FSB FINANCIAL STABILITY BOARD

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

The Alternative Investment Management Association

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?**

   We have attached our covering letter and submission to the end of the questions. If you have any questions please do not hesitate to contact us.

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

   We are concerned that the CP's exclusion of banks from its scope prevents it from presenting a complete picture of all the relevant interactions at play. This undermines the FSB's aim of taking, "a holistic perspective, given the interconnectedness between participants within and across markets."6 Banks are key counterparties of, and providers of liquidity to, NBFIs. Their actions, particularly in times of market stress, can have a material impact on the availability of liquidity and their requirements, for example for cash as collateral, may create pro-cyclical behaviour as NBFIs are forced to draw cash rather than other equally appropriate instruments to meet their obligations. This inflexibility on the part of CCPs may also cause issues for banks as entities all withdraw cash at the same time in stressed markets. This risks creating an entirely avoidable Silicon Valley Bank-like run on some credit institutions.

   A major factor in the 2020 market turmoil was the decision by banks to effectively stop trading, in stark contrast to the equity and derivatives markets. This demonstrates that one of the biggest risks to, for example, bond markets come from NBFIs having to rely on bank intermediation rather than being able to trade freely with anonymous counterparties.

   The CP cites the dysfunction in the UK gilts market and its effect on liability driven investment ("LDI") funds in 2022 as an example of where NBFIs create financial stability risks. An analysis of the structure of how a UK defined benefit pension fund using a segregated leveraged LDI portfolio is useful in explaining the depth of interconnectedness with banks and their services.

Portfolio management of the LDI strategy will be delegated to an LDI investment manager and parameters will be set for liquidity monitoring, a liquidity waterfall and the use of assets. Usually, the scheme's custodian will hold liquid securities, which are often gilts but can be high-quality corporate bonds, in an individually segregated account for the purpose of supporting the LDI trades.

Cash is often held in a money market fund ("MMF"), which may be run by the custodian which can be a third party. The custodian may act as the collateral manager for the scheme. The counterparty to the LDI trades will be bank counterparties or other financial institutions.

In addition to the cash and liquid securities held for the purpose of collateralising the LDI trades, the scheme may have one or more of the following liquidity backstops:

- repo lines with bank counterparties or other financial institutions, for example to convert liquid securities into cash if cash collateral is required, such as for cleared variation margin;

- borrowing facilities which may be with a lender or, more commonly, with the corporate sponsor of the pension scheme. The corporate sponsor will in turn source its liquidity either from reserves or by borrowing from a lender itself;

- less liquid and higher yielding assets such as asset backed securities ("ABS"), which will often be managed by a different manager to the LDI investment manager, which can be sold if required; and

- a further pre-agreed list of assets beyond the cash, liquid securities and less liquid securities that could be sold, in extremis.

This surfaces some non-NBFI interconnections for:

- banks and other financial institutions that face the scheme under the LDI trades which will themselves have back-to-back positions, with concomitant liquidity considerations;

- potentially different banks and other financial institutions that face the scheme under any repo trades, noting that these trades will also be collateralised and so have their own liquidity considerations;

- The lenders, who may be more traditional lenders and so different to the markets facing banks and other financial institutions listed in the bullet points above, who extend credit to the pension scheme or its sponsor under any borrowing arrangements. These may be drawn in times of market stress and the lender may itself need to source liquidity from the market;

- third-party funds, for example, MMFs or ABS, which may be required to liquidate assets to distribute cash and may have to do so in times of market stress; and

- the custodian, which will usually provide an overdraft facility, primarily to cover settlement, may be called upon as the various transactions are effected.

We also note the concerns raised by a number of participants at the FSB's industry outreach on the CP7 in relation to the role of repo markets in liquidity provision. They raised the issue of banks withdrawing from those markets, so restricting the availability of liquidity to NBFIs.

Banks' own shortcomings on risk management can also be major factors in creating the kinds of risks the FSB is concerned about. For example, the 2021 Credit Suisse Group special committee of the board of directors report on Archegos Capital Management referred to exactly this issue:

"The Archegos default exposed several significant deficiencies in CS's risk culture, revealing a Prime Services business with a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk. The Archegos matter directly calls into question the competence of the business and risk personnel who had all the information necessary to appreciate the magnitude and urgency of the Archegos risks, but failed at multiple junctures to take decisive and urgent action to address them."8

Further, it is important to understand the role of NBFIs in maintaining market integrity and highlighting bad actors. The role of short sellers over Wirecard is a point in case.9

The CP also does not consider the role of direct holders of assets. They may behave in a correlated manner during times of stress, but are not subject to the same level of regulation as NBFIs. We urge the FSB to address this issue as it continues to develop its policy thinking.

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?**

We endorse the FSB's overall approach to the use of tools such as stress testing. However, the CP's approach of using aggregate stress testing does not seem to account for how investment funds are structured and so may give a misleading picture. The assets and liabilities of each investment fund are usually discreet and non-fungible and so are not capable of cross-subsidisation. This is often referred to as the "protected cell regime".10 It means that it is not possible to treat assets held in a range of investment funds run by a single asset manager as if they can be aggregated and moved in a single homogeneous way.

We are concerned that this incorrect idea that investment funds can be aggregated or treated as cohorts because they have superficial similarities has become embedded in some central banks' approach to macroprudential regulation. Assuming all funds with a similar stated investment strategy will operate and be managed in the same way is to misunderstand the diversity of investment funds, the investment techniques they use, how they are financed, how often they allow redemptions and how they are managed in the best interests of their investors. As we noted in our response to the Central Bank of Ireland's discussion paper on macroprudential regulation, "the concept of "cohorts" has no more meaning than the marketing device of grouping funds into “growth”, “equity”, “bonds” or other categories.”11

We would also urge the FSB to take greater account of the unconcentrated nature of the asset management industry and its very wide range of investors who are routinely based in jurisdictions other than those of the funds they commit capital to. AIMA alone has over 2,000 members in over 60 countries.12 It is estimated that in Europe alone there are over 4,500 asset management companies.13

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

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?**

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

The detail underlying some of the recommendations appear to set unrealistic expectations as to the amount of data entities can collect from their counterparties. For example, the second paragraph under recommendation 3 on page 14 ends with a requirement for entities to close data gaps. If interpreted in a rigid manner, this could be used to make entities request information that is commercially sensitive and so unavailable.

We are also concerned that many of the terms used are loose and undefined. They will cause confusion to entities and regulators alike as to when they would be expected to apply or be triggers. This may also lead to different interpretations and the fragmentation of regulatory approaches, which we do not believe is the CP’s intention.

For example, the CP refers to “mitigating” liquidity risk from margin and collateral calls. It is clear that market participants should understand what potential margin calls might be, and this should form part of routine stress testing. However, it is not clear what liquidity risk means in this context. Is it the possibility of selling assets to meet the margin calls and does ”liquidity risk tolerance” extend to willingness for positions to be closed out?

Similarly, further explanation of what “extreme but plausible stress” means and how it is triggered in practice is needed. Given that “preparation” for these scenarios will extend to issues to minimum cash requirements and collateral buffers it creates scope for interpretation, regulatory arbitrage, and the creation of an uneven playing field.

The notion that leverage is somehow building up in the system does not bear scrutiny in relation to hedge funds and private credit. The most recent International Organization of Securities Commissions (“IOSCO”) Investment Funds Statistics Report show that financial leverage has remained at a steady level since data since at least 2016.14

Analysis by the Alternative Credit Council also shows that, over the past few years, the use of leverage has remained steady in the private credit industry. Those funds that use leverage will operate at levels around or below 1.5 times of debt to equity. While there has been a small reduction in the percentage of funds that do not employ any leverage, it still remains high at 36% in 2023. Overall, there has been no significant change in the use of leverage by private credit funds despite the significant growth in size of the industry.15

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

   The recommendations would benefit from a fuller understanding of the wide range of sectoral rules that already apply to many of the activities and entities grouped under the umbrella term of NBFI. Our example of the way the AIFMD applies to margining and collateral is a good example of this.

   We recommend the FSB does a deeper dive into the very thorough-going regulation and supervision that is already applied to NBFIs such as investment funds than is demonstrated by the analysis in Annex 1 of the CP. Far more focus should be put on identifying entities that are not subject to appropriate regulation rather than giving more requirements to those who already are.

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?**

   As we have already discussed in relation to CCPs' inflexible attitude towards receiving cash as collateral, recommendation 7 in particular risks introducing prescriptive requirements for portfolio and risk management that do not align with existing market practises.

   For example, the requirement to hold "sufficient available cash to meet cash-only margin calls with a high degree of certainty" could be interpreted as a minimum cash buffer applied across non-bank market participants, with significant room for interpretation both within jurisdictions and between market participants. It also creates credit risks for entities that must hold elevated amounts cash and create procyclical risks were a stress to require a number of market participants to withdraw cash from banks at the same time.

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

   As we have already discussed above, the role of banks, infrastructure providers and direct owners of assets should be taken into account in this work. If this is not the case, then there will be serious unaddressed gaps that will undermine the intended effectiveness of the final recommendations.

   If you have any additional comments, please provide them below.

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Bank for International Settlements
Centralbahnplatz 2
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Switzerland

Submitted via online form

18 June 2024

Dear Sir/Madam,

AIMA response to the Financial Stability Board consultation report, Liquidity Preparedness for Margin and Collateral Calls

The Alternative Investment Management Association ("AIMA")[1] is pleased to respond to the Financial Stability Board ("FSB") consultation on liquidity preparedness for margin and collateral calls (the "CP").[2] This CP is the latest in a series of policy initiatives targeting non-bank financial intermediation ("NBFI") from the FSB and is an element in its work plan.[3] AIMA fully supports the desire to ensure that potential risks to the global financial system are identified and mitigants put in place. To do so requires identifying all participants and giving proper weight to the roles they play.

AIMA supports the FSB's aim to ensure NBFI sector market participants have clear and robust practices in place so that market participants can meet their commitments to investors and counterparties in times of stressed market conditions. Stress testing and tools such as those for liquidity risk management such as

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1 The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$3 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage over US$1 trillion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

2 FSB, Consultation Report, "Liquidity Preparedness for Margin and Collateral Calls" (17 April 2024), available at https://www.fsb.org/wp-content/uploads/P170424.pdf.

3 FSB, "FSB Work Programme for 2024" (24 January 2024), available at https://www.fsb.org/wp-content/uploads/P240124.pdf.

side pockets, anti-dilution levies and, in some jurisdictions, swing pricing are key to mitigating the risks that the FSB is concerned about.

In doing this we urge greater recognition of the extremely wide variety of entities covered by the umbrella term NBFI. This will allow the FSB to differentiate between not only the different activities NBFIs undertake but also the applicable regulatory regimes. Page 6 of the CP asserts that, "leveraged hedge funds face minimal directly applicable liquidity risk rules, if any". This is incorrect. The Alternative Investment Fund Managers Directive ("AIFMD") delegated regulations, for example, require in Article 48(2) that the stress tests alternative investment fund managers must carry out for each fund under both normal and exceptional liquidity conditions "(c)over market risks and any resulting impact, including on margin calls, collateral requirements or credit lines".[4] Nor does it take into account the requirement in the revised AIFMD to use liquidity management tools where there are risks to investor protection or financial stability.[5]

Given the diversity of actors and strategies, relying on quantitative liquidity measures and tools such as cash buffers can have the unintended consequence of increasing rather than reducing liquidity strains. We believe that a qualitative approach which does not take a rigid, pro-cyclical and possibly game-able approach will best help achieve the FSB's goals.

The CP currently excludes discussion of the role of commercial banks and financial market infrastructures such as central counterparty clearing houses ("CCPs"), as well as the role of direct owners of assets who are subject to far lighter and in some cases no regulatory requirements but may act in a correlated way that can create stresses in markets. Banks, financial market infrastructures such as CCPs, and direct asset owners are profoundly intertwined with other market participants, for example, as providers of liquidity and counterparties. Excluding them from scope prevents a full picture of market interconnections and how they operate. We share, for instance, the widespread concern that CCP inflexibility in only accepting cash for margin calls is procyclical and there should be greater flexibility on the use of non-cash assets for such purposes.

Some ideas and phrases used in the CP are very broad and do not explain the circumstances in which they would expect to be triggered or used. "Extreme but plausible stress" is one example. While it is important that global recommendations should be suitably high level, they also need to be explained fully to avoid creating fragmented and inconsistent interpretation.

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4 *See* Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, available at here.

5 *See, e.g.,* Recital (20) of Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024 amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202400927.

We provide further details on all these issues in the annex. We would be happy to elaborate further on any of the points raised in this response. For further information, please contact James Hopegood, Director of Asset Management Regulation and Sound Practices (jhopegood@aima.org).

Yours faithfully,

Jiří Król
Deputy CEO, Global Head of Government Affairs

ANNEX

A truly meaningful approach to liquidity risk management in all circumstances lies in the identification of all the relevant risks and all the market participants that can have an effect on it. As we have noted in our covering letter, this key element is missing as banks, infrastructure providers and direct owners of assets are excluded from scope. This is an issue for questions (i) 1 and 2, (ii) 4 and 7, and (iii) 5 and 6 and so we have given a single response to each of these pairs of questions.

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?

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

We are concerned that the CP's exclusion of banks from its scope prevents it from presenting a complete picture of all the relevant interactions at play. This undermines the FSB's aim of taking, "a holistic perspective, given the interconnectedness between participants within and across markets."[6] Banks are key counterparties of, and providers of liquidity to, NBFIs. Their actions, particularly in times of market stress, can have a material impact on the availability of liquidity and their requirements, for example for cash as collateral, may create pro-cyclical behaviour as NBFIs are forced to draw cash rather than other equally appropriate instruments to meet their obligations. This inflexibility on the part of CCPs may also cause issues for banks as entities all withdraw cash at the same time in stressed markets. This risks creating an entirely avoidable Silicon Valley Bank-like run on some credit institutions.

A major factor in the 2020 market turmoil was the decision by banks to effectively stop trading, in stark contrast to the equity and derivatives markets. This demonstrates that one of the biggest risks to, for example, bond markets come from NBFIs having to rely on bank intermediation rather than being able to trade freely with anonymous counterparties.

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[6] *See* CP, *supra* note 2, at 9.

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We also note the concerns raised by a number of participants at the FSB's industry outreach on the CP[7] in relation to the role of repo markets in liquidity provision. They raised the issue of banks withdrawing from those markets, so restricting the availability of liquidity to NBFIs.

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7 *See* FSB, Summary Agenda for meeting to be held 31 May 2024, "Industry outreach on liquidity preparedness for margin and collateral calls" (2 May 2024), available at https://www.fsb.org/2024/05/industry-outreach-on-liquidity-preparedness-for-margin-and-collateral-calls/.

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> "The Archegos default exposed several significant deficiencies in CS's risk culture, revealing a Prime Services business with a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk. The Archegos matter directly calls into question the competence of the business and risk personnel who had all the information necessary to appreciate the magnitude and urgency of the Archegos risks, but failed at multiple junctures to take decisive and urgent action to address them."[8]

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8 *See* Credit Suisse Group Special Committee of the Board of Directors, "Report on Archegos Capital Management" (29 July 2021), at 2, available at csg-special-committee-bod-report-archegos.pdf.

9 *See, e.g.,* the press coverage at https://www.ft.com/wirecard.

10 *See, e.g.,* "Explanatory Memorandum to the [UK] Open-Ended Investment Companies (Amendment) Regulations 2011", available at https://www.legislation.gov.uk/ukdsi/2011/9780111517239/pdfs/ukdsiem_9780111517239_en.pdf.

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11 Letter from Jiří Król to the Central Bank of Ireland, "AIMA response to discussion paper: An approach to macroprudential policy for investment funds" (15 November 2023), available at https://www.aima.org/resource/aima-response-to-the-cbi-s-discussion-paper-an-approach-to-macroprudential-policy-for-investment-funds.html.

12 *See* "AIMA in numbers", available at https://www.aima.org/about/aima-in-numbers.html.

13 *See* European Fund and Asset Management Association, "An overview of the asset management industry" (December 2023), at 52, available at https://www.efama.org/sites/default/files/files/Asset%20Management%20Report%202023_3_0.pdf.

to different interpretations and the fragmentation of regulatory approaches, which we do not believe is the CP's intention.

For example, the CP refers to "mitigating" liquidity risk from margin and collateral calls. It is clear that market participants should understand what potential margin calls might be, and this should form part of routine stress testing. However, it is not clear what liquidity risk means in this context. Is it the possibility of selling assets to meet the margin calls and does "liquidity risk tolerance" extend to willingness for positions to be closed out?

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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?

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For example, the requirement to hold "sufficient available cash to meet cash-only margin calls with a high degree of certainty" could be interpreted as a minimum cash buffer applied across non-bank market participants, with significant room for interpretation both within jurisdictions and between market participants. It also creates credit risks for entities that must hold elevated amounts cash and create

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14 *See* IOSCO, "IOSCO Investment Funds Statistics Report" (January 2024, FRJAN/24), at page 16, figure 16, available at, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD761.pdf

15 *See* Alternative Credit Council, "Financing the Economy" (November 2023), at 38, available at, https://www.aima.org/compass/insights/private-credit/financing-the-economy-2023.html.

procyclical risks were a stress to require a number of market participants to withdraw cash from banks at the same time.

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