FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

Association Française de la Gestion financière (AFG)

Recommendation 1

1. **Is the description of the financial stability risks from leverage in NBFI accurate and comprehensive? Are there additional vulnerabilities or risk dimensions related to NBFI leverage that authorities should consider for monitoring purposes?**

AFG largely agrees with the description of the financial stability risks stemming from leverage.

AFG would like to remind some fundamental principles relating to the industry of investment funds. A fund is not a deposit, it is an investment vehicle where investors freely choose to be exposed to a risk-return profile. They are the ultimate bearer of the risks they are exposed. Funds' assets are segregated in depositary banks.

The role of the fund manager is to manage the assets according to the risk-return profile disclosed in the fund documentation, according to an agency model and in the best interest of investors. In this context NBFI should be understood as the fund usually denominated as Collective Investment Scheme.

In the frame of the European fund industry leverage is possible to some extent but closely monitored as explained later.

We also agree on the importance of adding proportionality and materiality in the setting of these recommendations by considering the different level of risks taken by each actor due their profile disparities. For instance, differentiation must be made between regulated players already subject to a certain level of rules on liquidity risk management (it's the case for investment fund for instance which are subject to ESMA guidelines stress testing for UCITS and AIFs), and non-regulated ones which are not submitted to those rules, nor to regulators/supervisors' approval and supervision, and who should be further concerned by these developments.

Proportionality and materiality should also be reflected by applying the recommendations at fund's level and only to those that have a significant liquidity risk embedded in their profile, typically when use of derivatives. Most investment funds do not rely on derivatives in their investment policy, so do not have to post margin and collateral. Imposing these recommendations to all funds would be disproportionate.

Only excessive leverage can be considered as a vulnerability and potentially be detrimental to the financial stability. AFG noted that most of the examples provided (default of Archegos, LDI crisis, …) fall out of scope of the European asset management industry.

To conclude, AFG believes that the European framework to monitor vulnerabilities related to leverage is sound and efficient.

2. **What are the most effective risk metrics that should be considered by authorities to identify and monitor financial stability risks arising from NBFI leverage?**

   AFG fully supports FSB on the need to tackle the "data challenge". AFG believes that the purposes of the toolkit metrics is to provide with a complete vision regarding the level of leverage.

   The UCITS and AIFM directives include extensive reporting requirements, with more than three hundreds of metrics. Among them, a comprehensive set of risk metrics related to the leverage is currently required (cf articles 2, 7, 8 et 14 of EU 231/2013 regulation and point 2 and box 24 de ESMA 10/788).

   According to the 2023 ESMA market report on EU AIF, at the aggregate level, the adjusted leverage is closed to 123% of the NAV.

   The current metrics toolkit adopted by the European fund regulation seems appropriate to provide the transparency seek by the authorities.

3. **What are the most effective metrics for the monitoring of financial stability risks resulting from:**

   (i) specific market activities, such as trading and investing in repos and derivatives

   Beyond the efficiency of the metrics, AFG would like to highlight some important points:

   The monitoring of the evolution of these metrics is a matter of importance as it provides with a view on the trend across time of the vulnerabilities related to leveraged.

   The international consistency in the definition and calculation of those metrics should also be improved. Technical requirements should be more harmonized in order to make the metrics comparable and enhance the oversight efficiency.

   In Europe, AIFMD and EMIR have introduced reporting requirements at fund and transaction level respectively (with more than 300 fields for AIFMD only), which allow for a comprehensive view of synthetic leverage.

   The accumulation of metrics is useless without a common set of definition. Typically leverage metrics are different between UCITS funds and AIF. Data collected by authorities should be, at least, aggregable if the objective is to build a true measure of risk, at a global level.

   (ii) specific types of entities, such as hedge funds, other leveraged investment funds, insurance companies and pension funds

   (iii) concentration and crowded trading strategies

Recommendation 3

4. **What types of publicly disclosed information (e.g. transaction volumes, outstanding amounts, aggregated regulatory data) are useful for market participants to enhance**

their liquidity or counterparty credit risk management? Are there trade-offs in publicly disclosing such information and, if so, what would be the most important elements to consider? What is the appropriate publication frequency and level of aggregation of publicly disclosed information?

AFG supports the objective of the recommendation 3. Increasing transparency will help to detect critical situations and improve the efficiency of the leverage-related risk oversight.

Within the current European framework many pieces of regulation (EMIR, MIFIR, Full PRIIPS and SFTR) include already a comprehensive set of reporting requirements which meet the criteria of the recommendation 3. These disclosures enhance the vision and the understanding of the market exposition regarding the derivatives exposure but also instruments such as Repos/ Reverse Repo/ Sec Lending/ Cash Lending, ….

The frequency and time lag should be set with a view of providing markets participants with actual market data useful from a risk management perspective. A too high frequency could lead to a situation where the disclosed information could be exploited by "smart" observers, while a too fast disclosure could also be detrimental to investors' interests.

Recommendation 5

5. **Do Recommendations 4 and 5 sufficiently capture measures that would be used to address the scope of non-bank financial entities under consideration in this report? In what ways may the policy measures proposed in the consultation report need to be adjusted to account for different types of non-bank financial entities?**

   AFG would like to remind that the European AM industry is governed by two directives, UCITSD and AIFMD, which both have requirements that restrict and/or monitor closely the use of leverage.

   Moreover, AIFMD (Art. 25) gives the possibility to NCAs to introduce leverage limits for an individual fund or groups of funds. Furthermore, the recent AIFMD review has introduced a structural (absolute) limit on leverage for loan-originating funds that will be applicable from 2026.

   Accordingly, AFG believes that the existing European policy measures are already compliant with these recommendations, to a great extent. Additional measures should be targeted to the very high leveraged NBFI only, by the mean of the application of thresholds or exemptions.

6. **In what circumstances can activity-based measures, such as (i) minimum haircuts in securities financing transactions, including government bond repos, (ii) enhanced margin requirements between non-bank financial entities and their derivatives counterparties, or (iii) central clearing, be effective in addressing financial stability risks related to NBFI leverage in core financial markets, including government bond markets? To what extent can these three types of policy measures complement each other?**

   AFG believes that, in principle, the proposed measures seem globally effective. We re-iterate that they must be set considering the risk profile of different entities.

Regulated European investment funds are already subject to effective and robust measures, both entities and activity based such as mandatory haircut or diversification rules required to the collateral.

Regarding the Variation Margin (VM) , AFG emphasize the importance of being able to post non-cash VM as it is already the case for the initial margins (IM). This is a critical issue, in particular in stressed market conditions as if VM has to be posted in cash only, it creates the need for either selling securities (including top quality ones) on the market and then amplifying the market stress or posting them on the repo market while the market conditions make it very illiquid (and such posting amplifying again the market stress). From a financial stability perspective, allowing the posting of top-quality securities (such a government bonds) for covering VM calls would play a positive role in such condition. As such, any type of collateral (cash and non-cash) authorized under EMIR should be accepted.

On enhanced margin requirements, it is very important that predictability, homogeneity of adjustments across the market and transparency prevail.

If in line with these features, incentivizing central clearing may be an effective risk management tool depending on the nature or the maturity of the operation and the initial margin requirements and costs.

7. **Are there benefits to dynamic approaches to minimum margin and haircut requirements, e.g. where the requirements change based on changes in concentration or system-wide leverage? If so, what types of indicators capturing concentration or system-wide leverage should the requirements be linked to?**

Such requirement changes should be predictable which could be ensured by drafting guidelines under which conditions on when and why such changes occurs. It is essential to bring transparence and predictability to these rules and allow for sufficient time to deal with liquidity management.

8. **Are there any potential unintended consequences from activity-based measures beyond those identified in the consultation report?**

It is important to have authorities adopting measures with clear rules and predetermined criteria which can provide participants with the visibility required to deal with collateral additional needs and liquidity management.

More predictability should be given during stress market events. While excessive granularity isn't necessary, market participants need predictability, especially during times of stress (e.g., the COVID crisis). Indeed, destabilizing changes in margin requirements in centrally cleared markets should be mitigated in those times to not add on liquidity pressure.

Exceptional and non-anticipated measures should be cautiously adopted because of the procyclical effect they can trigger from a liquidity risk perspective

Clearing Members (CM) should also inform the client with appropriate minimum notice when they are adjusting their calibration of client margin add-ons and changes for buffers or multipliers. In that way client will be in better capacity to anticipate the provision of collateral. Otherwise, insufficient notice periods in advance for margin calls by CMs towards clients may strongly and very rapidly destabilize financial markets (or at least segments of financial markets).

For all those matters, we highly support the consultation of market participants, higher public transparency and the promotions of exchanges within the CCP risk committees under authorities supervision (although risk committees only embed very few players, creating an asymmetry of information to the detriment of the rest of market participants).

9. For non-centrally cleared securities financing transactions, including government bond repos, what are the merits of margin requirements compared to minimum haircuts?

Both measures are recommended in Europe and are usually applied in the context of non-centrally cleared securities financing transactions. They are complementary in addressing two different aspects: margins react to market volatility, while haircuts take into consideration the intrinsic characteristics of the collateral.

Haircuts protect one of the counterparts, while initial margins are pledged by both counterparties, to face bilateral default risk. Haircuts also have the advantage of imposing themselves before transactions, impacting ex-ante the available cash, in exchange of the assets that were lent

10. In what circumstances can entity-based measures, such as (i) direct and (ii) indirect leverage limits be effective in addressing financial stability risks related to NBFI leverage in core financial markets?

Effectiveness of entity-based measures is linked to the proximity with the market participants. They should be tailored to the specific market's conditions. AIFMD Art 25 must be triggered on a case-by-case basis and must target a narrow perimeter.

Direct measures such as total debt/total assets maximum ratio make sense as both numerator and denominator will be impacted by market stress.

VAR is easy to understand and aggregating all kind of risks but also being able to split them and point to the ones to be reduced. It Is effective in the way that it is broadly applicable and analyzed, making it a good support to ongoing leverage risk control. This risk measure is very useful for some specific types of asset management.

11. Are there ways to design and calibrate entity-based measures to increase their risk sensitivity and/or their effectiveness in addressing financial stability risks from NBFI leverage?

AFG re-iterate the fact that Management companies follow an agency business model in which they manage investments on behalf of their investors. Because asset managers do not engage in proprietary trading, insolvency risks are very low. In the context of the asset management industry, the word "entities" should mean investment funds only.

The fund manager is entitled to use leverage in the frame of the limits disclosed to the fund documentation and/or set by the corresponding regulation. Risk management is constitutive of the fund management function leading to a high level of risk sensitivity.

FSB states (p.31) that "the design of leverage limits should appropriately reflect the specificities of the type(s) of entities", and indeed, "existing regulatory definitions of entity types could be used to define the scope of policy measures": we believe that entity-based measures should focus on non-regulated NBFIs and notably those with high leverage.

In relation to some of the entity-based measures mentioned by FSB, we can point at some notions, along their effectiveness:

Annex 1 provides various leverage metrics. Most of them are included in the UCITS & AIFM directives which work very well without the need of other unnecessary additional measures.

About VaR, fine-tuning of its modeling (such as CreVaR, embedding credible expected risk modeling) are offering reliable risk forecasts, in the frame of an ever evolving and enhancement of the metrics toolkit used by the risk management function within asset management companies

12. **Are there any potential unintended consequences from entity-based measures beyond those identified in the consultation report?**

The consultation report rightly states that entity-based measures may harm liquidity.

We also think that yield buffer may potentially be pro-cyclical, including a cliff effect, inducing forced sales on stressed markets.

13. **To what extent can activity-based and entity-based measures complement each other? What are the main considerations around using these two types of measures in combination?**

Market stress, amplified by leverage, can be linked to specific assets or be more diffuse and irrational. It is right to use asset-linked and actor-linked sensors to well capture the holistic risk that a market player is facing at any time.

Beyond the complementary of these measures, it is crucial to have them capture the non-regulated entities, notably those with high leverage, such as hedge funds, in the asset management area.

Beside, they are more meaningful and correctly focused at portfolio level, rather than at top-company level, for regulated entities.

Recommendation 6

14. **How could counterparty credit risk management requirements for leverage providers be enhanced to be more effective in addressing financial stability risks from NBFI leverage in core financial markets, such as government bond repo markets? In what circumstances can they be most effective?**

We think that a strict treatment of non-regulated NBFI is key in enhancing the effectiveness of counterparty risk assessment by the leverage provider. This could push them to have quantity-based LMTs or liquidity management measures available and ready to activate, in order to be better treated by the leverage providers.

Conversely, regulated NBFI should be better treated, with a view to have a more homogeneous risk assessment globally.

Beside, insightful pro-active due diligence and accurate analysis of the counterparty assessment is a must, to spot warnings and act accordingly.

Recommendation 7

15. **Would a minimum set of disclosures to be provided by leverage users to leverage providers be beneficial in improving counterparty credit risk management and reducing financial stability risks from NBFI leverage, including concentration risks?**

If so, which types of information and what level of granularity should (and should not) be included in this minimum set and why?

We agree with FSB intentions to seek homogeneity and completeness of leverage disclosure, to improve counterparty / concentration risk.

We would recommend to pragmatically expand the existing set of disclosures due by regulated NBFIs to non-regulated actors, to achieve this goal without adding unnecessary burden to the regulated industry. Priority inclusions are highly leveraged NBFIs (cf the 300% leverage level, calling for enhanced reporting, as per the AIFM directive).

16. **What are the main impediments that leverage users face in sharing additional or more granular data with their leverage providers? Is there a risk that a minimum recommended set of disclosures may lead leverage users to limit the information they share with their leverage providers to that minimum set?**

    Key consideration in sharing additional information is the ratio burden / usefulness.

    Another impediment is the difficulty to find the right balance between homogeneity and effective customization to each jurisdiction, to prevent cross-border arbitrages.

    It is quite likely that if there is a proposed set of disclosures, it will become the standard.

17. **Should such a minimum set of disclosures rely on harmonised data and metrics to ensure transparency and efficiency in the use of such information for risk management purposes? Do respondents agree that such a minimum set of disclosures should be based on the list of principles outlined in the consultation report? If not, which principles should be added, deleted or amended?**

    As mentioned above, we thank FSB for their attention, not to demand redundant nor inadequate or excessively strict information, as presented notably in their point 4.4.

    We reiterate that targeting nonregulated entities for these disclosure requests should be added. Harmonization and full coverage of players is of paramount importance, and FSB preparatory work is very useful.

18. **Should leverage users be required or expected to provide enhanced disclosures (beyond that provided in normal market conditions) to their leverage providers during times of stress?**

    We genuinely believe that market stability will be much more reinforced through onboarding all players under regulations, similar to the strong set of supervision already established in Europe for regulated NBFI, especially during times of stress.

    UCITS and AIFs leveraged activities benefit from a robust and rich framework, that international authorities such as FSB have the power to extend to more “dangerous” players.

19. **Should authorities design a minimum set of harmonised disclosures and guidelines on its application, or should they convene a cross-industry working group to do so? How do respondents believe such a standard should be incorporated into market practice? Through regulation, supervisory guidance, and/or via a Code of Conduct or similar approach?**

    AFG would be happy to assist authorities in designing the right set of guidelines, through a cross-industry working group for instance.

By reaching a consensus, homogeneity and usefulness would be supported. That would strongly support the appropriation of such standard by the industry and its incorporation into market practice. Using the Code of conduct / MoU wrapper seem to us the right road to travel.

Homogeneity across industry players has to be targeted but also – and foremost- across NCAs and worldwide regulators.

Recommendation 8

20. Are there areas where the principle of "same risk, same regulatory treatment" should be more consistently applied? Are there circumstances in which the principle should not apply or should not apply comprehensively?

The principle of "same risk, same regulatory treatment" raises many questions.

The meaning of "same risks" should be more elaborate and declined according to the specific characteristics of different entities. This principle could lead to some misleading interpretation which ultimately draw near the "one size fits all" approach.

We re-iterate the need to have clear distinctions within NBFI. Indeed, some NBFI are already regulated and submitted to several requirements regarding liquidity and risk management while others are not. Measures must be set considering the risk profile of different entities. The Archegos failure and LDI crisis cannot be systematically used to say that there is a big issue with NBFI. Both cases are not representative of regulated investment funds who, on the contrary, have rules to follow especially on market and liquidity risk management.

Most focus should be given to the unknown side of the NBFI universe i.e. the non-reporting entities.

However, some collected data may indirectly provide some insight from this "unknow side": EU Member States can allow non-EU asset managers to market alternative funds at national level under the National Private Placement Regime (NPPR). Non-EU AIFMs are subject to reporting under the AIFMD in each jurisdiction in which they are authorised to market their products. According to the data collected by ESMA the non-EU AIFs are marketed in 12 EU jurisdictions with a size equivalent to about 30% of the EU AIF market. Mainly domiciled in the United States (US) (67% of the NAV) and offshore domiciles (24%), the segment consists of ETFs (68% of the NAV, mainly exchange-traded funds investing in equities), HFs (16%) with very large derivatives exposures (EUR 4.6tn) and high leverage (600% of the NAV) .

Figures collected in Non-EU funds suggests that leverage levels seems much higher than with EU funds, especially regarding Hedge Funds located in offshore domiciles.

AFG concludes that a regulated framework such as the European risk management industry is cumbersome but effective and could be promoted by the FSB as a model to be replicated.