

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

European Fund and Asset Management Association (EFAMA)

- 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?**

The European Fund and Asset Management Association (EFAMA) agrees with the FSB that market participants should integrate the management of margin and collateral calls into their risk management, governance, and operational processes. In fact, European investment funds have complied with a comprehensive set of margin and collateral management rules since the post-Global Financial Crisis reforms.

Recent market developments, and in particular the UK mini-budget crisis in September 2022 and the prior failure of Archegos in April 2021, have demonstrated that greater scrutiny may be necessary around the use of leverage in global capital markets. EFAMA believes that the proposed recommendations will strengthen the ability of supervisors to monitor and manage financial stability risks associated with insufficient liquidity preparedness. These recommendations will notably incentivise every market participant materially using derivatives to conduct stress testing exercises and make the results available to their relevant supervisory authority. We doubt however that these recommendations will reduce the allegedly 'excessive' pro-cyclical behaviour of investment funds resulting from margin calls since, as aforementioned, the European regulation already requires them to consider such calls in their liquidity management processes, unlike other market participants. EFAMA therefore still sees room for adjustments, particularly with regard to the principle of proportionality.

As ordinary users of derivatives, investment funds are no differently exposed to margin calls than the myriad of other financial market actors. While it is necessary to prepare for a potentially increased liquidity demand during stressed market conditions, it is important to acknowledge that risks in the regulated fund sector are lower than in other parts of the market. The vast majority of European funds typically only enter into derivative transactions to hedge market risks (e.g., currency, interest rate, or credit risks). Although funds do sometimes sell assets or borrow liquidity, they will usually first use available cash to meet margin calls. This does not mean however that European funds engage in substantial sales during periods of stress. For instance, during the COVID-19 crisis, Euro

area investment funds disbursed EUR 60 billion from their cash holdings and sold EUR 250 billion in debt securities and EUR 120 billion in shares to meet both redemption demands and margin calls. These asset sales represented approximately two and a half percent of the total assets under management (AuM) in Euro area funds at that time. In an hypothetical scenario in which European funds had only sold European assets, these sales would have amounted to a fraction of the European equity and bond markets (i.e., less than one percent of the valuation of these respective markets).

The existing regulatory framework in the European fund sector has indeed proven to be sufficient. The UCITS/AIFM Directives require management companies to have a risk management process that identifies and monitors the liquidity risk associated with every position. The ESMA Guidelines on ETFs and other UCITS issues also specify rules applying to UCITS funds when they engage in OTC derivative transactions (e.g., the monitoring of counterparty risks and risks linked to the management of collateral). Finally, the ESMA Guidelines on liquidity stress testing in UCITS and AIFs require that every management company stress test the resilience of their fund range to liquidity demand stemming from either redemptions and/or margin calls.

While some concerns have been expressed as regards the pro-cyclicality of margin calls in the fund sector, we are not aware of any supervisory findings demonstrating the validity of these claims. In the consultation report, the FSB notes that it identified “inadequate liquidity preparedness for margin and collateral calls” in non-bank financial intermediation. It did not however provide any example that would demonstrate that sales by investment funds during recent stressed market situations were caused by “liquidity risk management and governance weaknesses” in the sector.

For these reasons, and considering that liquidity preparedness cannot by itself address the concerns of the FSB as regards potential ‘dashes for cash’, we strongly recommend that the FSB continue to actively engage with other Standards Setters Bodies (SSBs) – and particularly the International Organization of Securities Commissions (IOSCO) – to ensure that structural reforms are brought forth. These reforms should include more transparent and predictable margining models. They should also include the possibility for market participants to transform their assets into cash through repo transactions and use, applying appropriate haircuts, a broad range of liquid assets, such as sovereign bonds and shares of MMFs, as collateral for variation margin calls. In parallel, bank regulators should reconsider requirements applying to banks to increase their market making activities during periods of stress, notably in repo transactions. Finally, bank supervisors also have a role to play in ensuring that prime brokers that are part of banking groups have sufficiently robust counterparty risk management frameworks in place to avoid the build-up of excessive leverage (as clearly demonstrated in the 2021 Archegos incident).

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

The FSB recommendations should seek more consistent margin management standards across capital markets, while acknowledging that there may be cross-sectoral differences in the way these standards should apply. As currently drafted, the proposed recommendations would only apply to non-bank financial intermediation. Considering that the risk associated with derivatives is the same for every market participant, EFAMA believes that the proposed recommendations should apply to every market participant

regardless of their regulatory licenses (including banks and non-regulated firms) as is currently the case under the European Market Infrastructure Regulation (EMIR). Failing this, the FSB recommendations would create an unlevel playing field with opportunities for regulatory arbitrage (of which, again, the Archegos case is a clear illustration).

The latest ESMA Derivatives Markets Report demonstrates the necessity to apply the proposed recommendations to every market participant. While banks continue to dominate European derivatives markets, investment funds only account for a fraction of total notional exposures. More precisely, the report states that:

“Credit institutions hold by far the largest amount of overall notional (62% in 4Q22,+7ppt since 4Q20) with over 80% of their notional amount in interest rate derivatives and just under 15% in currency derivatives in 4Q22. In terms of non-banks, their overall share of notional amount fell over the reporting period (48%, -7ppt) with a shift away from non-banks in all assets except commodities, and away from alternative investment funds and non-financial firms to banks in particular. Investment firms accounted for 22% of the total outstanding notional amount in 4Q22. The split of their exposures was similar to credit institutions [...]. Non-financial firm exposures, which account for 4% of total notional amounts had half of their exposures in interest rate derivatives, a third in currency derivatives and 10% in commodities in 4Q22. For undertakings for collective investment in transferable securities (UCITS), which account for 2% of total notional, 43% of exposures were in currency derivatives, 35% in interest rate, 12% in equity and 10% in credit. Alternative investment funds (AIFs), also 2% of total notional, had almost two thirds of their notional in interest rate derivatives, a fifth in currency, and 8% and 7% in credit and equity respectively in 4Q22.”

Acknowledging that capital markets are quite diverse, we do recognise that the aforementioned risks may translate differently from one sector to another and hence warrant a differentiated approach. We therefore support the FSB’s decision to leave the SSBs to develop, where necessary, complementary requirements, along with its acknowledgement that “sector specific regulations and frameworks may already provide some ways of meeting the recommendations.” As regards the banking sector, we understand that the current regulatory framework is already quite extensive and broadly in line with the proposed FSB recommendations. There are moreover several initiatives jointly led by the Basel Committee on Banking Supervision (BCBS) and IOSCO that will further strengthen margining practices among clearing members. This being said, we still see room for greater supervisory attention to certain prime brokers’ counterparty risk management procedures, as further explained in the section ‘beyond liquidity preparedness’.

In the European fund sector, the existing regulatory framework has also proven itself to be sufficient. The UCITS/AIFM Directives require management companies to have a risk management process that identifies and monitors the liquidity risk associated with every position. The ESMA Guidelines on ETFs and other UCITS issues also specify rules applying to UCITS funds when they engage in OTC derivative transactions (e.g., the monitoring of counterparty risks and risks linked to the management of collateral). Finally, the ESMA Guidelines on liquidity stress testing in UCITS and AIFs require that every

management company stress test the resilience of their fund range to liquidity demand stemming from either redemptions and/or margin calls.

On the other hand, although the proposed FSB recommendations do mention that the recommendations should apply to every entity engaged in non-bank financial intermediation, they do not sufficiently account for the fact that some of these market participants operate outside the regulatory perimeter. For the proposed recommendations to be effective, the FSB should put a particular emphasis on identifying the non-regulated entities that have material exposures to derivatives. The FSB should also ensure that the recommendations effectively apply to these entities also in the absence of a direct competent supervisor.

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?

While liquidity preparedness is without a doubt important, there are several regulatory or supervisory measures that would also contribute to the resilience of capital markets:

- Robust counterparty risk management in the prime broker space: As prime brokers play a central role in the derivative markets by taking the opposite side of investors in derivative trades, prime brokers could be described as 'gatekeepers'. Due to a lack of transparency, and sometimes also insufficiently robust counterparty risk management frameworks, some market participants may leverage to an extent that can result in large losses for prime brokers.

- Repo market accessibility to the buy-side: Banks have capital and liquidity buffers to act counter-cyclically during periods of stress by providing liquidity to the market. Yet, during March 2020, banks were unwilling to dip into these buffers. This was, for instance, evident in the repo market when banks retreated from bond repo transactions just as demand for cash increased. This called into question the well-functioning of the repo market and illustrated the necessity to better incentivise banks to provide liquidity during periods of stress. Greater guidance from banking regulators on when and how banks can deploy these buffers would contribute significantly to the resilience of capital markets. Moreover, as outlined in the section 'margin and collateral management in the fund sector', certain retail funds such as UCITS cannot use repo transactions to transform their assets into cash to meet margin calls. In view to prevent future 'dashes for cash', it is crucial to change this situation.

- Transparent and predictable margin calls: EFAMA strongly supports the recent BCBS-IOSCO reports on central counterparty transparency and responsiveness. Improving CCP margin transparency and predictability would avoid unforeseen spikes in margin calls during periods of market stress as experienced during the COVID-19 crisis. CCPs should use appropriate model to size margin requirements more conservatively (for example, historical market trends and margin period of risk) and regularly review the assumptions used to mitigate the potential for future procyclical margin moves. Moreover, it is crucial that CCPs provide additional public disclosures regarding their margin models to allow market participants to incorporate these models in their stress testing exercises. It is equally important to ensure that clearing members' collateral policies are sufficiently

transparent to those investors that use their services, as brokers may impose additional margin requirements on their clients on top of those required by CCPs. Clearing members should, in particular, provide for sufficient notice periods before modifying such add-ons.

- Expanded list of eligible CCP collateral: Currently, market participants need to hold cash, or other short-term financial instruments, to meet variation margins in non-cleared markets. This is because certain bank capital rules strongly incentivise banks to only accept cash for these margin calls. To reduce the procyclical demand for cash during stressed market conditions, CCPs and clearing members should also accept, applying appropriate haircuts, sovereign bonds as well as shares of money market funds (MMFs) as eligible collateral. In this regards, we note that this is already possible in certain jurisdictions (e.g., the U.S. Commodity Futures Trading Commission (CFTC) already recognises MMFs as eligible assets). It is important that the FSB promotes international convergence in this respect.

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

EFAMA welcomes the proportionality and materiality principles outlined in Part 2.4 of the consultation report. We would suggest that the FSB could provide more indication with regards to the ways these principles would apply to different sectors. Indeed, considering that market participants have different risk profiles, the FSB recommendations should be applied proportionately with the objective to mitigate the liquidity risks stemming from material exposures to spikes in margin and collateral calls during times of stress. From an asset management perspective, these recommendations should apply at the fund level only, rather than at the management company one as each fund constitutes a separate entity with its own liquidity risk policy and governance framework. In addition, in line with their agency business model, management companies do not themselves engage in proprietary trading. This distinction is crucial because it has important implications for the way the proposed recommendations should be transposed to investment funds.

Moreover, these recommendations should not apply to the same extent to every fund considering how diverse the fund sector is. For instance, we believe that the proportionality principle should imply that investment funds with no exposure to derivatives would not have to comply with the FSB recommendations. Similarly, for investment funds with a limited exposure to derivatives, we believe that recommendations such as the requirements to have a dedicate liquid risk appetite for spikes in margin calls, to conduct regular reviews of the risk management policy, or to carry complex stress testing exercises, would be excessive in regards to the limited liquidity risks that these funds take.

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?

- Recommendations n°1 states that “[m]arket participants should incorporate the assessment of liquidity risks arising from margin and collateral calls in their liquidity risk management and governance frameworks.” We agree that every market participant should “assess the materiality of the liquidity risk that may arise from margined and collateralised transactions”. We also welcome the statement that “liquidity risk management systems

and processes should be commensurate”. For investment funds, this risk assessment should however be performed at the fund level rather than at management company one.

- Recommendation n°2 states that “[m]arket participants should establish contingency funding plans that appropriately address the material elevation of liquidity risk due to spikes in margin and collateral calls” and that “[t]he design and the implementation of effective contingency plans [...] are especially important for market participants whose business models involve a structural liquidity mismatch, such as some types of investment funds.” We disagree with the statement that investment funds are more vulnerable to spikes in margin calls due to an alleged structural liquidity mismatch. As outlined in our response to the FSB consultation on vulnerabilities in open-ended funds, it is inaccurate to argue that there is such a structural mismatch. We also show that redemption levels remain low, even during periods of stress, and that liquidity management tools (LMTs) allow asset managers to limit the level of dilution that could create room for an alleged first-mover advantage. Margin requirements also serve a different purpose to that of managing redemptions and so should not be conflated with the latter. On the other hand, it is fully appropriate to expect, as the ESMA Guidelines on liquidity stress testing in UCITS and AIFs do, that funds consider the impact of combined redemptions and margin calls on the liquidity of their portfolios.

- Recommendations n°1, 2, and 3 call for market participants to calibrate their risk management depending on their footprint in the financial system, accounting for concentration and other market participants. For instance recommendation n°1 states that “[m]arket participants should consider [...] their role in the financial system to assess the materiality of liquidity risk propagating from margined and collateralised transactions”. Recommendation n°3 states that “[market participants should [...] take into consideration how the risk management practices of their counterparties may respond” and that they should “actively seek information, or consider alternative means of accessing data, to close any data gaps to improve their liquidity risk management (e.g. data on volumes of OTC derivatives transactions reported to trade repositories)”. While it is appropriate for market participants to use data and simulations that proxy the behaviour of other market participants (e.g., to estimate the risk of market impact in case of asset sales), it is important to note that market participants should not be expected to adjust for their ‘role in the financial system’ and that there are moreover important limitations to the information that market participants can have access to. Supervisors have therefore an important role to play in improving access to data (firstly, among themselves) and increasing their visibility into other parts of the financial system.

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

Similarly to recommendations n°1, 2, and 3, recommendation n°5 calls for market participants to calibrate their risk management depending on their footprint in the financial system, accounting for concentration and other market participants. As argued in our response to the previous question, while it is appropriate for market participants to use data and simulations that proxy the behaviour of other market participants (e.g., to estimate the risk of market impact in case of asset sales), it is important to note that market participants should not be expected to adjust for their ‘role in the financial system’

and that there are moreover important limitations to the information that market participants can have access to. Supervisors have therefore an important role to play in improving access to data (firstly, among themselves) and increasing their visibility into other parts of the financial system.

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

From an asset management perspective, the proposed recommendations should apply at the fund level only, rather than at the management company one as each fund constitutes a separate entity with its own liquidity risk policy and governance framework. In addition, in line with their agency business model, management companies do not themselves engage in proprietary trading. This distinction is crucial because it has important implications for the way the recommendations should be transposed to investment funds.

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?

Recommendation n°7 states that “[m]arket participants should maintain sufficient available cash to meet cash-only margin calls with a high degree of certainty in the called currency, time zone and location of delivery.” This recommendation is not appropriate because mandatory cash buffers interfere with the implementation of a given investment strategy and are likely to produce a ‘cash drag’ that could penalise the performance that investors seek. Moreover, at least in jurisdictions such as Luxembourg, the UCITS Directive imposes limits on cash holdings and ancillary liquid assets that UCITS funds can hold. The FSB should therefore underscore, as it did in recommendation n°4, that market participants should hold liquid assets in line with their chosen liquidity risk appetite.

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

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

In the investment fund sector, management companies can respond to margin and collateral calls in different ways depending on the situation in which the fund finds itself. Considering that two funds are rarely similar due to differences in investment strategies, investor bases, and liquidity management policies, there is no single playbook that every management company can follow when managing margin and collateral calls. It is therefore the responsibility of the portfolio manager to choose, among the three standard approaches outlined below, the approach that is in the best interest of end-investors:

- Use of cash: Investment funds frequently use readily available cash to meet margin calls. There is however a limit to the amount of cash a fund can hold considering that high liquidity holdings negatively impact the performance of the fund and the fact that investment funds cannot diverge too significantly from their advertised investment

strategies. Moreover, in countries like Luxembourg, the UCITS Directive imposes limits on cash holdings and ancillary liquid assets that UCITS funds can hold.

- **Asset sales:** Investment funds may also sell assets following either a ‘waterfall’ or a ‘vertical slicing’ approach when it is inappropriate to use cash or when the fund intends to sell assets for another reason (e.g., during portfolio adjustments, or when the funds face pre-existing redemption demands). The waterfall approach is however less frequently used when funds face larger margin calls because it could alter the liquidity profile of the fund.

- **Cash borrowing:** Alternative Investment Funds (AIFs) may finally seek temporary liquidity from a bank through an overdraft, or from the market through a repo operation. While certain leveraged AIFs might prefer to use overdrafts rather than selling assets, other funds tend to see overdrafts as a last-resort solution. One must indeed recall that the latter comes at a considerable costs for funds (e.g. charges for any undrawn amounts), as well as for banks (e.g. via a higher bank capital charge). Repo operations are also crucial channels during periods of stress, as they can allow funds to transform their assets into cash without having to sell them in the first place. These operations are however complex and require a certain preparation. These may moreover be unavailable, or at least very costly, during stressed market conditions because certain market dealers can exit the repo market when there is excessive uncertainty (e.g., the corporate bond repo market during the COVID-19 crisis). Unfortunately, neither of these two options are available to UCITS funds considering that the UCITS Directive prohibits both borrowing for investment purposes and the use of cash collateral for clearing obligations.

The FSB should ensure that investment funds can continue to have access to these different approaches to ensure that they can manage their portfolio in the best interest of end-investors. It is also crucial that the FSB and relevant SSBs promote the use and resilience of repo markets during stressed market conditions by resolving the difficulties outlined above.

Brussels, 18 June 2024

EFAMA response to the FSB consultation on liquidity preparedness for margin calls in non-bank financial intermediation

Introduction

The European Fund and Asset Management Association (EFAMA) agrees with the FSB that market participants should integrate the management of margin and collateral calls into their risk management, governance, and operational processes. In fact, European investment funds have complied with a comprehensive set of margin and collateral management rules since the post-Global Financial Crisis reforms.

Recent market developments, and in particular the UK mini-budget crisis in September 2022 and the prior failure of Archegos in April 2021, have demonstrated that greater scrutiny may be necessary around the use of leverage in global capital markets. EFAMA believes that the proposed recommendations will strengthen the ability of supervisors to monitor and manage financial stability risks associated with insufficient liquidity preparedness. These recommendations will notably incentivise every market participant materially using derivatives to conduct stress testing exercises and make the results available to their relevant supervisory authority. We doubt however that these recommendations will reduce the allegedly 'excessive' pro-cyclical behaviour of investment funds resulting from margin calls since the European regulation already requires them to consider such calls in their liquidity management processes, unlike other market participants. EFAMA therefore still sees room for adjustments, particularly with regard to the principle of proportionality.

As ordinary users of derivatives, investment funds are no differently exposed to margin calls than the myriad of other financial market actors. While it is necessary to prepare for a potentially increased liquidity demand during stressed market conditions, it is important to acknowledge that risks in the regulated fund sector are lower than in other parts of the market. The vast majority of European funds typically only enter into derivative transactions to hedge market risks (e.g., currency, interest rate, or credit risks). Although funds do sometimes sell assets or borrow liquidity, they will usually first use available cash to meet margin calls. This does not mean however that European funds engage in substantial sales during periods of stress. For instance, during the COVID-19 crisis, Euro area investment funds disbursed EUR 60 billion from their cash holdings and sold EUR 250 billion in debt securities and EUR 120 billion in shares to meet both redemption demands and margin calls. These asset sales represented approximately two and a half percent of the total assets under management (AuM) in Euro area funds at that time.¹ In an hypothetical scenario in which

¹ ECB, [Transactions by investment funds in the euro area](#) and [Total assets held by investment funds in the euro area](#), ECB data warehouse, accessed on Friday 31 May 2024.

European funds had only sold European assets, these sales would have amounted to a fraction of the European equity and bond markets (i.e., less than one percent of the valuation of these respective markets).²

To preserve current margin management practices, and to ensure a level-playing field across sectors and jurisdictions, EFAMA calls for several adjustments to the recommendations outlined in the consultation. There should be:

- A system-wide approach through the inclusion of banking institutions operating in similar manners to market participants (e.g., prime brokers) into the scope of the recommendations;
- A prioritisation of the application of these recommendations to non-regulated market participants using derivatives (e.g., family offices and commodities traders);
- A greater emphasis on proportionality to ensure that market participants that have limited exposure to derivatives (i.e., the vast majority of regulated investment funds) should not have to comply with the recommendations to the same extent;
- A clarification, in line with the FSB's recognition that market-based finance is a diverse ecosystem, that certain aspects of these recommendations may not apply to all sectors (e.g., in the fund sector, the recommendations should apply at the fund level rather than at the management company one);
- An acknowledgment that these recommendations should apply in principle. No market participant can guarantee it will always be in a position to meet margin calls in a pre-determined way (e.g., with cash), if at all. Market stress can be unpredictable and, despite optimising one entity's own risk management, it is impossible to know in advance how other market participants will exactly respond to given stressed conditions; and
- An explicit recognition that, for investment funds, liquidity buffers should not be the default solution to counter financial volatility.

Lastly, considering that liquidity preparedness cannot by itself address the concerns of the FSB as regards potential 'dashes for cash', we strongly recommend that the FSB continue to actively engage with other Standards Setters Bodies (SSBs) – and particularly the International Organization of Securities Commissions (IOSCO) – to ensure that structural reforms are brought forth. These reforms should include more transparent and predictable margining models. They should also include the possibility for market participants to transform their assets into cash through repo transactions and use, applying appropriate haircuts, a broad range of liquid assets, such as sovereign bonds and shares of MMFs, as collateral for variation margin calls. In parallel, bank regulators should reconsider requirements applying to banks to increase their market making activities during periods of stress, notably in repo transactions. Finally, bank supervisors also have a role to play in ensuring that prime brokers that are part of banking groups have sufficiently robust counterparty risk management frameworks in place to avoid the build-up of excessive leverage (as clearly demonstrated in the 2021 Archegos incident).

Scope, diversity, and proportionality

The FSB recommendations should seek more consistent margin management standards across capital markets, while acknowledging that there may be cross-sectoral differences in the way these standards should apply. As currently drafted, the proposed recommendations would only apply to non-bank financial intermediation. Considering that the risk associated with derivatives is the same for every market participant, EFAMA believes that the proposed recommendations should apply to every market participant regardless of their regulatory licenses (including banks and non-regulated firms) as is currently the case under the European Market Infrastructure Regulation (EMIR). Failing this, the FSB recommendations would create an unlevel playing field with opportunities for regulatory arbitrage (of which, again, the Archegos case is a clear illustration).

² ESMA, [EU securities markets](#), Annual Statistical Report, November 2020.

The latest ESMA Derivatives Markets Report demonstrates the necessity to apply the proposed recommendations to every market participant. While banks continue to dominate European derivatives markets, investment funds only account for a fraction of total notional exposures. More precisely, the report states that:

“Credit institutions hold by far the largest amount of overall notional (62% in 4Q22, +7ppt since 4Q20) with over 80% of their notional amount in interest rate derivatives and just under 15% in currency derivatives in 4Q22. In terms of non-banks, their overall share of notional amount fell over the reporting period (48%, -7ppt) with a shift away from non-banks in all assets except commodities, and away from alternative investment funds and non-financial firms to banks in particular. Investment firms accounted for 22% of the total outstanding notional amount in 4Q22. The split of their exposures was similar to credit institutions [...]. Non-financial firm exposures, which account for 4% of total notional amounts had half of their exposures in interest rate derivatives, a third in currency derivatives and 10% in commodities in 4Q22. For undertakings for collective investment in transferable securities (UCITS), which account for 2% of total notional, 43% of exposures were in currency derivatives, 35% in interest rate, 12% in equity and 10% in credit. Alternative investment funds (AIFs), also 2% of total notional, had almost two thirds of their notional in interest rate derivatives, a fifth in currency, and 8% and 7% in credit and equity respectively in 4Q22.”³

Acknowledging that capital markets are quite diverse, we do recognise that the aforementioned risks may translate differently from one sector to another and hence warrant a differentiated approach. We therefore support the FSB’s decision to leave the SSBs to develop, where necessary, complementary requirements, along with its acknowledgement that “*sector specific regulations and frameworks may already provide some ways of meeting the recommendations.*” As regards the banking sector, we understand that the current regulatory framework is already quite extensive and broadly in line with the proposed FSB recommendations. There are moreover several initiatives jointly led by the Basel Committee on Banking Supervision (BCBS) and IOSCO that will further strengthen margining practices among clearing members. This being said, we still see room for greater supervisory attention to certain prime brokers’ counterparty risk management procedures, as further explained in the section ‘beyond liquidity preparedness’.

In the European fund sector, the existing regulatory framework has also proven itself to be sufficient. The UCITS/AIFM Directives require management companies to have a risk management process that identifies and monitors the liquidity risk associated with every position.⁴ The ESMA Guidelines on ETFs and other UCITS issues also specify rules applying to UCITS funds when they engage in OTC derivative transactions (e.g., the monitoring of counterparty risks and risks linked to the management of collateral).⁵ Finally, the ESMA Guidelines on liquidity stress testing in UCITS and AIFs require that every management company stress test the resilience of their fund range to liquidity demand stemming from either redemptions and/or margin calls.⁶ While some concerns have been expressed as regards the pro-cyclicality of margin calls in the fund sector, we are not aware of any supervisory findings demonstrating the validity of these claims. In the consultation report, the FSB notes that it identified “inadequate liquidity preparedness for margin and collateral calls” in non-bank financial intermediation. It did not however provide any example that would demonstrate that sales by investment funds during recent stressed market situations were caused by “liquidity risk management and governance weaknesses” in the sector.

On the other hand, although the proposed FSB recommendations do mention that the recommendations should apply to every entity engaged in non-bank financial intermediation, they do not sufficiently account for the fact that some of these market participants operate outside the regulatory perimeter. For the proposed recommendations to be effective, the FSB should put a particular emphasis on identifying the

³ ESMA, [EU Derivatives Markets 2023](#), December 2023, p. 9.

⁴ Article 51(1) of the [UCITS Directive](#); Article 16 of the [Alternative Investment Manager Directive](#); Article 48 of the [Delegated Regulation \(EU\) No. 231/2013](#).

⁵ ESMA, [Guidelines on ETFs and other UCITS issues](#), August 2014.

⁶ ESMA, [Guidelines on liquidity stress testing in UCITS and AIFs](#), July 2020.

non-regulated entities that have material exposures to derivatives. The FSB should also ensure that the recommendations effectively apply to these entities also in the absence of a direct competent supervisor.

Lastly, EFAMA welcomes the proportionality and materiality principles outlined in Part 2.4 of the consultation report. We would suggest that the FSB could provide more indication with regards to the ways these principles would apply to different sectors. Indeed, considering that market participants have different risk profiles, the FSB recommendations should be applied proportionately with the objective to mitigate the liquidity risks stemming from material exposures to spikes in margin and collateral calls during times of stress. From an asset management perspective, these recommendations should apply at the fund level only, rather than at the management company one as each fund constitutes a separate entity with its own liquidity risk policy and governance framework. In addition, in line with their agency business model, management companies do not themselves engage in proprietary trading. This distinction is crucial because it has important implications for the way the proposed recommendations should be transposed to investment funds.

Moreover, these recommendations should not apply to the same extent to every fund considering how diverse the fund sector is. For instance, we believe that the proportionality principle should imply that investment funds with no exposure to derivatives would not have to comply with the FSB recommendations. Similarly, for investment funds with a limited exposure to derivatives, we believe that recommendations such as the requirements to have a dedicated liquid risk appetite for spikes in margin calls, to conduct regular reviews of the risk management policy, or to carry complex stress testing exercises, would be excessive in regards to the limited liquidity risks that these funds take.

Leverage in the European fund sector

Leverage in the European fund sector remains low, with derivatives being typically employed for reasons other than gaining additional exposure to an underlying market. For example, investment funds usually enter into derivative arrangements to hedge specific risks such as changes in exchange rates, manage inflows, and build efficient portfolios.⁷

Despite the long-standing concerns over leverage in the fund sector, a majority of funds do not use 'synthetic' leverage.⁸ The UCITS Directive forbids a net exposure higher than 200% (including the value of the physical securities) of the fund's net asset value (NAV).⁹ The AIFMD, in turn, requires that management companies set a net leverage limit for each AIF. In some countries, such as Germany, the regulation even prohibits for certain AIFs the use of leverage on a substantial basis. As a result, and as outlined in Table 1, 65% of European funds do not use any 'synthetic' leverage. The use of leverage is however more prevalent in funds with assets under management over EUR 5 billion (80%), as well as in some subsectors such as bond, hedge and mixed funds (over 45%).¹⁰

Using the standard AIFMD regulatory measures, the ESMA AIF Statistical Report shows that the average adjusted gross leverage in the AIF sector (including both 'financial' leverage and 'synthetic' leverage) was 139% at the end of 2020. This figure, however, overstates the exposure of most alternative funds, as the use of leverage is concentrated in only a few AIFs. Indeed, while the average adjusted gross leverage for

⁷ EFAMA/AMIC, [Use of leverage in investment funds in Europe](#), July 2017.

⁸ In contrast to 'financial leverage', which is gained through borrowing from a counterpart, 'synthetic leverage' is gained through derivatives. By using derivatives, investors can magnify their returns (and therefore losses) by gaining a larger exposure to an underlying market than they could have by directly purchasing the relevant financial instruments (e.g., shares or bonds).

⁹ There is however one notable exception. Pursuant to Article 41 of Commission Directive 2010/43/EU, UCITS funds may opt for the Value at Risk (VaR) approach to comply with their leverage limit. While this approach may allow these funds to exceed the 200% commitment leverage limit, they are required to calculate their gross leverage and to report it to their supervisor.

¹⁰ ECB, [The impact of derivatives collateralisation on liquidity risk: evidence from the investment fund sector](#), Working Paper Series, No 2756, December 2022, p. 9.

hedge funds is of 327%, it would not exceed an average of 141% for the other alternative fund categories. In fact, even within the hedge fund category, there are important disparities: the top 10% most leveraged hedge funds have an aggregate gross adjusted exposure of 600%.¹¹ As a result, the median of alternative investment funds has an adjusted gross leverage of only 102%, far below the AIF average.¹² Although similar figures are not available on a European level for UCITS funds, one can expect that the leverage levels for these funds would be even lower given that UCITS funds follow more traditional investment strategies and comply with stricter product rules, and in particular, the aforementioned limit on net exposure, as well as the interdiction to borrow for investment purposes.

Table 1 – Share of funds using derivatives broken down by NAV and strategy

| NAV in EUR million | Bonds | Equities | Hedge | Mixed | Real estate | Other | All types | Number of all euro area funds |
|-------------------------------|--------|----------|--------|---------|-------------|---------|-----------|-------------------------------|
| 0 – 1 | 6% | 2% | 6% | 7% | 3% | 3% | 4% | 7, 575 |
| 1 – 5 | 24% | 15% | 23% | 24% | 6% | 37% | 28% | 5, 274 |
| 5 – 50 | 42% | 26% | 49% | 40% | 9% | 34% | 34% | 19, 215 |
| 50 – 100 | 53% | 34% | 55% | 50% | 13% | 31% | 42% | 6, 932 |
| 100 – 500 | 63% | 45% | 65% | 61% | 16% | 36% | 52% | 11, 696 |
| 500 – 1, 000 | 72% | 57% | 70% | 68% | 16% | 40% | 62% | 2, 364 |
| 1, 000 – 5, 000 | 78% | 68% | 76% | 73% | 26% | 40% | 69% | 2, 013 |
| > 5, 000 | 88% | 77% | 75% | 85% | 78% | 45% | 81% | 183 |
| Not available | 2% | 2% | 3% | 4% | 1% | 3% | 3% | 3, 292 |
| All sizes | 50% | 33% | 46% | 45% | 8% | 23% | 35% | 58, 544 |
| Number of all euro area funds | 9, 693 | 12, 481 | 2, 089 | 15, 270 | 5, 072 | 13, 939 | 58, 544 | |

Source: ECB

Margin and collateral management in the fund sector

In the fund sector, management companies can respond to margin and collateral calls in different ways depending on the situation in which the fund finds itself. Considering that two funds are rarely similar due to differences in investment strategies, investor bases, and liquidity management policies, there is no single playbook that every management company can follow when managing margin and collateral calls. It is therefore the responsibility of the portfolio manager to choose, among the three standard approaches outlined below, the approach that is in the best interest of end-investors:

- **Use of cash:** Investment funds frequently use readily available cash to meet margin calls. There is however a limit to the amount of cash a fund can hold considering that high liquidity holdings negatively impact the performance of the fund and the fact that investment funds cannot diverge too significantly from their advertised investment strategies. Moreover, in countries like Luxembourg, the UCITS Directive imposes limits on cash holdings and ancillary liquid assets that UCITS funds can hold.
- **Asset sales:** Investment funds may also sell assets following either a ‘waterfall’ or a ‘vertical slicing’ approach¹³ when it is inappropriate to use cash or when the fund intends to sell assets for another reason (e.g., during portfolio adjustments, or when the funds face pre-existing redemption demands). The waterfall approach is however less frequently used when funds face larger margin calls because it could alter the liquidity profile of the fund.

¹¹ ESMA, [AIF Statistical Report](#), February 2022, pp. 6-13.

¹² ESMA, [TRV Report](#), September 2021, pp. 27-28.

¹³ When a fund follows a waterfall approach, it starts by selling its most liquid assets first. On the other hand, when a fund uses the vertical slicing approach, it sells a representative slice of its portfolio to preserve its investment strategy. The latter is most frequently used among passive funds that seek to closely replicate an index.

- **Cash borrowing:** Alternative Investment Funds (AIFs) may finally seek temporary liquidity from a bank through an overdraft, or from the market through a repo operation. While certain leveraged AIFs might prefer to use overdrafts rather than selling assets, other funds tend to see overdrafts as a last-resort solution. One must indeed recall that the latter comes at a considerable costs for funds (e.g. charges for any undrawn amounts), as well as for banks (e.g. via a higher bank capital charge). Repo operations are also crucial channels during periods of stress, as they can allow funds to transform their assets into cash without having to sell them in the first place. These operations are however complex and require a certain preparation. These may moreover be unavailable, or at least very costly, during stressed market conditions because certain market dealers can exit the repo market when there is excessive uncertainty (e.g., the corporate bond repo market during the COVID-19 crisis). Unfortunately, neither of these two options are available to UCITS funds considering that the UCITS Directive prohibits both borrowing for investment purposes and the use of cash collateral for clearing obligations.¹⁴

The FSB should ensure that investment funds can continue to have access to these different approaches to ensure that they can manage their portfolio in the best interest of end-investors. It is also crucial that the FSB and relevant SSBs promote the use and resilience of repo markets during stressed market conditions by resolving the difficulties outlined above.

Our views on the FSB recommendations

EFAMA supports the FSB recommendations, which are broadly reflective of the way a market participant using synthetic leverage should manage its exposure to derivatives. There are nonetheless several areas in which the FSB should introduce improvements to the proposed recommendations:

- **Recommendations n°1** states that “[m]arket participants should incorporate the assessment of liquidity risks arising from margin and collateral calls in their liquidity risk management and governance frameworks.” We agree that every market participant should “assess the materiality of the liquidity risk that may arise from margined and collateralised transactions”. We also welcome the statement that “liquidity risk management systems and processes should be commensurate”. As outlined in section ‘scope, diversity, and proportionality’, for investment funds, this risk assessment should be performed at the fund level rather than at management company one.
- **Recommendation n°2** states that “[m]arket participants should establish contingency funding plans that appropriately address the material elevation of liquidity risk due to spikes in margin and collateral calls” and that “[t]he design and the implementation of effective contingency plans [...] are especially important for market participants whose business models involve a structural liquidity mismatch, such as some types of investment funds.” We disagree with the statement that investment funds are more vulnerable to spikes in margin calls due to an alleged structural liquidity mismatch. As outlined in our response to the FSB consultation on vulnerabilities in open-ended funds, it is inaccurate to argue that there is such a structural mismatch. We also show that redemption levels remain low, even during periods of stress, and that liquidity management tools (LMTs) allow asset managers to limit the level of dilution that could create room for an alleged first-mover advantage.¹⁵ Margin requirements also serve a different purpose to that of managing redemptions and so should not be conflated with the latter. On the other hand, it is fully appropriate to expect, as the ESMA Guidelines on liquidity stress testing in UCITS and AIFs do, that funds consider the impact of combined redemptions and margin calls on the liquidity of their portfolios.

¹⁴ Articles 50(f) and 83 of the [UCITS Directive](#); Paragraph 43(j) from the [ESMA Guidelines on ETFs and other UCITS issues](#); Answer 6(j) in the collateral management sector from the [ESMA Q&As on the application of the UCITS Directive](#).

¹⁵ EFAMA, [Response to the FSB consultation report on addressing vulnerabilities from liquidity mismatch in open-ended funds](#), September 2023.

- Recommendation n°4** notably states that *“[m]arket participants should conduct liquidity stress tests to identify sources of potential liquidity strains caused by margin and collateral calls, and to ensure a level of resilience consistent with their established liquidity risk appetite.”* In this recommendation, we have an objection as regards the following assertion: *“[d]epending on the organisational structure of the market participant, stress tests should be conducted at an aggregate level (e.g. based on collective exposure of all funds managed by the same market participant) and, where feasible, at individual entity level each of which may be exposed to different sources of liquidity risk.”* In the fund sector, stress testing takes place at the fund level rather than at the aggregate level because investment funds are separate vehicles with potentially very different liquidity risk profiles. As outlined in the section ‘leverage in the European fund sector’, most investment funds do not employ, or employ very little leverage. Consequently, a stress test exercise that would aggregate margin calls from an asset manager’s fund range would likely generate erroneous results (i.e., by undervaluing the liquidity risks of certain funds while overvaluing the liquidity risks of others).
- Recommendations n°1, 2, 3, and 5** call for market participants to calibrate their risk management depending on their footprint in the financial system, accounting for concentration and other market participants. For instance recommendation n°1 states that *“[m]arket participants should consider [...] their role in the financial system to assess the materiality of liquidity risk propagating from margined and collateralised transactions”*. Recommendation n°3 states that *“[market participants should [...] take into consideration how the risk management practices of their counterparties may respond”* and that they should *“actively seek information, or consider alternative means of accessing data, to close any data gaps to improve their liquidity risk management (e.g. data on volumes of OTC derivatives transactions reported to trade repositories)”*. While it is appropriate for market participants to use data and simulations that proxy the behaviour of other market participants (e.g., to estimate the risk of market impact in case of asset sales), it is important to note that market participants should not be expected to adjust for their ‘role in the financial system’ and that there are moreover important limitations to the information that market participants can have access to. Supervisors have therefore an important role to play in improving access to data (firstly, among themselves) and increasing their visibility into other parts of the financial system.
- Recommendation n°7** states that *“[m]arket participants should maintain sufficient available cash to meet cash-only margin calls with a high degree of certainty in the called currency, time zone and location of delivery.”* This recommendation is not appropriate because mandatory cash buffers interfere with the implementation of a given investment strategy and are likely to produce a ‘cash drag’ that could penalise the performance that investors seek. Moreover, at least in jurisdictions such as Luxembourg, the UCITS Directive imposes limits on cash holdings and ancillary liquid assets that UCITS funds can hold. The FSB should therefore underscore, as it did in recommendation n°4, that market participants should hold liquid assets in line with their chosen liquidity risk appetite.

Beyond liquidity preparedness

While liquidity preparedness is without a doubt important, there are several regulatory or supervisory measures that would also contribute to the resilience of capital markets:

- Robust counterparty risk management in the prime broker space:** As prime brokers play a central role in the derivative markets by taking the opposite side of investors in derivative trades, prime brokers could be described as ‘gatekeepers’. Due to a lack of transparency, and sometimes

also insufficiently robust counterparty risk management frameworks, some market participants may leverage to an extent that can result in large losses for prime brokers.¹⁶

- **Repo market accessibility to the buy-side:** Banks have capital and liquidity buffers to act counter-cyclically during periods of stress by providing liquidity to the market. Yet, during March 2020, banks were unwilling to dip into these buffers. This was, for instance, evident in the repo market when banks retreated from bond repo transactions just as demand for cash increased. This called into question the well-functioning of the repo market and illustrated the necessity to better incentivise banks to provide liquidity during periods of stress.¹⁷ Greater guidance from banking regulators on when and how banks can deploy these buffers would contribute significantly to the resilience of capital markets. Moreover, as outlined in the section ‘margin and collateral management in the fund sector’, certain retail funds such as UCITS cannot use repo transactions to transform their assets into cash to meet margin calls. In view to prevent future ‘dashes for cash’, it is crucial to change this situation.
- **Transparent and predictable margin calls:** EFAMA strongly supports the recent BCBS-IOSCO reports on central counterparty transparency and responsiveness.¹⁸ Improving CCP margin transparency and predictability would avoid unforeseen spikes in margin calls during periods of market stress as experienced during the COVID-19 crisis. CCPs should use appropriate model to size margin requirements more conservatively (for example, historical market trends and margin period of risk) and regularly review the assumptions used to mitigate the potential for future procyclical margin moves. Moreover, it is crucial that CCPs provide additional public disclosures regarding their margin models to allow market participants to incorporate these models in their stress testing exercises. It is equally important to ensure that clearing members’ collateral policies are sufficiently transparent to those investors that use their services, as brokers may impose additional margin requirements on their clients on top of those required by CCPs. Clearing members should, in particular, provide for sufficient notice periods before modifying such add-ons.
- **Expanded list of eligible CCP collateral:** Currently, market participants need to hold cash, or other short-term financial instruments, to meet variation margins in non-cleared markets. This is because certain bank capital rules strongly incentivise banks to only accept cash for these margin calls. To reduce the procyclical demand for cash during stressed market conditions, CCPs and clearing members should also accept, applying appropriate haircuts, sovereign bonds as well as shares of money market funds (MMFs) as eligible collateral. In this regards, we note that this is already possible in certain jurisdictions (e.g., the U.S. Commodity Futures Trading Commission (CFTC) already recognises MMFs as eligible assets).¹⁹ It is important that the FSB promotes international convergence in this respect.

Conclusion

The proposed FSB recommendations well reflect the expectations that regulators should have towards market participants that use derivatives for their investment strategies. These recommendations are moreover broadly consistent with the comprehensive set of margin and collateral management rules that have been applied to the European fund sector for many years.

¹⁶ Credit Suisse, [Special Committee of the Board of Directors report on Archegos Capital Management](#), July 2021; ESMA, [Leverage and derivatives – the case of Archegos](#), TRV Risk Analysis, May 2022.

¹⁷ EFAMA, [Reply to BCBS-CPMI-IOSCO consultative report “Review of margining practices”](#), January 2022.

¹⁸ BCBS-CPMI-IOSCO, [Transparency and responsiveness of initial margin in centrally cleared markets – Review and policy proposals](#), January 2024; CPMP-IOSCO, [Streamlining variation margin in centrally cleared markets – examples of effective practices](#), February 2024.

¹⁹ CFTC, [GMCA key recommendations](#), 8 February 2024.

In our response, we nonetheless suggest a number of areas where further progress could be made:

- A system-wide approach through the inclusion of banking institutions operating in similar manners to market participants (e.g., prime brokers) into the scope of the recommendations;
- A prioritisation of the application of these recommendations to non-regulated market participants using derivatives (e.g., family offices and commodities traders);
- A greater emphasis on proportionality to ensure that market participants that have limited exposure to derivatives (i.e., the majority of regulated investment funds) should not have to comply to the same extent with the recommendations;
- A clarification, in line with the FSB's recognition that market-based finance is a diverse ecosystem, that certain aspects of these recommendations may not apply to all sectors (e.g., in the fund sector, the recommendations should apply at fund level rather than at the management company one);
- An acknowledgment that these recommendations should apply in principle. No market participant can guarantee it will always be in a position to meet margin calls in a pre-determined way (e.g., with cash), if at all. Market stress can be unpredictable and, despite optimising one entity's own risk management, it is impossible to know in advance how other market participants will exactly respond to given stressed conditions; and
- An explicit recognition that, for investment funds, liquidity buffers should not be the default solution to counter potential financial volatility.

Finally, we also call for broader set of reforms that are necessary to increase the resilience of capital markets. These should include more transparent and predictable margining models. They should also include the possibility for market participants to transform their assets into cash through repo transactions and use, applying appropriate haircuts, a broad range of liquid assets such as sovereign bonds and shares of MMFs, as collateral for variation margin calls. In parallel, bank regulators should reconsider requirements applying to banks to increase their market making activities during periods of stress, notably in repo transactions. Finally, bank supervisors have also a role to play in ensuring that prime brokers that are part of banking groups have sufficiently robust counterparty risk management frameworks in place to avoid the build-up of excessive leverage (as clearly demonstrated in the 2021 Archegos incident).



ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages about 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book

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