FSB FINANCIAL STABILITY BOARD

# Leverage in Non-Bank Financial Intermediation: Consultation report

## Response to Consultation

## Committee on Capital Markets Regulation

*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?**

   The FSB has failed to cite any data on aggregate NBFI leverage that indicates that there has been an increase in overall NBFI leverage that could pose systemic risk concerns. Data indicate that NBFI leverage has not increased as an overall share of financial intermediation.

   For example, overall NBFI debt as a percentage of GDP among developed economies has been relatively unchanged over the past twenty years.

   While aggregate NBFI assets demonstrate absolute growth of the NBFI sector - e.g., U.S. aggregate NBFI assets grew from

   56.5 trillion in 2015 to 88.7 trillion in 2023 - this growth should be viewed relative to the growth of the entire financial services industry.

   As a relative share of total financial assets, the size of the NBFI sector has been stable. NBFI assets relative to total financial assets in the U.S. was 64% in 2023, up marginally from 62% in 2015.

   In the Euro area, NBFI assets have decreased as a share of total financial assets, dropping from 54% in 2015 to 52% in 2023.

   Overall, the FSB's general references to "NBFI" in this Consultation Report, which constitutes a broad range of institutions with vastly different risk profiles, is particularly misguided given the lack of clearly identified aggregate "NBFI" problems.

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?**

   The Consultation Report includes two proposed leverage metrics for purposes of risk identification and monitoring - a gross leverage measure and an entity-level leverage metric - which would be misleading.

   First, the FSB's proposal for a gross leverage measure includes gross notional exposure (GNE) with respect to derivatives positions, but GNE is an inappropriate measure of both risk and size.

The calculation of GNE is an unadjusted sum of the notional value of all derivatives contracts without adjusting for hedging or offsetting positions, which can significantly overstate actual risk exposure.

For example, a portfolio with offsetting long and short positions may have high GNE but minimal net market risk.

Second, the FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

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**

   The FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

   Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

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

   The FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

   Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

   **(iii) concentration and crowded trading strategies**

   The FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

   Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

## *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?**

While we are generally in favor of regulatory policy focused on transparency with respect to NBFI leverage, disclosure mandates must be appropriately tailored.

Public disclosure of aggregate anonymized leverage data that does not reveal details of individual transactions or entities is useful information for financial market participants.

To this end, we are supportive of the Consultation Report's recommendation for public disclosure of aggregate positions for an asset class or transaction-level volumes.

However, the FSB's proposed recommendations for more granular public disclosures, such as weekly publication of large trader positions in specific asset classes or markets, or similar entity- or transaction-level details that might expose the identity, investment positions or strategies of individual market participants, are severely flawed.

Investment, trading, arbitrage and hedging strategies and positions of financial institutions represent highly sensitive proprietary information.

Direct or indirect public disclosure of portfolio holdings or trading activity could lead to substantial losses caused by copycat trading, short squeeze attacks or retaliation.

As a result, affected financial institutions would likely curtail otherwise beneficial market activity, depriving all market participants of the added value with respect to price discovery, liquidity, and resiliency.

Transaction costs will increase in the relevant markets and fundamental research will suffer as institutional investors become less incentivized to conduct such research.

Given the myriad of negative effects, we are opposed to the public disclosure of any market participant position or transaction data unless it is appropriately and sufficiently aggregated, anonymized, and/or delayed.

### *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?**

   The Consultation Report includes proposals for direct entity-based leverage limits (i.e., leverage caps) as well as concentration or large exposure limits (i.e., position limits). Each of these recommendations is ill-advised.

   Directly limiting an entity's allowable level of leverage through regulation would be a significant misstep by policymakers.

   While banks are subject to leverage caps to reduce the systemic risk concerns associated with large scale losses at depository institutions, similar caps would not be appropriate for NBFIs.

   Leverage is a fundamental feature of all financial intermediation, both bank and non-bank, and allows market participants to engage in several valuable intermediary activities, including market making and arbitrage, as well as conducting prudent risk management.

Leverage caps would reduce this valuable activity and may drive market participants out of the market entirely depending on the calibration of the regulatory cap.

With respect to market making and arbitrage activities, liquidity, price efficiency, and transaction costs in these markets would likely be negatively impacted as a result.

These potential negative impacts on financial markets would be wholly unjustified, particularly given the lack of specific concerns associated with aggregate NBFI leverage (as noted above).

In addition, leverage caps may have the perverse effect of increasing risk.

Since leverage is often employed for risk management, rather than directional position taking purposes, leverage caps would disrupt the ability of investors to hedge portfolio risks through leveraged positions.

Overall portfolio risk may increase as a result.

Moreover, entity-level leverage caps that apply to an individual firm's entire balance sheet, as opposed to activity-level caps, may lead to a concentration of risk.

For example, an entity-level cap would not distinguish between leverage associated with an interest rate swap versus a single name CDS position.

As a result, firms may respond to leverage caps by consolidating leverage into fewer riskier positions, rather than diversifying their exposures.

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?**

The Consultation Report's proposed recommendation for implementing minimum haircuts in government bond repos would have negative consequences for the U.S. Treasury market.

First, efficient financing through the Treasury repo market is a key component of the Treasury basis trade, which entails a short position in Treasury futures and an offsetting long position in cash Treasuries.

Treasury basis trading confers significant benefits on financial markets and the U.S. government.

Purchases of U.S. Treasuries by basis traders fills gaps in demand for Treasuries, thus buoying the price and lowering the interest rate paid by the U.S. government.

Empirical research shows that hedge fund participation in the Treasury market, typically conducted through basis trades, indeed leads to lower Treasury yields.

In addition, the basis trade also benefits institutional investors by allowing them to gain Treasury exposure through futures rather than cash purchases, which requires a lower cash outlay, thus freeing up capital to be alternatively invested in higher yielding securities.

Treasury basis traders finance the cash purchase leg through the Treasury repo market.

Regulatory minimum haircuts on repos would raise the financing costs of the trade, which would dampen basis trade activity and may incentivize market participants to abandon the trade entirely.

As a result, the benefits to the U.S. government and institutional investors, including pension funds and retirement accounts, would be significantly diminished.

The Consultation Report also errs in its support for minimum haircuts in its implication that zero haircuts are a common feature of Treasury repos.

Zero haircut repos are not as prevalent as suggested, as those repo transactions that do include a zero haircut are often executed in accordance with a master netting agreement (MNA).

Under the MNA significant collateral is frequently posted in other legs of the transaction, thus providing additional collateralization of the "zero haircut" leg.

Effectively, zero haircut Treasury repos are not truly zero haircut.

Moreover, financial stability concerns with respect to repos have largely been addressed by recent regulations.

Central clearing mandates for Treasury repos as well as the introduction of central bank repo facilities that serve as a backstop for repo financing are effective tools in combatting systemic risk concerns in the Treasury repo market.

As such, regulatory minimums become unnecessary and excessive, serving only to disrupt the efficient functioning of this market.

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?**

   The FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

   Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

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

   The Consultation Report's proposed recommendation for implementing minimum haircuts in government bond repos would have negative consequences for the U.S. Treasury market.

   Regulatory minimum haircuts on repos would raise the financing costs of the trade, which would dampen basis trade activity and may incentivize market participants to abandon the trade entirely.

   As a result, the benefits to the U.S. government and institutional investors, including pension funds and retirement accounts, would be significantly diminished.

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As such, regulatory minimums become unnecessary and excessive, serving only to disrupt the efficient functioning of this market.

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

The Consultation Report's proposed recommendation for implementing minimum haircuts in government bond repos would have negative consequences for the U.S. Treasury market.

Regulatory minimum haircuts on repos would raise the financing costs of the trade, which would dampen basis trade activity and may incentivize market participants to abandon the trade entirely.

As a result, the benefits to the U.S. government and institutional investors, including pension funds and retirement accounts, would be significantly diminished.

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Central clearing mandates for Treasury repos as well as the introduction of central bank repo facilities that serve as a backstop for repo financing are effective tools in combatting systemic risk concerns in the Treasury repo market.

As such, regulatory minimums become unnecessary and excessive, serving only to disrupt the efficient functioning of this market.

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?**

The Consultation Report includes proposals for direct entity-based leverage limits (i.e., leverage caps) as well as concentration or large exposure limits (i.e., position limits). Each of these recommendations is ill-advised.

Directly limiting an entity's allowable level of leverage through regulation would be a significant misstep by policymakers.

While banks are subject to leverage caps to reduce the systemic risk concerns associated with large scale losses at depository institutions, similar caps would not be appropriate for NBFIs.

Leverage is a fundamental feature of all financial intermediation, both bank and non-bank, and allows market participants to engage in several valuable intermediary activities, including market making and arbitrage, as well as conducting prudent risk management.

Leverage caps would reduce this valuable activity and may drive market participants out of the market entirely depending on the calibration of the regulatory cap.

With respect to market making and arbitrage activities, liquidity, price efficiency, and transaction costs in these markets would likely be negatively impacted as a result.

These potential negative impacts on financial markets would be wholly unjustified, particularly given the lack of specific concerns associated with aggregate NBFI leverage (as noted above).

In addition, leverage caps may have the perverse effect of increasing risk.

Since leverage is often employed for risk management, rather than directional position taking purposes, leverage caps would disrupt the ability of investors to hedge portfolio risks through leveraged positions.

Overall portfolio risk may increase as a result.

Moreover, entity-level leverage caps that apply to an individual firm's entire balance sheet, as opposed to activity-level caps, may lead to a concentration of risk.

For example, an entity-level cap would not distinguish between leverage associated with an interest rate swap versus a single name CDS position.

As a result, firms may respond to leverage caps by consolidating leverage into fewer riskier positions, rather than diversifying their exposures.

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?**

    The FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt).

    Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless.

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

    In addition, leverage caps may have the perverse effect of increasing risk.

Since leverage is often employed for risk management, rather than directional position taking purposes, leverage caps would disrupt the ability of investors to hedge portfolio risks through leveraged positions.

Overall portfolio risk may increase as a result.

Moreover, entity-level leverage caps that apply to an individual firm's entire balance sheet, as opposed to activity-level caps, may lead to a concentration of risk.

For example, an entity-level cap would not distinguish between leverage associated with an interest rate swap versus a single name CDS position.

As a result, firms may respond to leverage caps by consolidating leverage into fewer riskier positions, rather than diversifying their exposures.

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?**

The Consultation Report includes proposals for direct entity-based leverage limits (i.e., leverage caps) as well as concentration or large exposure limits (i.e., position limits). Each of these recommendations is ill-advised.

Directly limiting an entity's allowable level of leverage through regulation would be a significant misstep by policymakers.

While banks are subject to leverage caps to reduce the systemic risk concerns associated with large scale losses at depository institutions, similar caps would not be appropriate for NBFIs.

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Leverage caps would reduce this valuable activity and may drive market participants out of the market entirely depending on the calibration of the regulatory cap.

With respect to market making and arbitrage activities, liquidity, price efficiency, and transaction costs in these markets would likely be negatively impacted as a result.

These potential negative impacts on financial markets would be wholly unjustified, particularly given the lack of specific concerns associated with aggregate NBFI leverage (as noted above).

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For example, an entity-level cap would not distinguish between leverage associated with an interest rate swap versus a single name CDS position.

As a result, firms may respond to leverage caps by consolidating leverage into fewer riskier positions, rather than diversifying their exposures.

### *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?**

Internal reports found that Credit Suisse was aware of certain of Archegos' exposures but simply failed to call for additional collateral when its own internal risk models required it to do so. The internal report further concluded that relevant parties "had all the information necessary to appreciate the magnitude and urgency of the Archegos risks." The Archegos default was thus characterized by fraud and risk management failures, not gaps in NBFI leverage regulation. Credit risk management, which is not an issue of NBFI leverage nor the focus of the Consultation Report, has already received significant regulatory attention in the wake of the Archegos default

### *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?**

The nature of information and data that leverage providers receive from their non-bank financial counterparties is heterogeneous, non-standardised, and may vary widely in both quality and quantity.

There could be benefits from a minimum principles-based set of standard disclosures to ensure visibility on aggregate leveraged positions.

These standards could apply to leverage users to support the provision of sufficient quality information to their leverage providers, or to the harmonisation of the data exchanged, which would facilitate comparisons and aggregation across clients.

Specific types of information and data disclosed should take account of the strategies, products and markets in which the client is active, to ensure that the information provided is relevant and effective for the purpose of the leverage provider's risk management.

Clients should provide aggregate information on their exposures across all entities or vehicles that are managed under a common strategy or decision-making process, to capture the impact of a coordinated liquidation across the client's full range of related investment products or vehicles.

The information disclosed to each leverage provider should be expressed in standardised metrics, wherever possible, potentially basing them on the toolkit metrics as set out in Recommendation 1 and in the Annex.

Private disclosures should grant leverage providers the necessary transparency to effectively manage risks, including concentration risks, while allowing for proprietary client information to remain confidential.

At a minimum, clients should provide information on the nature, scale and contours of their aggregate exposures and leverage in each major asset class, market or strategy, including through the provision of internal risk assessments (e.g. stress test results) and information about their risk management framework that covers such aspects.

The information disclosed to each leverage provider should be limited to that which is relevant to the current and prospective risk exposure that the specific leverage provider has to the client, considering concentration and expected correlations amongst exposure types.

The granularity of disclosures should be applied proportionately, using a risk-based approach that incorporates the nature, scale and complexity of the risks that a given client poses to its leverage provider.

Leverage providers may also request specific types of information and data beyond the minimum standard disclosures, taking account of the strategies, products and markets in which the client is active.

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?**

    The nature of information and data that leverage providers receive from their non-bank financial counterparties is heterogeneous, non-standardised, and may vary widely in both quality and quantity.

    There could be benefits from a minimum principles-based set of standard disclosures to ensure visibility on aggregate leveraged positions.

    These standards could apply to leverage users to support the provision of sufficient quality information to their leverage providers, or to the harmonisation of the data exchanged, which would facilitate comparisons and aggregation across clients.

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?**

    These standards could apply to leverage users to support the provision of sufficient quality information to their leverage providers, or to the harmonisation of the data exchanged, which would facilitate comparisons and aggregation across clients.

    Specific types of information and data disclosed should take account of the strategies, products and markets in which the client is active, to ensure that the information provided is relevant and effective for the purpose of the leverage provider's risk management.

    Clients should provide aggregate information on their exposures across all entities or vehicles that are managed under a common strategy or decision-making process, to capture the impact of a coordinated liquidation across the client's full range of related investment products or vehicles.

The information disclosed to each leverage provider should be expressed in standardised metrics, wherever possible, potentially basing them on the toolkit metrics as set out in Recommendation 1 and in the Annex.

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At a minimum, clients should provide information on the nature, scale and contours of their aggregate exposures and leverage in each major asset class, market or strategy, including through the provision of internal risk assessments (e.g. stress test results) and information about their risk management framework that covers such aspects.

The information disclosed to each leverage provider should be limited to that which is relevant to the current and prospective risk exposure that the specific leverage provider has to the client, considering concentration and expected correlations amongst exposure types.

The granularity of disclosures should be applied proportionately, using a risk-based approach that incorporates the nature, scale and complexity of the risks that a given client poses to its leverage provider.

Leverage providers may also request specific types of information and data beyond the minimum standard disclosures, taking account of the strategies, products and markets in which the client is active.

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?**

    At a minimum, clients should provide information on the nature, scale and contours of their aggregate exposures and leverage in each major asset class, market or strategy, including through the provision of internal risk assessments (e.g. stress test results) and information about their risk management framework that covers such aspects.

    The information disclosed to each leverage provider should be limited to that which is relevant to the current and prospective risk exposure that the specific leverage provider has to the client, considering concentration and expected correlations amongst exposure types.

    The granularity of disclosures should be applied proportionately, using a risk-based approach that incorporates the nature, scale and complexity of the risks that a given client poses to its leverage provider.

    Leverage providers may also request specific types of information and data beyond the minimum standard disclosures, taking account of the strategies, products and markets in which the client is active.

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?**

    The nature of information and data that leverage providers receive from their non-bank financial counterparties is heterogeneous, non-standardised, and may vary widely in both quality and quantity.

There could be benefits from a minimum principles-based set of standard disclosures to ensure visibility on aggregate leveraged positions.

These standards could apply to leverage users to support the provision of sufficient quality information to their leverage providers, or to the harmonisation of the data exchanged, which would facilitate comparisons and aggregation across clients.

Specific types of information and data disclosed should take account of the strategies, products and markets in which the client is active, to ensure that the information provided is relevant and effective for the purpose of the leverage provider's risk management.

Clients should provide aggregate information on their exposures across all entities or vehicles that are managed under a common strategy or decision-making process, to capture the impact of a coordinated liquidation across the client's full range of related investment products or vehicles.

The information disclosed to each leverage provider should be expressed in standardised metrics, wherever possible, potentially basing them on the toolkit metrics as set out in Recommendation 1 and in the Annex.

Private disclosures should grant leverage providers the necessary transparency to effectively manage risks, including concentration risks, while allowing for proprietary client information to remain confidential.

At a minimum, clients should provide information on the nature, scale and contours of their aggregate exposures and leverage in each major asset class, market or strategy, including through the provision of internal risk assessments (e.g. stress test results) and information about their risk management framework that covers such aspects.

The information disclosed to each leverage provider should be limited to that which is relevant to the current and prospective risk exposure that the specific leverage provider has to the client, considering concentration and expected correlations amongst exposure types.

The granularity of disclosures should be applied proportionately, using a risk-based approach that incorporates the nature, scale and complexity of the risks that a given client poses to its leverage provider.

Leverage providers may also request specific types of information and data beyond the minimum standard disclosures, taking account of the strategies, products and markets in which the client is active.

### *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 Consultation Report includes repeated references to interconnectedness as a significant factor with respect to the purported systemic risks posed by leverage, and it claims that interconnectedness is a particularly concerning factor among NBFIs.

However, while interconnectedness can lead to relatively localized losses among direct counterparties, the concerns that interconnectedness causes a cascade of systemwide failures is unfounded.

To the contrary, it has been well established by past Committee research that contagion, not interconnectedness, is the key driver of system risk concerns during financial crises.

Interconnectedness generally entails the concern that the failure of one financial institution will directly cause the collapse of other financial institutions, thus setting off a chain of systemwide failures.

Financial institutions can generally protect themselves from significant losses due to interconnectedness through prudent internal risk management practices, as was the case during the 2008 global financial crisis ("2008 GFC"), and continues to be the case today.

Interconnectedness concerns did not materialize then, and there is no evidence that interconnectedness contributes meaningfully to systemic risk now.

On the contrary, if anything interconnectedness concerns have been reduced as a result of post-2008 regulations (e.g., central clearing mandates).

In fact, it is widespread panic-driven runs on short-term funding (i.e., contagion) that is the primary driver of systemic risk, not interconnectedness.

As such, NBFI interconnectedness should not be a motivating factor with respect to NBFI regulation aimed at enhancing financial market stability.

February 28, 2025

Secretariat to the Financial Stability Board
Bank for International Settlements
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(submitted electronically)

Re: Consultation Report: Leverage in Non-bank Financial Intermediation

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Financial Stability Board's ("**FSB**") consultation report, *Leverage in Non-Bank Financial Intermediation* ("**Consultation Report**"), that proposes policy recommendations to address purported risks to financial stability from leverage in non-bank financial intermediation ("**NBFI**").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes forty leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

In 2023 the FSB issued a report entitled *The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation* (the "**2023 NBFI Report**").[2] NBFIs include all non-bank financial institutions, including broker-dealers, hedge funds, insurance companies and pension funds. The Consultation Report is intended to build upon the 2023 NBFI Report. It raises purported risks to financial stability from NBFI leverage and proposes recommendations that policymakers should consider to address such risks. The proposed recommendations are broad and far-reaching, focusing on both activity-based and entity-based regulations, as well as data disclosure and transparency mandates.

Our letter proceeds in two parts. Part I briefly summarizes the key elements of the FSB's Consultation Report, including the purported systemic risk concerns associated with NBFI

[1] FINANCIAL STABILITY BOARD, *Consultation Report: Leverage in Non-Bank Financial Intermediation* (Dec. 18, 2024), https://www.fsb.org/uploads/P181224.pdf [hereinafter, *Consultation Report*]. Throughout this letter we also use NBFI to stand for "non-bank financial intermediary."

[2] FINANCIAL STABILITY BOARD, *The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation* (Sept. 6, 2023), https://www.fsb.org/uploads/P060923-2.pdf [hereinafter, *2023 NBFI Report*].

leverage as well as the recommendations they propose. Part II presents our analysis and discussion of several fundamental flaws with the FSB's wide-ranging recommendations.

## I. Summary of key elements of the Consultation Report

The Consultation Report sets forth two channels through which the build-up of leverage at NBFIs purportedly could pose financial stability concerns: (i) a position liquidation channel whereby unexpected collateral or margin calls prompt leveraged entities to deleverage through asset sales, thus depressing asset prices and destabilizing the market and (ii) a counterparty channel whereby distress or failure of a leveraged entity imposes significant losses on its counterparties, thus triggering a cascade of distress throughout the market.[3] Importantly, the Consultation Report notes that leverage can pose financial stability concerns through these two channels "*if not properly managed*." [emphasis added][4]

As evidence of the financial stability concerns associated with NBFI leverage, the Consultation Report invokes four past episodes of financial market disruptions, each representing (according to the FSB) a specific example of NBFI leverage contributing to stress in the relevant market. These episodes are the: (i) March 2020 US Treasury market turmoil, (ii) March 2021 default of Archegos, (iii) 2022 commodities market stress, and (iv) September 2022 UK Gilt market stress.

The FSB also highlights particular concern with hedge funds that utilize high levels of leverage, both due to the potential stability concerns from rapid deleveraging as well as concerns that the "failure of a major hedge fund could lead to substantial losses for prime brokers," which could then spillover more broadly.[5] The FSB also expresses concern that a lack of disclosure by NBFI entities can lead to unexpected buildups in leverage (e.g., a single prime broker would not know the full extent of its client's leveraged positions if other brokers also supply leverage to that client).

The Consultation Report proceeds with proposed policy recommendations intended to address three distinct issues with respect to NBFI leverage. First, the Consultation Report recommends enhanced transparency, including that policymakers: establish a framework to identify and monitor financial stability risks stemming from NBFI leverage; assess and address any data challenges under the framework such as data gaps, data quality, and accessibility; and consider possible public disclosure mandates.[6] Second, the Consultation Report recommends that policymakers consider leverage restrictions, including activity-based measures such as minimum haircuts in government bond repos, increased margining requirements and central clearing mandates, as well as entity-based measures such as leverage caps and constraints, position limits and large position reporting requirements. Finally, the Consultation Report includes recommendations that focus on the interconnectedness of NBFIs with systemically important banking entities and other NBFIs, suggesting authorities should ensure a robust counterparty credit risk management framework and review and enhance private disclosure practices.[7]

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[3] *Consultation Report*, *supra* note 1 at 4-5.
[4] *Id*.
[5] *Id*.
[6] *Id*. at 17-20.
[7] *Id*. at 26-28.

## II. Comments and Analysis

The Consultation Report has failed to provide any compelling data documenting a growing problem with NBFI leverage. Moreover, the Consultation Report's attempt to support the need for NBFI leverage regulation by citing certain past examples of market turmoil is equally flawed. The specific events highlighted by the FSB were neither triggered nor materially exacerbated by excessive NBFI leverage. In addition, the FSB's repeated reference to interconnectedness as a significant factor that creates systemic risk is flawed and misguided.

With respect to the Consultation Report's proposed policy recommendations, the FSB proposes certain public disclosure mandates that would be harmful to financial markets and recommends NBFI leverage metrics that are potentially inaccurate and misleading. Moreover, the Consultation Report suggests leverage caps and positions limits that would reduce market efficiency and increase transaction costs for all market participants. Finally, the FSB's recommendation for minimum haircuts imposed on Treasury repos are unnecessary and would significantly diminish Treasury market efficiency.

### A. General Flaws of the Consultation Report

#### 1. The FSB has failed to identify an aggregate problem with NBFI leverage.

The FSB has failed to cite any data on aggregate NBFI leverage that indicates that there has been an increase in overall NBFI leverage that could pose systemic risk concerns. Data indicate that NBFI leverage has not increased as an overall share of financial intermediation.

For example, overall NBFI debt as a percentage of GDP among developed economies has been relatively unchanged over the past twenty years.[8] While aggregate NBFI assets demonstrate *absolute* growth of the NBFI sector – e.g., U.S. aggregate NBFI assets grew from $56.5 trillion in 2015 to $88.7 trillion in 2023 – this growth should be viewed relative to the growth of the entire financial services industry.[9] As a relative share of total financial assets, the size of the NBFI sector has been stable. NBFI assets relative to total financial assets in the U.S. was 64% in 2023, up marginally from 62% in 2015.[10] In the Euro area, NBFI assets have *decreased* as a share of total financial assets, dropping from 54% in 2015 to 52% in 2023.[11]

Overall, the FSB's general references to "NBFI" in this Consultation Report, which constitutes a broad range of institutions with vastly different risk profiles, is particularly misguided given the lack of clearly identified aggregate "NBFI" problems. Rather than focusing on NBFI *per se*, the FSB should be more specific about the types of institutions that it aims to address. Improved clarity in this respect would not only avoid oversimplification of the systemic risk concerns, but also would allow for a more transparent and targeted discussion on risks and risk mitigation.

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[8] *See 2023 NBFI Report*, *supra* note 2 at 8 (Graph 1). While specific data is not provided, the graph illustrates relative consistency over the past twenty years and, if anything, highlights a *decrease* in the relative percentage of NBFI debt.
[9] Shelly Antoniewicz and Shane Worner, *Financial Policymakers Need to Look at the Facts About the "Growing Threat" of NBFI*, ICI VIEWPOINTS (Aug. 6, 2024), https://www.ici.org/viewpoints/24-view-nbfi-growth.
[10] *Id.*
[11] *Id.*

**2. Anecdotal accounts of past market events do not support concerns regarding NBFI leverage.**

The FSB cites four specific examples of market turmoil as *de facto* evidence of financial stability concerns associated with NBFI leverage. These events are the (i) March 2020 Treasury market turmoil, (ii) March 2021 Archegos default, (iii) 2022 commodity markets disruptions, and (iv) September 2022 UK Gilt market stress. However, NBFI leverage was not the primary driver of any of these stressed market events.

(i) March 2020 Treasury market turmoil

The U.S. Treasury market in March 2020 experienced rapid selloffs of Treasuries, primarily due to a high degree of market fear and uncertainty related to the Covid-19 pandemic (aka a "global dash for cash").[12] Increased Treasury market volatility led to an increase in margin requirements on Treasury futures positions, which required leveraged Treasury basis traders, including hedge funds, to post more cash collateral against their short futures positions. Some hedge funds chose to de-leverage as a result (i.e., unwind basis trade positions by selling cash Treasuries), rather than posting the additional margin.

The FSB attempts to argue that the hedge fund de-leveraging is indicative of financial stability concerns associated with the leverage. However, the FSB fails to provide any data supporting this claim. As discussed in a 2023 report by the Committee, hedge fund de-leveraging likely played a relatively minor role in the Treasury market turmoil.[13] Rather, the substantial selloff of Treasuries by foreign investors - more than $400 billion in March 2020 - fueled the market disruption, not de-leveraging by NBFIs. The Fed even noted in its Financial Stability Report that de-leveraging by hedge funds has not been shown to be a primary driver of the turmoil.[14]

(ii) March 2021 Archegos default

In March 2021, Archegos Capital Management, a family office run by Bill Hwang, defaulted on margin calls tied to leveraged positions in a concentrated portfolio of equities, primarily executed through total return swaps. The Archegos default imposed losses of approximately $10 billion on its dealer counterparties, including $5.5 billion at Credit Suisse and $2.9 billion at Nomura Securities. Importantly, however, the propagation of losses to Archegos' counterparties was not due to a lack of adequate safeguards against NBFI leverage or transparency but rather was caused by a combination of fraud and counterparty mismanagement. Bill Hwang was subsequently found guilty of wire fraud and securities fraud for lying to banks about his fund's portfolio exposures.[15]

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[12] *See* COMMITTEE ON CAPITAL MARKETS REGULATION ["CCMR"], *An Overview of the Treasury Cash-Futures Basis Trade* (Dec. 20, 2023), https://capmktsreg.org/wp-content/uploads/2023/12/An-Overview-of-the-Treasury-Basis-Trade-12-20-23-FINAL.pdf.

[13] *Id*.

[14] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *Financial Stability Report – November 2020*, https://www.federalreserve.gov/publications/2020-november-financial-stability-report-purpose.htm.

[15] Luc Cohen and Jonathan Stempel, *Archegos' Bill Hwang Sentenced to 18 Years in Prison for Massive US Fraud*, REUTERS (Nov. 20, 2024), https://www.reuters.com/legal/archegos-bill-hwang-be-sentenced-massive-us-fraud-2024-11-20/.

Moreover, Archegos' counterparties had sufficient transparency about the fund's positions but failed to conduct prudent risk management. Internal reports found that Credit Suisse was aware of certain of Archegos' exposures but simply failed to call for additional collateral when its own internal risk models required it to do so.[16] The internal report further concluded that relevant parties "had all the information necessary to appreciate the magnitude and urgency of the Archegos risks."[17] The Archegos default was thus characterized by fraud and risk management failures, not gaps in NBFI leverage regulation. Credit risk management, which is not an issue of NBFI leverage nor the focus of the Consultation Report, has already received significant regulatory attention in the wake of the Archegos default.[18]

(iii) 2022 commodity markets disruptions

In 2022, global commodity markets experienced significant disruptions, including supply shocks, that led to extreme price volatility and resulting liquidity strains and margin call pressures on commodity trading firms and other financial institutions. However, while leverage contributed to the strains faced by financial institutions, the FSB itself has previously commented that the commodity market disruptions in 2022 were triggered by a significant geopolitical macro event, specifically the Russian invasion of Ukraine,[19] not by excessive NBFI leverage. Moreover, the FSB further concluded that "[t]here were no major disruptions to market functioning…[with] limited impact on the rest of the financial system." Thus, the FSB's own conclusions on this event provide no support for the premise that NBFI leverage is a growing concern in need of additional policy action.

While the FSB does highlight one exception – the London nickel market – which did experience a more severe disruption, the stress in this market was not propagated by NBFI leverage. Rather nickel markets were disrupted by the combination of significant price volatility along with a series of canceled trades initiated by the LME, which threatened market confidence.[20] In this case, it was unprecedented volatility in nickel prices that propelled the market disruption, not excessive NBFI leverage.

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[16] For this point, *see* CCMR, *Comment Letter to the SEC on the SBS Proposal* (Mar. 21, 2022), https://capmktsreg.org/wp-content/uploads/2022/03/CCMR-Comment-Letter-SEC-SBS-Proposal-03-21-22-2.pdf.

[17] *Id*.

[18] *See e.g.*, BASEL COMMITTEE ON BANKING SUPERVISION, *Final Guidelines for Counterparty Credit Risk Management* (Dec. 11, 2024), https://www.bis.org/bcbs/publ/d588.htm; BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *SR 21-19: The Federal Reserve Reminds Firms of Safe and Sound Practices for Counterparty Credit Risk Management in Light of the Archegos Capital Management Default* (Dec. 10, 2021), https://www.federalreserve.gov/supervisionreg/srletters/SR2119.htm; EUROPEAN CENTRAL BANK, *Sound Practices in Counterparty Credit Risk Governance and Management* (Oct. 2023), https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisory_guides202310_ccrgovernancemanagement.en.pdf.

[19] FINANCIAL STABILITY BOARD, *The Financial Stability Aspects of Commodities Markets* (Feb. 20, 2023) https://www.fsb.org/2023/02/the-financial-stability-aspects-of-commodities-markets/.

[20] Sam Tobin, Eric Onstad, and Pratima Desai, *LME Cancelled Nickel Trades to "Save" Tsingshan, London Court Told*, REUTERS (Jun. 20, 2023), https://www.reuters.com/markets/commodities/lme-cancelled-nickel-trades-save-tsingshan-london-court-told-2023-06-20/.

(iv) September 2022 UK Gilt market stress

The September 2022 UK Gilt market disruption was not triggered by excessive NBFI leverage, but rather by a rapid repricing of interest rates, sparked by the UK government's "mini budget" proposing large unfunded tax cuts, and the resultant impact on liability-driven investment (LDI) strategies utilized by UK pension funds.[21] Since LDI funds employ leverage to hedge and manage long-term obligations, the sudden spike in gilt yields forced LDI funds to sell to meet margin calls. But it was not the *size* of leverage at LDI funds that triggered sell pressure on UK gilts,[22] but rather the liquidity mismatch at the pension funds, which forced the need for additional collateral. Again, deficiencies in NBFI leverage regulation do not explain this market event.

**3. The FSB's focus on the role of interconnectedness in the propagation of systemic risk is flawed and misguided.**

The Consultation Report includes repeated references to interconnectedness as a significant factor with respect to the purported systemic risks posed by leverage, and it claims that interconnectedness is a particularly concerning factor among NBFIs.[23] However, while interconnectedness can lead to relatively localized losses among direct counterparties, the concerns that interconnectedness causes a cascade of systemwide failures is unfounded. To the contrary, it has been well established by past Committee research that contagion, not interconnectedness, is the key driver of system risk concerns during financial crises.[24]

Interconnectedness generally entails the concern that the failure of one financial institution will directly cause the collapse of other financial institutions, thus setting off a chain of systemwide failures.[25] Financial institutions can generally protect themselves from significant losses due to interconnectedness through prudent internal risk management practices, as was the case during the 2008 global financial crisis ("2008 GFC"),[26] and continues to be the case today. Interconnectedness concerns did not materialize then, and there is no evidence that interconnectedness contributes meaningfully to systemic risk now. On the contrary, if anything interconnectedness concerns have been reduced as a result of post-2008 regulations (e.g., central clearing mandates). In fact, it is widespread panic-driven runs on short-term funding (i.e., contagion) that is the primary driver of

[21] Ketan B. Patel and Santiago I. Sordo Palacios, *UK Pension Market Stress in 2022—Why It Happened and Implications for the U.S.*, CHICAGO FED LETTER (Jun. 2023), https://www.chicagofed.org/publications/chicago-fed-letter/2023/480

[22] *Consultation Report*, *supra* note 1 at 24 (Sec. 4.2.1).

[23] *See e.g.*, *Consultation Report*, *supra* note 1 at 1 ("Certain factors, which include interconnectedness…can amplify vulnerabilities related to leverage…."). *See also Consultation Report* at Sec. 2.2 ("Amplification factors, such as interconnectedness…are particularly pronounced in NBFI.")

[24] For a detailed examination of interconnectedness in the 2008 financial crisis, *see* Hal S. Scott, *Interconnectedness and Contagion* (Nov. 20, 2012), https://capmktsreg.org/wp-content/uploads/2022/11/2012.11.20_Interconnectedness_and_Contagion-1.pdf.
Also, *see generally,* Hal S. Scott, *Connectedness and Contagion: Protecting the Financial System from Panics*, MIT PRESS (2016).

[25] Interconnectedness can be triggered on the asset side of the balance sheet (asset interconnectedness), whereby the failures propagate through credit exposures, and on the liability side of the balance sheet (liability interconnectedness), whereby the failure propagates through funding exposures.

[26] *See* Scott (2012), *supra* note 24.

systemic risk, not interconnectedness.[27] As such, NBFI interconnectedness should not be a motivating factor with respect to NBFI regulation aimed at enhancing financial market stability.

### B. Specific issues with the Consultation Report's proposed recommendations

#### 1. The recommendations propose harmful public disclosure mandates.

While we are generally in favor of regulatory policy focused on transparency with respect to NBFI leverage, disclosure mandates must be appropriately tailored. Public disclosure of aggregate anonymized leverage data that does not reveal details of individual transactions or entities is useful information for financial market participants. To this end, we are supportive of the Consultation Report's recommendation for public disclosure of aggregate positions for an asset class or transaction-level volumes.[28]

However, the FSB's proposed recommendations for more granular public disclosures, such as weekly publication of large trader positions in specific asset classes or markets,[29] or similar entity- or transaction-level details that might expose the identity, investment positions or strategies of individual market participants, are severely flawed. Investment, trading, arbitrage and hedging strategies and positions of financial institutions represent highly sensitive proprietary information. Direct or indirect public disclosure of portfolio holdings or trading activity could lead to substantial losses caused by copycat trading, short squeeze attacks or retaliation. As a result, affected financial institutions would likely curtail otherwise beneficial market activity, depriving all market participants of the added value with respect to price discovery, liquidity, and resiliency. Transaction costs will increase in the relevant markets and fundamental research will suffer as institutional investors become less incentivized to conduct such research.[30] Given the myriad of negative effects, we are opposed to the public disclosure of any market participant position or transaction data unless it is appropriately and sufficiently aggregated, anonymized, and/or delayed.

#### 2. Certain proposed leverage metrics are potentially misleading.

The Consultation Report includes two proposed leverage metrics for purposes of risk identification and monitoring – a gross leverage measure[31] and an entity-level leverage metric[32] – which would be misleading.

First, the FSB's proposal for a gross leverage measure includes gross notional exposure (GNE) with respect to derivatives positions, but GNE is an inappropriate measure of both risk and size. The calculation of GNE is an unadjusted sum of the notional value of all derivatives contracts without adjusting for hedging or offsetting positions, which can significantly overstate actual risk exposure. For example, a portfolio with offsetting long and short positions may have high GNE

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[27] *Id*.
[28] *Consultation Report*, *supra* note 1 at Sec 4.1.3.
[29] *Id*.
[30] For a detailed discussion of these effects with respect to security-based swaps reporting requirements, *see* CCMR (Mar. 21, 2022), *supra* note 16.
[31] *Consultation Report*, *supra* note 1 at Sec. 4.1.1 and Annex 1.
[32] *Id.* at Sec. 4.1.1.

but minimal net market risk. In addition, comparing the riskiness of positions based on notional value is not appropriate. For example, the risk profile of interest rate swaps with high notional values should not be directly compared to the riskiness of credit derivatives, which often carry much lower notional values.

The Bank for International Settlements (BIS) reported the notional value of all outstanding OTC derivatives globally as nearly $730 trillion in the first half of 2024.[33] However, this large notional value translated into only $17 trillion of gross market value (GMV), which is a more accurate reflection of market value and risk.[34] Actual risk exposure is further reduced with netting taken into account, which neither GNE nor GMV do. With netting considered, global OTC derivatives produced only $2.8 trillion of gross credit exposure (GCE).[35] Clearly, leverage metrics based on GNE severely distorts the actual risk of leveraged positions. As such, we strongly oppose leverage metrics based on gross notional amounts.

Second, the FSB's proposed recommendation for entity-level leverage metrics do not include adjustments for different types of assets (e.g., leverage for highly liquid US Treasuries as compared to less liquid private debt). Since different asset classes have dramatically different risk profiles, entity-level leverage metrics that treat all assets equally would fail to capture actual risk exposure, rendering comparisons of leverage across entities meaningless. For example, an NBFI entity holding $1 billion of leveraged positions in US Treasuries would generate the same entity-level leverage metric as an NBFI entity holding $1 billion of leveraged positions in less liquid private debt. Equating the leverage metrics of both entities is nonsensical and potentially misleading.

**3. The proposed recommendations related to leverage caps or position limits are misguided and would impose negative consequences on all financial market participants.**

The Consultation Report includes proposals for direct entity-based leverage limits (i.e., leverage caps)[36] as well as concentration or large exposure limits (i.e., position limits).[37] Each of these recommendations is ill-advised.

i. Leverage Caps

Directly limiting an entity's allowable level of leverage through regulation would be a significant misstep by policymakers. While banks are subject to leverage caps to reduce the systemic risk concerns associated with large scale losses at depository institutions, similar caps would not be appropriate for NBFIs. Leverage is a fundamental feature of all financial intermediation, both bank and non-bank, and allows market participants to engage in several valuable intermediary activities,

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[33] BIS DATA PORTAL, *Global OTC Derivatives Market Data* at Table D5.1, https://data.bis.org/topics/OTC_DER/tables-and-dashboards/BIS,DER_D5_1,1.0.

[34] *See* BIS MONETARY AND ECONOMIC DEPARTMENT, *Statistical Release: OTC Derivatives Statistics at end-June 2014* (Nov. 2014), http://www.bis.org/publ/otc_hy1411.pdf. The BIS states that "The gross market value represents the maximum loss that market participants would incur if all counterparties failed to meet their contractual payments and the contracts were replaced at current market prices."

[35] BIS DATA PORTAL, *supra* note 33 at Table D5.2.

[36] *Consultation Report*, *supra* note 1 at Sec 4.2.1.

[37] *Id*. at Sec 4.2.2.

including market making and arbitrage, as well as conducting prudent risk management. Leverage caps would reduce this valuable activity and may drive market participants out of the market entirely depending on the calibration of the regulatory cap. With respect to market making and arbitrage activities, liquidity, price efficiency, and transaction costs in these markets would likely be negatively impacted as a result. These potential negative impacts on financial markets would be wholly unjustified, particularly given the lack of specific concerns associated with aggregate NBFI leverage (as noted above).[38]

In addition, leverage caps may have the perverse effect of increasing risk. Since leverage is often employed for risk management, rather than directional position taking purposes, leverage caps would disrupt the ability of investors to hedge portfolio risks through leveraged positions. Overall portfolio risk may increase as a result. Moreover, entity-level leverage caps that apply to an individual firm's entire balance sheet, as opposed to activity-level caps, may lead to a concentration of risk. For example, an entity-level cap would not distinguish between leverage associated with an interest rate swap versus a single name CDS position. As a result, firms may respond to leverage caps by consolidating leverage into fewer riskier positions, rather than diversifying their exposures.

ii. Position Limits

Position limits would also be a significant mistake by policymakers. Similar to leverage caps, position limits would potentially harm valuable financial market activity. For example, by preventing financial institutions from fully expressing their views on prices for a specific asset class by limiting the size of their position, price discovery can be distorted and liquidity reduced. In addition, not only can position limits hinder risk management strategies, but they also can increase transaction costs as firms are forced to fragment trades across multiple entities, counterparties, or exchanges.

In a previous consideration of position limits, the CFTC conducted a review of several government and academic studies examining the impact of position limits, ultimately determining that consensus was lacking with respect to the imposition of position limits.[39] Our own internal review of those same studies found that a majority of studies opposed the implementation of position limits.[40]

**4. Minimum haircuts for Treasury repos are unnecessary and would significantly harm Treasury market efficiency.**

The Consultation Report's proposed recommendation for implementing minimum haircuts in government bond repos would have negative consequences for the U.S. Treasury market. First, efficient financing through the Treasury repo market is a key component of the Treasury basis trade, which entails a short position in Treasury futures and an offsetting long position in cash

[38] *See* Part II.A.1.
[39] *See* CCMR, *Comment Letter to the CFTC on Position Limits* (Feb. 10, 2014), https://capmktsreg.org/wp-content/uploads/2014/02/CFTC.position.limits.comment.ltr_.with-sigs.pdf.
[40] *Id.*

Treasuries.[41] Treasury basis trading confers significant benefits on financial markets and the U.S. government. Purchases of U.S. Treasuries by basis traders fills gaps in demand for Treasuries, thus buoying the price and lowering the interest rate paid by the U.S. government. Empirical research shows that hedge fund participation in the Treasury market, typically conducted through basis trades, indeed leads to lower Treasury yields.[42] In addition, the basis trade also benefits institutional investors by allowing them to gain Treasury exposure through futures rather than cash purchases, which requires a lower cash outlay, thus freeing up capital to be alternatively invested in higher yielding securities.

Treasury basis traders finance the cash purchase leg through the Treasury repo market. Regulatory minimum haircuts on repos would raise the financing costs of the trade, which would dampen basis trade activity and may incentivize market participants to abandon the trade entirely. As a result, the benefits to the U.S. government and institutional investors, including pension funds and retirement accounts, would be significantly diminished.

The Consultation Report also errs in its support for minimum haircuts in its implication that zero haircuts are a common feature of Treasury repos. Zero haircut repos are not as prevalent as suggested, as those repo transactions that do include a zero haircut are often executed in accordance with a master netting agreement (MNA). Under the MNA significant collateral is frequently posted in other legs of the transaction, thus providing additional collateralization of the "zero haircut" leg. Effectively, zero haircut Treasury repos are not truly zero haircut.

Moreover, financial stability concerns with respect to repos have largely been addressed by recent regulations. Central clearing mandates for Treasury repos as well as the introduction of central bank repo facilities that serve as a backstop for repo financing are effective tools in combatting systemic risk concerns in the Treasury repo market.[43] As such, regulatory minimums become unnecessary and excessive, serving only to disrupt the efficient functioning of this market.

[41] For a detailed discussion of the Treasury basis trade, *see* CCMR (Dec. 20, 2023), *supra* note 12.

[42] Ron Alquist and Ram Yamarthy, *Hedge Funds and Treasury Market Impact: Evidence from Direct Exposures*, OFFICE OF FINANCIAL RESEARCH WORKING PAPER (Aug. 23, 2022), https://www.financialresearch.gov/working-papers/2022/08/23/hedge-funds-and-treasury-market-price-impact/.

[43] See, e.g., Hal Scott et al., *Mandatory Central Clearing for U.S. Treasuries and U.S. Treasury Repos* (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3961739; US DEPARTMENT OF THE TREASURY, *Developments in Central Clearing in the U.S. Treasury Market* (2025), https://home.treasury.gov/system/files/221/TBACCharge2Q12025.pdf.

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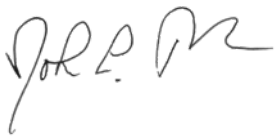
Thank you for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott, or its Executive Director, John Gulliver, at your convenience.

Respectfully submitted,



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