the central bank and be subject to appropriately high haircuts, maybe even with a repayment term. In our view, the conditions and design of such a backstop will require analytical work.²²

²¹ Aramonte, S., Schrimpf, A., & Shin, H.S. (2021), "[Non-financial intermediaries and financial stability](#)", *BIS Working Paper*, no. 972, October 2021.

²² Following for instance the example of the Money Market Mutual Fund Liquidity Facility of the Federal Reserve as part of its response to the COVID crisis, see: <https://www.federalreserve.gov/monetarypolicy/mmlf.htm>.

4 Conclusions

The question of how to mitigate potential financial stability risks in and emanating from the asset management sector is an ongoing topic of debate internationally. The stress in financial markets resulting from the COVID-19 pandemic has shown how investment funds are prone to and can contribute to market stress and systemic risk. The vulnerabilities and risks to financial stability are greater for some types of funds than others, depending on the degree of liquidity mismatch and the size and source of leverage used. Addressing systemic risks requires both a microprudential and macroprudential approach.

The AFM is of the opinion that the existing EU regulatory framework for investment funds already contributes to a reduction of systemic risks, but improvements can be made. The regulatory framework includes regulatory requirements and tools for fund managers and provides NCAs with instruments that can be activated at the discretion of the supervisor to address system-wide risks. This framework reduces vulnerabilities at the level of the fund, protects investors, and contributes to the mitigation of systemic risks. However, we see three areas where enhancements can be made: (i) a prudent design of the fund, (ii) proactive ongoing risk management, and (iii) macroprudential tools at the discretion of NCAs.

Effective macroprudential policy for investment funds starts at the microprudential level with a prudent design of the fund by the fund manager and improvements can be made on this front. Fund managers must ensure that the redemption terms, a combination of a notice period, redemption frequency, settlement period and a redemption gate, match with the underlying assets and limit liquidity risk. Current regulation is not very prescriptive on redemption terms. Therefore, the AFM supports additional guidance by NCAs. For funds that use derivatives, a liquidity buffer can be effective to limit the dependency on market liquidity for margin calls. A liquidity buffer should always be weighed up against its costs and the investment objectives of the fund. The AFM does not support a general liquidity buffer for all types of funds.

Fund managers must employ adequate risk management procedures and consider appropriate liquidity management tools (LMTs). Fund managers should have robust risk management procedures that provide them with a wide range of LMTs that can be used when their funds face liquidity pressure. Fund managers must take steps to ensure they can use LMTs that are effective for their funds and communicate these LMTs to investors in the prospectus. LMTs that impose the costs of redemptions on redeeming investors are an effective way to address first-mover advantage among investors and should in our opinion be part of a fund's standard toolkit. In using LMTs, there is no 'one size fits-all' solution and fund managers are expected to exercise their sound professional judgement in the best interest of investors.

As a final backstop and measure of last resort or to prevent the build-up of systemic risks, competent authorities should be able to step in and use macroprudential tools. As risks and vulnerabilities differ per situation and per type of funds, different types of macroprudential tools should be made available to NCAs. Granting authorities discretionary powers to intervene by using LMTs would be a valuable addition to the macroprudential toolkit aimed at investment funds. For instance, a redemption gate would allow authorities to mitigate the transmission of risk from the investment fund to the wider market and to fund participants collectively by limiting the outflow, but without fully restricting investors' access to liquidity as a full suspension of redemptions does.

Part of the vulnerabilities and risks should also be addressed beyond the investment fund sector. Liquidity stress in the financial system transmitted from investment funds that use derivatives can be mitigated by limiting the procyclicality of margins and haircuts. Furthermore, part of the transmission of liquidity stress from investment funds to the wider markets is caused by the fact that market makers may not provide sufficient liquidity to the market in times of stress. There could also be a role for central banks to step in as liquidity provider of last resort. A central bank facility should be restricted to liquidity provision secured by high-quality collateral, and should only be accessible in certain market conditions and with a high haircut to prevent overuse and moral hazard.



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