FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

European Fund and Asset Management Association (EFAMA)

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 European Fund and Asset Management Association (EFAMA) welcomes the FSB's initiative to develop 'domestic frameworks' in order to monitor and mitigate the build-up of leverage in capital markets.

   While leverage has multiple benefits, it can undermine financial stability if not properly managed, as the recent UK mini-budget crisis illustrated.

   Greater international convergence in regulatory standards and supervisory oversight would reduce the risks from diverging approaches across jurisdictions.

   Since the Great Financial Crisis, the EU has actively sought to limit risk from leverage in its financial system.

   In many regards, the EU macroprudential framework can inspire other jurisdictions.

   Nonetheless, in our response to the EC consultation on the adequacy of macroprudential policies in Non-Bank Financial Intermediation (NBFI), we recommended, similarly to FSB in proposed recommendation 1, that the EU develop a macroprudential framework to identify potential pockets of risk that would require deeper analyses.

   As outlined in proposed recommendation 3, additional public disclosures from supervisory authorities could also help market participants better understand core markets and their associated risks (e.g., information such as the outstanding positions per sector in a given market).

   When comparing leverage across financial institutions, it is important to distinguish how market participants use leverage (i.e., for maximising investment returns vs. hedging risks), how material the exposure is (i.e., how the entity/product's footprint compares with its equity), and the different risks stemming from these exposures (i.e., solvency vs. liquidity risks).

   By analysing the European fund sector through these lenses, we find that both financial and synthetic leverage remain well below regulatory limits.

Leverage is, moreover, usually deployed for reasons other than gaining additional exposure to an underlying market, including for efficient portfolio and risk management purposes.

For example, investment funds may enter into derivative arrangements to hedge specific risks (e.g., a potential currency de/revaluation), manage inflows, or build efficient portfolios.

For this reason, it is problematic to associate European funds with the Archegos incident, as is sometimes done.

Even among hedge funds, such leveraged and concentrated investment strategies would be rare - if not non-existent.

Most funds do not employ financial leverage, especially outside hedge funds and LDI funds using repo borrowing.

Synthetic leverage is also limited across the fund sector, with less than half of EU funds using derivatives and those that do making relatively light use of them.

As a result, while certain funds may be confronted with spikes in margin calls, insolvency is quite unlikely, even among hedge funds.

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?**

To ensure that the FSB recommendations improve jurisdictions' ability to monitor and address the build-up of leverage across the globe, the FSB should take into account the following considerations:

Financial stability analyses must take a holistic approach.

This means looking beyond non-bank financial intermediation (or the banks providing leverage to these institutions) given that leverage is concentrated among banks and investment firms.

It also means considering the interplay between different risks (e.g., leverage and liquidity) because (collective) defaults are not the primary risk in capital markets.

The FSB should prioritise international convergence in regulatory approaches, supervisory reporting, and oversight capabilities.

It should also prioritise the identification of non-regulated entities/products with material leverage exposures.

Considering that leverage is not per se an indication of risk, supervisors should have sufficient capabilities to parse through the information they collect and narrow in on activities that could result in well-evidenced harm to the real economy.

Faced with a well-evidenced vulnerabilities, jurisdictions should duly consider the costs and benefits of different interventions.

Product-based measures have demonstrated their utility as ex-ante interventions in specific situations (e.g., for LDI funds).

Activity-based and concentration-related measures already exist, although not in a form supervisors could use to mitigate a perceived build-up (e.g., by anti-cyclically increasing haircuts or margin requirements depending on the build-up of leverage in a specific market).

The latter, as described in proposed recommendations 4 and 5, would inevitably result in unintended consequences such as unduly disincentivising the use of derivatives and repo transactions or increasing the liquidity demand during periods of stress.

When evaluating whether a regulatory treatment is 'congruent', one should consider both the underlying investment risks associated with a specific activity and the risks associated with the entity/product itself.

For instance, while a bank and an investment fund may engage in similar activities (e.g., providing loans to non-financial corporations), they should not be subject to the same regulatory treatment (e.g., capital requirements) because their business models and liability structures differ significantly (e.g., investment funds are more resilient than banks because they finance their activities through equity issuance).

These result in different entity/product-level risks and, therefore, different potential systemic risks.

Lastly, the FSB recommendations miss several regulatory interventions that would help mitigate leverage-related liquidity risks.

The main threat to financial stability is the mismatch between liquidity demand and supply during periods of stress, not mass defaults in the NBFI ecosystem.

This gap can be bridged by 1) increasing margin call transparency and predictability, 2) allowing the use of non-cash collaterals in variation margin calls, and 3) improving the functioning of repo markets

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 should take a holistic and proportionate approach to monitoring and mitigating the build-up across the financial system.

The proposed recommendations should clearly outline the entities/products and/or markets that require greater attention.

It is welcome that the FSB states that jurisdictions should "focus on markets, entities, and activities where financial stability risks from NBFI leverage are more pronounced".

It is also welcome that the FSB suggests that jurisdictions should give particular attention to 'core markets'.

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

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(iii) concentration and crowded trading strategies

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It is also welcome that the FSB suggests that jurisdictions should give particular attention to 'core markets'.

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?**

Unfortunately, the proposed FSB recommendations do not sufficiently account for the fact that regulatory frameworks and supervisory oversight greatly differ across jurisdictions and that certain market participants operate outside the regulatory perimeter.

For the proposed recommendations to be effective, the FSB should prioritise international convergence in regulatory approaches, supervisory reporting, and oversight capabilities while recognising that certain variations may result from legitimate reasons (incl. investor demand or market structures).

In addition, the FSB should prioritise identifying non-regulated entities/products with material leverage exposures.

Failing this, jurisdictions risk focusing on the usual, well-regulated suspects (e.g., investment and pension funds) and introducing new regulatory measures before developing the foundations without which a supervisory authority cannot properly calibrate its interventions (e.g., analytical frameworks, appropriate risk metrics, sufficient supervisory reporting, and enabling regulatory framework).

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?**

Looking at both financial and synthetic leverage, it is apparent that leverage is concentrated outside regulated non-bank financial intermediation.

Regarding financial leverage, the ECB acknowledged in the past that "compared to the traditional banking sector where assets are often more than 10-30 times the size of equity, leverage in the investment fund sector is low with total assets much less than twice the amount of equity".

The recent FSB report on NBFI leverage notes that "[t]he level of debt issued by the NBFI sector in FSB member jurisdictions is significant and similar in scale to household debt. However, this is unevenly distributed within the sector. While insurance companies, pension funds and investment funds represent two-thirds of NBFI assets, more than 90% of on balance sheet financial leverage is in so-called other financial intermediaries (OFIs), such as broker-dealers, hedge funds, finance companies, holding companies and securitisation vehicles."

Similarly, the latest ESMA Derivatives Markets Report demonstrates that synthetic leverage in Europe is low within the regulated NBFI.

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. Pension funds, about 1% of total notional, had about 40% in interest rate derivatives and just under 60% in currency derivatives. Assurance and insurance accounted for just over 0.5% of total notional amount, both with about three quarters of exposures in interest rate derivatives."

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 existing European regulatory framework is fully consistent with the proposed FSB recommendations related to transparency and entity/product-based measures.

It ensures that investment funds are properly regulated, report sufficient information, and do not excessively leverage.

As a result, in contrast with more opaque sectors, supervisors have extensive information on asset managers and their investment products.

As outlined below, supervisors can rely on multiple rules and powers to ensure that funds do not take on more leverage than they should.

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?**

   Under Articles 6 UCITS and 7 AIFMD, asset managers must obtain a license before engaging in collective investment management and obtain an authorisation for each fund they distribute (Art. 5 UCITS and 31 AIFMD).

   No asset managers can operate in Europe without the knowledge of its supervisory authority.

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

   Pursuant to Article 83 UCITS, UCITS funds cannot borrow cash for investment purposes.

   This implies that UCITS funds cannot have any financial leverage, including from repo operations.

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

   Article 51(3) UCITS forbids a net exposure higher than 200% (including the value of the physical securities) of the fund's net asset value (NAV), with the notable exception of UCITS funds that use the Value at Risk (VaR) approach to calculate their leverage levels.

   Article 15(3) 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 using leverage on a substantial basis (300%) for certain AIFs.

   During the authorisation process, supervisors evaluate a fund's expected use of leverage and may require additional assurances from the management company when the expected leverage exceeds a certain threshold, usually a gross leverage higher than 300 or 400%.

   These limits structurally constrain the use of leverage in the fund sector.

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?**

    Article 52 UCITS requires that UCITS funds comply with a concentration limit known as the '5/10/40' rule.

    A UCITS fund cannot invest more than 5% of its assets in securities issued by the same issuer.

    When engaging in derivative transactions, a UCITS fund should keep its counterparty risk exposure below 10% of its assets when the counterparty is a credit institution and below 5% in case it is not.

    Should a UCITS fund benefit from a regulatory exemption and invest up to 10% of its assets in securities issued by a single issuer, these 'large exposures' should not exceed 40% of its assets.

This rule protects UCITS funds from excessive concentration, a root problem that caused the Archegos incident and the UK mini-budget crisis.

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?**

    Article 51(1) UCITS and 16 AIFMD require management companies to have a risk management process that identifies and monitors the risk associated with each portfolio.

    The ESMA Guidelines on ETFs and other UCITS issues also specify rules for UCITS engaging in OTC derivative transactions (e.g., monitoring counterparty risks and risks linked to collateral management).

    Furthermore, 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.

    This means asset managers are already in a good position to monitor leverage-related risks.

    However, as outlined in the following sections, additional public disclosures in certain core markets (e.g., sovereign bond markets) and margin transparency could help asset managers better understand the risks to which their funds are exposed and how to mitigate them.

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

    Article 70 UCITS requires that asset managers disclose in their prospectuses whether a fund may engage in derivative transactions and, if so, whether these operations would be carried out for hedging or investment reasons.

    Asset managers should also specify how leverage would impact the fund's risk profile.

    This information should include the method used to calculate leverage (i.e., commitment, absolute VaR, or relative VaR) and the expected leverage levels for funds using the VaR approach.

    The latter must also disclose the actual leverage employed in their annual reports.

    Article 23 AIFMD requires similar initial disclosures (e.g., circumstances in which an AIF may use leverage, type and source of leverage, and restrictions on leverage, including maximum leverage).

    In addition, asset managers should also regularly disclose any change to the maximum leverage limits and the total amount of leverage employed for every AIF.

    Beyond the fact that these disclosures help investors choose how much risk they are willing to take, they can also help prime brokers size up the counterparty credit risk they take when transacting with funds.

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?**

    Statistical reporting: Asset managers report monthly their funds' portfolios to their respective National Central Banks (NCBs).

Considering that central banks collect similar information on other financial sectors, although less frequently, these institutions should have extensive insights into local capital markets.

Transaction reporting: Under the Market in Financial Instruments Directive (MiFID), market makers report daily to supervisory authorities the transactions to which they are counterparties.

In addition, asset managers report their derivatives and repo transactions daily to trade repositories under the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transaction Regulation (SFTR).

These repositories then make this information available to supervisory authorities.

The latter, therefore, have extensive information on entities/products' trading patterns and exposure to financial and synthetic leverage.

Supervisory reporting: Pursuant to Article 24 AIFMD, Alternative Investment Fund Managers (AIFMs) have to regularly provide their supervisors with supervisory information on the AIFs under their management, including leverage figures (both gross and net), principal exposures and exposures to derivatives.

These reporting requirements are even more stringent for AIFs, whose leverage calculated under the commitment (net) approach exceeds 300% (including the value of physical securities).

This additional information, notably, covers the total financial borrowing of the AIF, including borrowing embedded in derivatives and short selling.

While UCITS funds benefit from a lighter-touch reporting regime under Article 51(1) UCITS, they still have to report certain information to their respective supervisory authorities.

Moreover, the EU will develop a reporting regime similar to the AIFMD one for these funds.

This supervisory reporting gives supervisors a consolidated perspective of fund leverage and associated risks.

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?

Under Articles 98 UCITS and 43 AIFMD, supervisory authorities have a wide array of powers to address well-documented financial stability threats: They can conduct on-site or off-site investigations, require the cessation of any practice that is contrary to applicable rules, suspend the issue or redemption of shares, and even withdraw an authorisation granted to a UCITS or a management company.

Last but not least, under Article 25(3) AIFMD, supervisors can cap the leverage an AIF can take on.

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?**

    Despite the long-standing concerns over leverage in the fund sector, most funds have limited exposure to 'financial' and 'synthetic' leverage.

    Many European funds rely on neither financial nor synthetic leverage.

    While the exact figure is not publicly available, one can safely argue that at least half of European funds are in this situation.

    As regards financial leverage, one can assume that UCITS funds, accounting for approximately 65 % of the European fund sector, use no financial leverage.

    Moreover, an ECB study found that 65% of European funds do not use synthetic leverage.

    However, derivatives are more prevalent in funds with assets under management over EUR 5 billion (80%) and in some subsectors such as bond, hedge and mixed funds (over 45%).

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?**

    In addition, among the funds that use leverage, it is clear that leverage remains low overall.

    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' and 'synthetic' leverage) was 139% at the end of 2020.

    This figure, however, overstates the exposure of most alternative funds, as leverage is concentrated in only a few AIFs.

    Indeed, while the average adjusted gross leverage for hedge funds is of 327%, it would not exceed an average of 141% for the other alternative fund categories.

    There are important disparities even within the hedge fund category: the leveraged hedge funds within the top decile have an aggregate gross adjusted exposure of 600%.

    As a result, the alternative investment fund at the median has an adjusted gross leverage of only 102%, far below the AIF average.

    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.

    In contrast with the above, following the AIFMD conventions, banks' leverage would range between 1000 and 3000%.

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?

While the proposed recommendations are going in the right direction by suggesting that each jurisdiction develop 'domestic frameworks' to monitor and mitigate the build-up of leverage, the FSB should be more cautious as regards the policy changes it recommends.

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?**

These analytical frameworks are essential to help jurisdictions understand the systemic risks to which they could be exposed.

When developing these frameworks, jurisdictions should consider the following points:

The proposed domestic frameworks should not aim to predict the next financial shock.

Instead, these should help identify unmitigated vulnerabilities that could negatively impact the real economy and determine whether specific market segments require closer supervision and/or a stricter regulatory treatment.

Considering the interplay between different transmission channels, jurisdictions should develop macroprudential frameworks that cover every systemic risk, not only those induced by leverage.

While leverage can amplify risk in capital markets, whether it is the primary source of systemic risk is highly questionable.

Some investment strategies (e.g., arbitrage, risk parity) can sustain high leverage without creating systemic concerns, provided they have adequate liquidity buffers and sufficient collateral management procedures.

From a financial stability perspective, the priority should remain to ensure an equilibrium in liquidity demand and supply, especially during periods of stress. The recent Bank of England's System-Wide Exploratory Scenario (SWES) exercise demonstrated that, at least in the UK, the main source of liquidity demand came from margin calls. In contrast, a recent ECB analysis of substantially leveraged AIFs demonstrated that most of these funds would not default even subject to a large interest rate shock (i.e., 300 bps). This analysis nonetheless found that some funds would face a 'liquidity shortfall' when subjected to a moderate interest rate shock (i.e., 100 bps). While insufficient cash and/or MMF holdings to meet the liquidity demand under a given shock does not per se indicate a 'liquidity shortfall', it does point out that, under that scenario, the entity/product would have to either exit its derivative positions or sell certain assets (e.g., sovereign bonds).

These domestic frameworks should also rely on appropriate and diverse risk metrics. While it may be tempting to zero in on entities/products with significant leverage levels, (gross) leverage figures only allow one to understand whether an entity/product's is using derivatives, but nothing about the investment strategy or the reason for which the derivative is being used for (i.e., maximising returns or hedging risk). These figures are not a one-to-one indication of risk. The ECB notably states in its analysis that "[r]isks associated with derivatives depend not only on the notional exposure, but also on the type of derivative and the underlying." Moreover, it is essential to recognise that no single risk metric can capture every leverage-related risk. This means that different risk metrics might be necessary to evaluate the risks associated with different investment strategies and that undue aggregation of these metrics could be misleading. As a result, supervisory authorities are instrumental in analysing different leverage and risk metrics, identifying potential solvency or liquidity risks, and determining whether additional measures are necessary to address well-evidenced vulnerabilities.

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?**

    While it is crucial to fill data gaps, reporting requirements must remain proportionate. First, jurisdictions should not seek to predict the next financial shock. This means that supervisory authorities do not need granular data daily. They should have access to sufficiently precise data to understand how the market functions, where potential vulnerabilities may be, and how past crises unfolded. To achieve this, supervisory authorities can, in many jurisdictions, access extensive information about the entities/products and markets they supervise (see the section on the EU regulatory framework). For instance, ESMA acknowledged that it would have been possible to detect Archegos' leveraged positions before its failure.

    Second, jurisdictions must share data domestically and internationally. As outlined in the section on the EU regulatory framework, in many jurisdictions, market participants report information to different authorities (e.g., central banks, on the one hand, and supervisors, on the other). This reporting fragmentation prevents jurisdictions from fully using reported information. In addition, since national capital markets usually have a global investor base (e.g., foreign investors own 25% of the euro bond markets), it is challenging to take a holistic approach while only relying on local reporting.

    Third, while further analyses would be necessary to determine whether additional reporting requirements would be necessary, certain data points would deserve particular attention (e.g., sufficient information about non-regulated market participants and market concentration data). On the other hand, it is inappropriate to suggest that entity/product-level reporting should be as granular as activity-level reporting. This suggests that market participants should provide their investment positions to supervisors daily. Beyond the fact that this information is confidential, such frequent and granular disclosures would be unnecessary because 1) supervisors can already monitor financial institutions to various extents through daily activity-level reporting (i.e., MiFID and EMIR reporting in the EU) as outlined by ESMA as regards Archegos, and 2) portfolio information only provides a partial view into the risk an entity or product is taking. Supervisors require additional risk metrics to have a more comprehensive perspective. Yet, some of these metrics cannot be computed daily (e.g. stress test results are, at best, available monthly).

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?**

Such disclosures could help market participants better understand the core markets in which they invest and integrate this information (e.g., the make-up of investors and concentration in a given market) into their risk management.

However, jurisdictions should not expect market participants to disclose publicly information to the broader market. Public disclosures are a tool to ensure prospective investors receive sufficient information before investing. These disclosures also ensure that existing investors receive the information required to evaluate their ongoing investments. For instance, as outlined in the section on the EU regulatory framework, investment funds provide information about their leverage in their offering material and sometimes in their reports to investors.

Public disclosures to the broader market would be counterproductive for at least two reasons. First, these could harm client interest and, thus, contravene asset managers' fiduciary duty. Opportunistic market participants could use public information to trade against the disclosing product or copy its investment strategy. Second, few market participants would have the resources to parse this information given the number of market participants. Approximately 65.000 investment funds are registered in Europe. Yet funds only account, on average, for 20 per cent of each market. One can, therefore, assume that there are hundreds, if not thousands, of participants in each market. Moreover, collecting this information would probably be of limited use if these market participants do not have access to these entities/products' holdings and, therefore, the markets in which they operate.

EFAMA European Fund and Asset Management Association 50 years 1974 2024

RESPONSE

Brussels, 28 February 2025

EFAMA response to the FSB consultation on leverage in non-bank financial intermediation (NBFI)

Introduction

The European Fund and Asset Management Association (EFAMA) welcomes the FSB's initiative to develop 'domestic frameworks' in order to monitor and mitigate the build-up of leverage in capital markets. While leverage has multiple benefits, it can undermine financial stability if not properly managed, as the recent UK mini-budget crisis illustrated. Greater international convergence in regulatory standards and supervisory oversight would reduce the risks from diverging approaches across jurisdictions.

Since the Great Financial Crisis, the EU has actively sought to limit risk from leverage in its financial system. In many regards, the EU macroprudential framework can inspire other jurisdictions. Nonetheless, in our response to the *EC consultation on the adequacy of macroprudential policies in Non-Bank Financial Intermediation (NBFI)*, we recommended, similarly to FSB in proposed recommendation 1, that the EU develop a macroprudential framework to identify potential pockets of risk that would require deeper analyses.[1] As outlined in proposed recommendation 3, additional public disclosures from supervisory authorities could also help market participants better understand core markets and their associated risks (e.g., information such as the outstanding positions per sector in a given market).

This being said, in the fund sector, the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive and the Alternative Fund Manager Directive (AFMD) already include various (macro-)prudential measures to limit and track leverage (i.e., borrowing limits, (self-imposed) exposure limits, and supervisory reporting). Moreover, following a recent review, the EU will strengthen this framework by introducing a dedicated reporting regime for UCITS funds and leverage limits for Loan-Origination Funds (LOFs). As a result, we are confident that the current UCITS/AIFMD framework fully complies with the proposed FSB recommendations related to transparency and product-based measures.

When comparing leverage across financial institutions, it is important to distinguish how market participants use leverage (i.e., for maximising investment returns vs. hedging risks), how material the exposure is (i.e., how the entity/product's footprint compares with its equity), and the different risks stemming from these exposures (i.e., solvency vs. liquidity risks). By analysing the European fund sector through these lenses, we find that both financial and synthetic leverage remain well below regulatory limits.[2] Leverage is,

[1] EFAMA, Response to the European Commission's consultation on the adequacy of macroprudential policies for non-bank financial intermediation, November 2025, pp. 6-7.

[2] Unlike '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

moreover, usually deployed for reasons other than gaining additional exposure to an underlying market, including for efficient portfolio and risk management purposes. For example, investment funds may enter into derivative arrangements to hedge specific risks (e.g., a potential currency de/revaluation), manage inflows, or build efficient portfolios.[3] For this reason, it is problematic to associate European funds with the Archegos incident, as is sometimes done. Even among hedge funds, such leveraged and concentrated investment strategies would be rare – if not non-existent. Most funds do not employ financial leverage, especially outside hedge funds and LDI funds using repo borrowing. Synthetic leverage is also limited across the fund sector, with less than half of EU funds using derivatives and those that do making relatively light use of them. As a result, while certain funds may be confronted with spikes in margin calls, insolvency is quite unlikely, even among hedge funds.

To ensure that the FSB recommendations improve jurisdictions' ability to monitor and address the build-up of leverage across the globe, the FSB should take into account the following considerations:

- Financial stability analyses must take a **holistic approach**. This means looking beyond non-bank financial intermediation (or the banks providing leverage to these institutions) given that leverage is concentrated among banks and investment firms. It also means considering the **interplay between different risks** (e.g., leverage and liquidity) because (collective) defaults are not the primary risk in capital markets.
- The FSB should prioritise **international convergence** in regulatory approaches, supervisory reporting, and oversight capabilities. It should also prioritise the identification of **non-regulated entities/products** with material leverage exposures.
- Considering that leverage is not per se an indication of risk, **supervisors** should have sufficient capabilities to parse through the information they collect and narrow in on activities that could result in well-evidenced harm to the real economy.
- Faced with a well-evidenced vulnerabilities, jurisdictions should duly consider the **costs and benefits** of different interventions. **Product-based measures** have demonstrated their utility as *ex-ante* interventions in specific situations (e.g., for LDI funds). **Activity-based and concentration-related measures** already exist, although not in a form supervisors could use to mitigate a perceived build-up (e.g., by anti-cyclically increasing haircuts or margin requirements depending on the build-up of leverage in a specific market). The latter, as described in proposed recommendations 4 and 5, would inevitably result in unintended consequences such as unduly disincentivising the use of derivatives and repo transactions or increasing the liquidity demand during periods of stress.
- When evaluating whether a **regulatory treatment** is 'congruent', one should consider both the underlying investment risks associated with a specific activity and the risks associated with the entity/product itself. For instance, while a bank and an investment fund may engage in similar activities (e.g., providing loans to non-financial corporations), they should not be subject to the same regulatory treatment (e.g., capital requirements) because their business models and liability structures differ significantly (e.g., investment funds are more resilient than banks because they finance their activities through equity issuance). These result in different entity/product-level risks and, therefore, different potential systemic risks.

Lastly, the FSB recommendations miss several regulatory interventions that would help mitigate leverage-related liquidity risks. The main threat to financial stability is the mismatch between liquidity demand and supply during periods of stress, not mass defaults in the NBFI ecosystem. This gap can be bridged by 1) increasing margin call transparency and predictability, 2) allowing the use of non-cash collaterals in variation margin calls, and 3) improving the functioning of repo markets.

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exposure to an underlying market than they could have by directly purchasing the relevant financial instruments (e.g., shares or bonds).

[3] EFAMA/AMIC, Use of leverage in investment funds in Europe, July 2017.

Scope

The FSB should take a holistic and proportionate approach to monitoring and mitigating the build-up across the financial system. The proposed recommendations should clearly outline the entities/products and/or markets that require greater attention. It is welcome that the FSB states that jurisdictions should "focus on markets, entities, and activities where financial stability risks from NBFI leverage are more pronounced". It is also welcome that the FSB suggests that jurisdictions should give particular attention to 'core markets'.

Unfortunately, the proposed FSB recommendations do not sufficiently account for the fact that regulatory frameworks and supervisory oversight greatly differ across jurisdictions and that certain market participants operate outside the regulatory perimeter. For the proposed recommendations to be effective, the FSB should prioritise international convergence in regulatory approaches, supervisory reporting, and oversight capabilities while recognising that certain variations may result from legitimate reasons (incl. investor demand or market structures). In addition, the FSB should prioritise identifying non-regulated entities/products with material leverage exposures. Failing this, jurisdictions risk focusing on the usual, well-regulated suspects (e.g., investment and pension funds) and introducing new regulatory measures before developing the foundations without which a supervisory authority cannot properly calibrate its interventions (e.g., analytical frameworks, appropriate risk metrics, sufficient supervisory reporting, and enabling regulatory framework).

Looking at both financial and synthetic leverage, it is apparent that leverage is concentrated outside regulated non-bank financial intermediation. Regarding financial leverage, the ECB acknowledged in the past that "compared to the traditional banking sector where assets are often more than 10-30 times the size of equity, leverage in the investment fund sector is low with total assets much less than twice the amount of equity".[4] The recent *FSB report on NBFI leverage* notes that "[t]he level of debt issued by the NBFI sector in FSB member jurisdictions is significant and similar in scale to household debt. However, this is unevenly distributed within the sector. While insurance companies, pension funds and investment funds represent two-thirds of NBFI assets, more than 90% of on balance sheet financial leverage is in so-called other financial intermediaries (OFIs), such as broker-dealers, hedge funds, finance companies, holding companies and securitisation vehicles."[5]

Similarly, the latest *ESMA Derivatives Markets Report* demonstrates that synthetic leverage in Europe is low within the regulated NBFI. 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. Pension funds, about 1% of total notional, had about 40% in interest rate derivatives and just under 60% in currency derivatives. Assurance and insurance accounted

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[4] ECB, Shadow banking in the euro area: risks and vulnerabilities in the investment fund sector, Occasional Paper Series, No 174, June 2016.

[5] FSB, The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation, September 2023, p. 1.

for just over 0.5% of total notional amount, both with about three quarters of exposures in interest rate derivatives."[6]

The European regulatory framework for funds

The existing European regulatory framework is fully consistent with the proposed FSB recommendations related to transparency and entity/product-based measures. It ensures that investment funds are properly regulated, report sufficient information, and do not excessively leverage. As a result, in contrast with more opaque sectors, supervisors have extensive information on asset managers and their investment products. As outlined below, supervisors can rely on multiple rules and powers to ensure that funds do not take on more leverage than they should.

Authorisation

Under Articles 6 UCITS and 7 AIFMD, asset managers must obtain a license before engaging in collective investment management and obtain an authorisation for each fund they distribute (Art. 5 UCITS and 31 AIFMD). No asset managers can operate in Europe without the knowledge of its supervisory authority.

Borrowing limits

Pursuant to Article 83 UCITS, UCITS funds cannot borrow cash for investment purposes. This implies that UCITS funds cannot have any financial leverage, including from repo operations.

Leverage limits

Article 51(3) UCITS forbids a net exposure higher than 200% (including the value of the physical securities) of the fund's net asset value (NAV), with the notable exception of UCITS funds that use the Value at Risk (VaR) approach to calculate their leverage levels.[7] Article 15(3) 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 using leverage on a substantial basis (300%) for certain AIFs. During the authorisation process, supervisors evaluate a fund's expected use of leverage and may require additional assurances from the management company when the expected leverage exceeds a certain threshold, usually a gross leverage higher than 300 or 400%. These limits structurally constrain the use of leverage in the fund sector.

Diversification rule

Article 52 UCITS requires that UCITS funds comply with a concentration limit known as the '5/10/40' rule. A UCITS fund cannot invest more than 5% of its assets in securities issued by the same issuer. When engaging in derivative transactions, a UCITS fund should keep its counterparty risk exposure below 10% of its assets when the counterparty is a credit institution and below 5% in case it is not. Should a UCITS fund benefit from a regulatory exemption and invest up to 10% of its assets in securities issued by a single issuer, these 'large exposures' should not exceed 40% of its assets. This rule protects UCITS funds from excessive concentration, a root problem that caused the Archegos incident and the UK mini-budget crisis.

Risk management requirements

Article 51(1) UCITS and 16 AIFMD require management companies to have a risk management process that identifies and monitors the risk associated with each portfolio. The *ESMA Guidelines on ETFs and other UCITS issues* also specify rules for UCITS engaging in OTC derivative transactions (e.g., monitoring counterparty risks and risks linked to collateral management).[8] Furthermore, the *ESMA Guidelines on liquidity stress testing in UCITS and AIFs* require that every management company stress test the resilience

[6] ESMA, EU Derivatives Markets 2023, December 2023, p. 9.
[7] 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.
[8] ESMA, Guidelines on ETFs and other UCITS issues, August 2014.

of their fund range to liquidity demand stemming from either redemptions and/or margin calls.[9] This means asset managers are already in a good position to monitor leverage-related risks. However, as outlined in the following sections, additional public disclosures in certain core markets (e.g., sovereign bond markets) and margin transparency could help asset managers better understand the risks to which their funds are exposed and how to mitigate them.

Public disclosures

Article 70 UCITS requires that asset managers disclose in their prospectuses whether a fund may engage in derivative transactions and, if so, whether these operations would be carried out for hedging or investment reasons. Asset managers should also specify how leverage would impact the fund's risk profile. This information should include the method used to calculate leverage (i.e., commitment, absolute VaR, or relative VaR) and the expected leverage levels for funds using the VaR approach. The latter must also disclose the actual leverage employed in their annual reports.[10] Article 23 AIFMD requires similar initial disclosures (e.g., circumstances in which an AIF may use leverage, type and source of leverage, and restrictions on leverage, including maximum leverage). In addition, asset managers should also regularly disclose any change to the maximum leverage limits and the total amount of leverage employed for every AIF. Beyond the fact that these disclosures help investors choose how much risk they are willing to take, they can also help prime brokers size up the counterparty credit risk they take when transacting with funds.

Supervisory reporting

- **Statistical reporting:** Asset managers report monthly their funds' portfolios to their respective National Central Banks (NCBs).[11] Considering that central banks collect similar information on other financial sectors, although less frequently, these institutions should have extensive insights into local capital markets.
- **Transaction reporting:** Under the Market in Financial Instruments Directive (MiFID), market makers report daily to supervisory authorities the transactions to which they are counterparties. In addition, asset managers report their derivatives and repo transactions daily to trade repositories under the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transaction Regulation (SFTR). These repositories then make this information available to supervisory authorities. The latter, therefore, have extensive information on entities/products' trading patterns and exposure to financial and synthetic leverage.
- **Supervisory reporting:** Pursuant to Article 24 AIFMD, Alternative Investment Fund Managers (AIFMs) have to regularly provide their supervisors with supervisory information on the AIFs under their management, including leverage figures (both gross and net), principal exposures and exposures to derivatives. These reporting requirements are even more stringent for AIFs, whose leverage calculated under the commitment (net) approach exceeds 300% (including the value of physical securities). This additional information, notably, covers the total financial borrowing of the AIF, including borrowing embedded in derivatives and short selling. While UCITS funds benefit from a lighter-touch reporting regime under Article 51(1) UCITS, they still have to report certain information to their respective supervisory authorities. Moreover, the EU will develop a reporting regime similar to the AIFMD one for these funds.[12] This supervisory reporting gives supervisors a consolidated perspective of fund leverage and associated risks.

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[9] ESMA, Guidelines on liquidity stress testing in UCITS and AIFs, July 2020.
[10] CESR, Guidelines on risk measurement and the calculation of global exposures and counterparty risk for UCITS, July 2010, p. 35.
[11] ECB, Regulation No 1073/2013 concerning statistics on the assets and liabilities of investment funds (recast), October 2013.
[12] EU, Directive No 2024/927 as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds, March 2024.

Supervision and enforcement

Under Articles 98 UCITS and 43 AIFMD, supervisory authorities have a wide array of powers to address well-documented financial stability threats: They can conduct on-site or off-site investigations, require the cessation of any practice that is contrary to applicable rules, suspend the issue or redemption of shares, and even withdraw an authorisation granted to a UCITS or a management company. Last but not least, under Article 25(3) AIFMD, supervisors can cap the leverage an AIF can take on.[13]

Leverage in the European fund sector

Despite the long-standing concerns over leverage in the fund sector, most funds have limited exposure to 'financial' and 'synthetic' leverage.

Many European funds rely on neither financial nor synthetic leverage. While the exact figure is not publicly available, one can safely argue that at least half of European funds are in this situation. As regards financial leverage, one can assume that UCITS funds, accounting for approximately 65 % of the European fund sector, use no financial leverage. Moreover, an ECB study found that 65% of European funds do not use synthetic leverage. However, derivatives are more prevalent in funds with assets under management over EUR 5 billion (80%) and in some subsectors such as bond, hedge and mixed funds (over 45%).[14]

In addition, among the funds that use leverage, it is clear that leverage remains low overall. 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' and 'synthetic' leverage) was 139% at the end of 2020. This figure, however, overstates the exposure of most alternative funds, as leverage is concentrated in only a few AIFs. Indeed, while the average adjusted gross leverage for hedge funds is of 327%, it would not exceed an average of 141% for the other alternative fund categories. There are important disparities even within the hedge fund category: the leveraged hedge funds within the top decile have an aggregate gross adjusted exposure of 600%.[15] As a result, the alternative investment fund at the median has an adjusted gross leverage of only 102%, far below the AIF average.[16] 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.

In contrast with the above, following the AIFMD conventions, banks' leverage would range between 1000 and 3000%.

Our views on the proposed FSB recommendations

While the proposed recommendations are going in the right direction by suggesting that each jurisdiction develop 'domestic frameworks' to monitor and mitigate the build-up of leverage, the FSB should be more cautious as regards the policy changes it recommends.

Recommendation 1 – Domestic frameworks

These analytical frameworks are essential to help jurisdictions understand the systemic risks to which they could be exposed. When developing these frameworks, jurisdictions should consider the following points:

- The proposed domestic frameworks should not aim to predict the next financial shock. Instead, these should help identify unmitigated vulnerabilities that could negatively impact the real economy

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[13] ESMA, Guidelines on Article 25 AIFMD, June 2021.
[14] ECB, The impact of derivatives collateralisation on liquidity risk: evidence from the investment fund sector, Working Paper Series, No 2756, December 2022, p. 9.
[15] ESMA, AIF Statistical Report, February 2022, pp. 6-13.
[16] ESMA, TRV Report, September 2021, pp. 27-28.

and determine whether specific market segments require closer supervision and/or a stricter regulatory treatment.

- Considering the interplay between different transmission channels, jurisdictions should develop macroprudential frameworks that cover every systemic risk, not only those induced by leverage. While leverage can amplify risk in capital markets, whether it is the primary source of systemic risk is highly questionable. Some investment strategies (e.g., arbitrage, risk parity) can sustain high leverage without creating systemic concerns, provided they have adequate liquidity buffers and sufficient collateral management procedures. From a financial stability perspective, the priority should remain to ensure an equilibrium in liquidity demand and supply, especially during periods of stress.[17] The recent Bank of England's System-Wide Exploratory Scenario (SWES) exercise demonstrated that, at least in the UK, the main source of liquidity demand came from margin calls.[18] In contrast, a recent ECB analysis of substantially leveraged AIFs demonstrated that most of these funds would not default even subject to a large interest rate shock (i.e., 300 bps). This analysis nonetheless found that some funds would face a 'liquidity shortfall' when subjected to a moderate interest rate shock (i.e., 100 bps).[19] While insufficient cash and/or MMF holdings to meet the liquidity demand under a given shock does not *per se* indicate a 'liquidity shortfall', it does point out that, under that scenario, the entity/product would have to either exit its derivative positions or sell certain assets (e.g., sovereign bonds).[20]
- These domestic frameworks should also rely on appropriate and diverse risk metrics. While it may be tempting to zero in on entities/products with significant leverage levels, (gross) leverage figures only allow one to understand whether an entity/product's is using derivatives, but nothing about the investment strategy or the reason for which the derivative is being used for (i.e., maximising returns or hedging risk). These figures are not a one-to-one indication of risk. The ECB notably states in its analysis that "[r]isks associated with derivatives depend not only on the notional exposure, but also on the type of derivative and the underlying." Moreover, it is essential to recognise that no single risk metric can capture every leverage-related risk. This means that different risk metrics might be necessary to evaluate the risks associated with different investment strategies and that undue aggregation of these metrics could be misleading. As a result, supervisory authorities are instrumental in analysing different leverage and risk metrics, identifying potential solvency or liquidity risks, and determining whether additional measures are necessary to address well-evidenced vulnerabilities.

Recommendation 2 – Data gaps

While it is crucial to fill data gaps, reporting requirements must remain proportionate. First, jurisdictions should not seek to predict the next financial shock. This means that supervisory authorities do not need granular data daily. They should have access to sufficiently precise data to understand how the market functions, where potential vulnerabilities may be, and how past crises unfolded. To achieve this, supervisory authorities can, in many jurisdictions, access extensive information about the entities/products and markets they supervise (see the section on the EU regulatory framework). For instance, ESMA acknowledged that it would have been possible to detect Archegos' leveraged positions before its failure.[21]

Second, jurisdictions must share data domestically and internationally. As outlined in the section on the EU regulatory framework, in many jurisdictions, market participants report information to different authorities (e.g., central banks, on the one hand, and supervisors, on the other). This reporting fragmentation prevents jurisdictions from fully using reported information. In addition, since national capital markets usually have a

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[17] FSB, Holistic Review of the March Market Turmoil, November 2020.
[18] Bank of England, SWES final report, November 2024.
[19] ECB, Leveraged investment funds: A framework for assessing risks and designing policies, January 2025.
[20] EFAMA, Response to the FSB consultation on liquidity preparedness for margin calls in non-bank financial intermediation, pp. 5-6.
[21] ESMA, Leverage and derivatives – the case of Archegos, May 2022.

global investor base (e.g., foreign investors own 25% of the euro bond markets), it is challenging to take a holistic approach while only relying on local reporting.

Third, while further analyses would be necessary to determine whether additional reporting requirements would be necessary, certain data points would deserve particular attention (e.g., sufficient information about non-regulated market participants and market concentration data). On the other hand, it is inappropriate to suggest that entity/product-level reporting should be as granular as activity-level reporting. This suggests that market participants should provide their investment positions to supervisors daily. Beyond the fact that this information is confidential, such frequent and granular disclosures would be unnecessary because 1) supervisors can already monitor financial institutions to various extents through daily activity-level reporting (i.e., MiFID and EMIR reporting in the EU) as outlined by ESMA as regards Archegos, and 2) portfolio information only provides a partial view into the risk an entity or product is taking. Supervisors require additional risk metrics to have a more comprehensive perspective. Yet, some of these metrics cannot be computed daily (e.g. stress test results are, at best, available monthly).

Recommendation 3 – Public disclosures

Such disclosures could help market participants better understand the core markets in which they invest and integrate this information (e.g., the make-up of investors and concentration in a given market) into their risk management.

However, jurisdictions should not expect market participants to disclose publicly information to the broader market. Public disclosures are a tool to ensure prospective investors receive sufficient information before investing. These disclosures also ensure that existing investors receive the information required to evaluate their ongoing investments. For instance, as outlined in the section on the EU regulatory framework, investment funds provide information about their leverage in their offering material and sometimes in their reports to investors.

Public disclosures to the broader market would be counterproductive for at least two reasons. First, these could harm client interest and, thus, contravene asset managers' fiduciary duty. Opportunistic market participants could use public information to trade against the disclosing product or copy its investment strategy. Second, few market participants would have the resources to parse this information given the number of market participants. Approximately 65.000 investment funds are registered in Europe. Yet funds only account, on average, for 20 per cent of each market. One can, therefore, assume that there are hundreds, if not thousands, of participants in each market. Moreover, collecting this information would probably be of limited use if these market participants do not have access to these entities/products' holdings and, therefore, the markets in which they operate.

Recommendations 4 & 5 – Activity-based and concentration-related measures

Certain situations (e.g., the interplay between leverage and concentration in LDI funds) can indeed require prudential interventions. Entity/product-based measures have demonstrated their utility as *ex-ante* interventions in certain situations. Activity-based and concentration-related measures already exist, although not in a form that could be used to mitigate a perceived build-up counter-cyclically (e.g., increasing haircuts or margin requirements when leverage increases in the system). Departing from the existing regulatory framework to give supervisors additional intervention powers would inevitably result in unintended consequences:

- **Risk-based haircuts and margin requirements** are essential because they ensure that counterparties are, at least, partially protected against defaults. CCPs and prime brokers should already adjust these requirements depending on the risk associated with a given transaction (including concentration and liquidity risks). Rather than introducing minimum requirements that could have unintended consequences (e.g., further disincentivising the use of repo markets), regulators should ensure that haircuts and margin calls are sufficiently risk-sensitive. This being said, it is important that this dynamic pricing does not negatively impact margin transparency and predictability.

- **Mandatory central clearing** is not a silver bullet because it is impossible to have such clearing in every type of derivative contract (sufficient standardisation and liquidity are necessary). Moreover, central clearing could increase liquidity demand during periods of stress as demonstrated by Bank of England's System-Wide Exploratory Scenario (SWES).[22] Before mandating central clearing, jurisdictions should closely observe how the transition to central clearing in the U.S. Treasury market plays out.[23]

The relevant authorities should duly take into account the advantages and disadvantages of entity/product-based, activity-based, or concentration-related measures when considering them.

Recommendation 6 – Counterparty credit risk management

This recommendation should specify that it only applies to banks within the scope of the new *BCBS guidelines for counterparty credit risk management* which provide leverage to the NBFI ecosystem. Indeed, the BCBS stated that these guidelines "are intended to be applicable to [...] banks".[24] Considering the proposed recommendations have a broader scope (i.e., NBFI and their leverage providers), one could understand that the BCBS guidelines should also apply to non-bank financial intermediaries such as insurance companies, pension funds, and investment funds. Although this is probably not the FSB's intention, the above clarification would be welcome.

Appropriate counterparty credit risk management among leverage providers ensures that the system does not take on more leverage than it can handle and prevents situations such as the Archegos incident. The *BCBS guidelines for counterparty credit risk management* adequately refresh the best practices in this area. Most leverage providers already have policies that are consistent with these. In the case of Archegos, the problem was not that Credit Suisse did not have such policies in place but rather that these were not duly followed. Rather than considering new regulatory initiatives, jurisdictions should ensure, through appropriate supervision, that leverage providers comply with existing policies.

As outlined in the section on the scope of the recommendations and the European regulatory framework, leverage providers should pay particular attention to broader market dynamics and non-regulated market participants.

Recommendation 7 – Minimum private disclosures

Leverage providers need to receive sufficient information from their counterparts to assess the risks they are taking when extending credit or engaging in a derivative/repo transaction. At this stage, it is unclear whether banks receive insufficient information to conduct their counterparty credit risk assessment. In the case of Archegos, the Credit Suisse report indicates that the bank had access to the necessary information.[25] In fact, it is common for a counterparty to provide certain information to leverage providers, including the obligation to inform the bank when certain indicators (e.g., the Net Asset Value (NAV) in the case of funds) drop below a given threshold.

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[22] Bank of England, SWES final report, November 2024.
[23] SEC, Standards for covered clearing agencies for U.S. Treasury securities and application of the Broker-Dealer Customer Protection Rule with respect to U.S. Treasury securities, December 2023.
[24] BCBS, Guidelines for counterparty credit risk management, December 2024, p. 2.
[25] Credit Suisse, Group special report of the Board of Directors: Report on Archegos Capital Management, July 29, 2021, pp. 17-18.

Moreover, minimum private disclosures could result in unnecessary or anti-competitive disclosures. Considering that risk may differ from transaction to transaction, minimum requirements will likely result in counterparties providing information that the leverage provider does not need. In addition, in the case of granular requirements (e.g., disclosures of actual positions at other prime brokers), these disclosures may provide the leverage provider with excessive insights into the strategy of its counterparty, disincentivising the use of leverage, including for hedging purposes. Such disclosures could also result in information overload on the bank side, especially during periods of stress.

Recommendation 8 – Same risk, same regulatory treatment

Jurisdictions should certainly seek to design consistent regulatory frameworks. However, the principle 'same risk, same regulatory treatment' is vague and could backfire by creating other types of risks.

First, the notions of 'same risk' and 'same regulatory treatment' can be understood differently. The notion of risk may refer to investment risks, entity/product-level risks, or systemic risks. When investing in the same asset, market participants are subject to the same investment risks (e.g., a default or market losses). However, these market participants are not subject to the same entity/product-level risks because investment risks will have different consequences for these entities/products depending on their respective liability characteristics (e.g., equity levels or redemption rights). For instance, sufficiently large defaults could result in a bank's insolvency because banks usually have limited equity. This is not the case with funds because they finance most, if not all, of their activities through equity. Moreover, signs of vulnerabilities in a bank can result in a bank run and, ultimately, insolvency (as was the case with Silicon Valley Bank in 2023). Investment funds have more flexibility in managing outflows. Their Net Asset Value (NAV) reflects the valuation in the underlying market. They also can activate liquidity management tools (LMTs) that can either limit outflows or ensure that the exiting investors pay the transaction costs resulting from these outflows. Consequently, the same shock to a bank or a fund would have different systemic implications.

From this perspective, it is welcome that the FSB acknowledges that "[c]ongruent treatment should not imply identical treatment. When assessing congruence, authorities should have regard to the specific characteristics of different entities, whether the entity is a bank or a non-bank entity, or whether the non-bank entity is already subject to regulatory requirements that may have direct or indirect impact on leverage (such as mutual funds or insurance companies), product types (SFTs and derivatives), and counterparty arrangements (centrally cleared and non-centrally cleared transactions). While entailing exposure to similar economic risks and benefits, corporate lending by banks and certain non-bank financial institutions, such as private credit funds, could be subject to distinct regulatory treatment based on the different risks they can pose to the broader financial system." However, based on the above explanations regarding the different business models in the banking and investment management industries, jurisdictions should not impose bank-like capital requirements onto funds. Leverage limits like the ones introduced by the recent AIFMD/UCITS review for Loan-Origination Funds (LOFs) are more appropriate.[26]

Second, as outlined in our comments on recommendations 4 and 5, measures that seek to introduce a congruent treatment could result in unintended consequences.

Beyond leverage

While the measures outlined in the proposed FSB recommendations seek to reduce systemic risks by reducing leverage, it is equally possible – and in our view, more desirable – to alleviate systemic liquidity

[26] EU, Directive No 2024/927 as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by alternative investment funds, March 2024.

risks stemming from synthetic leverage by improving market transparency and reducing the procyclicality of margin calls. Several regulatory measures could achieve this:

- **Transparent and predictable margin calls:** Improving 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 models 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, CCPS must provide additional public disclosures regarding their margin models to allow market participants to incorporate them in their stress testing exercises. It is equally important to ensure that clearing members' collateral policies are sufficiently transparent to those investors who 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. While the recent *BCBS-IOSCO reports on central counterparty transparency and responsiveness*[27] are a welcome development, insufficient progress has been made in the variation margin space.

- **Expanded list of eligible CCP collateral:** Currently, market participants need to hold cash, or other short-term financial instruments, to meet variation margins. 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 regard, 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).[28] The FSB must promote international convergence in this respect.

- **Repo market accessibility for 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 partially retreated from bond repo transactions just as demand for cash increased. This called into question the well-functioning of repo markets and illustrated the necessity to incentivise banks better to provide liquidity during periods of stress.[29] Greater guidance from banking regulators on when and how banks can deploy these buffers would contribute significantly to the resilience of capital markets. Moreover, certain retail funds such as UCITS cannot use repo transactions to transform their assets into cash to meet margin calls.[30] In view to prevent future 'dashes for cash', it is crucial to change this situation.

Conclusion

In the final recommendations, the FSB should focus on ensuring that jurisdictions develop domestic frameworks that allow supervisory authorities to monitor and mitigate the build-up of leverage. These

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[27] BCBS/CPMI/IOSCO, Final report on transparency and responsiveness of initial margin in centrally cleared markets – review and policy proposals, January 2025; BCBS/IOSCO, Final report on streamlining variation margin processes and initial margin responsiveness of margin models in non-centrally cleared markets, January 2025; CPMI/IOSCO, Final report on streamlining variation margin in centrally cleared markets – examples of effective practices, January 2025.
[28] CFTC, GMCA key recommendations, 8 February 2024.
[29] ICMA, The European repo market and the COVID-19 crisis, April 2020.
[30] Paragraph 43(j) form 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.

analytical frameworks should take a holistic approach and be empirically driven. The main systemic risk stemming from leverage is the imbalance between liquidity demand and supply during periods of stress, not the (collective) default of non-bank financial intermediaries.

Rather than promoting new macroprudential interventions, such as activity-based or concentration-related measures, the FSB should prioritise international convergence in regulatory approaches, supervisory reporting, oversight capabilities, and an enabling regulatory regime (e.g., facilitating the use of non-cash collateral and access to repo markets). A supervisory authority cannot properly calibrate its countercyclical interventions without these foundations.

EFAMA

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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