FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

Investment Company Institute

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 term NBFI covers a broad range of market participants, products, and services. It is important to distinguish between different financial vehicles and the regulatory frameworks that govern them when assessing systemic risks and vulnerabilities and establishing policies to mitigate identified systemic risks.

   While the Consultation provides an overview of general leverage risks, it does not account for NBFI participants' different leverage uses or their varied levels of risk. This approach could undermine, rather than support the FSB's financial stability goals. We therefore strongly encourage the FSB to revise the report to account for this variation in risk and calibrate the recommendations for sector-specific leverage risks.

   Our members are regulated funds that are comprehensively regulated, and the robust regulatory framework includes strict controls on leverage to ensure that the economic risk associated with a fund's use of leverage remains low. Management of leverage is fully incorporated as a

   component of broader risk management, with regulations providing comprehensive and specific obligations for managers that are subject to detailed oversight.

   Given the strict regulatory requirements, many regulated funds use little to no leverage. Some regulated funds use derivatives for portfolio management to hedge risks, improve efficiency, enhance liquidity, and reduce costs for shareholders. Regulated funds must comprehensively manage derivatives risks and comply with strict limitations on the resulting exposure to leverage.

   These guardrails prevent the build-up of leverage in the fund sector, making it very unlikely that regulated funds' use of leverage could pose a risk to financial stability.

   Data on global leverage trends further demonstrate that regulated funds' leverage is low. IOSCO compiles and analyses these data annually, and in the most recent report, found that "all leverage measures for [regulated funds] remain low," [1] which echoes the findings of earlier reports. IOSCO has further observed that regulated funds mainly have long

exposures to cash securities assets and that their "[t]otal borrowings represent a trivial amount in terms of the total NAV [net asset value]." [2] Similarly, the EC has noted that "on average EU [regulated fund]s are not highly leveraged." [3] In its annual report, CSSF states that Luxembourgish UCITS' "usage of leverage remain[s] generally low in comparison to the regulatory limit" and that UCITS' usage of reverse repo and securities lending is low. [4]

[1] IOSCO, 2023 Investment Funds Statistics Report (30 January 2024) at 25.

[2] IOSCO, 2022 Investment Funds Statistics Report (27 January 2023) at 27-28.

[3] EC, Targeted consultation document: assessing the adequacy of macroprudential policies for NBFI (22 May 2024) at 26.

[4] CSSF, UCITS Risk Reporting Dashboard (31 December 2023) at 7.

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?**

Monitoring leverage involves evaluating a wide range of instruments that arguably could create leverage in a variety of ways and requires looking at a variety of metrics. It is important to recognise that the use of certain instruments may reduce or offset existing leverage. Certain metrics that are appropriate for one type of investment strategy may be uninformative, less appropriate, or inappropriate for other investment strategies. Thus, a single metric cannot reflect the extent of leverage in all types of NBFI (or indeed all types of regulated funds) in a manner appropriate for regulatory monitoring. We agree that the appropriateness of measures for monitoring leverage may also vary across jurisdictions.

To assist meaningfully the evaluation of financial stability risks, any measure of leverage must focus on risk. Each measure should incorporate some form of risk assessment or adjustment. Risk assessments and adjustments may be imperfect and may continue to overstate a portfolio's true risk but ensuring that each measure considers some element of risk would reduce the likelihood of misidentifying entities that do not pose financial stability risks. [1] In this vein, IOSCO has developed a risk-based framework to facilitate monitoring leverage in investment funds across jurisdictions. [2]

In addition, regulated funds are transparent with their investments, including their use of derivatives. Regulatory frameworks also generally include requirements for regulated funds to report information regarding leverage data to supervisors and to make public disclosures regarding their expected level of leverage, including their derivatives usage in their prospectuses, shareholder reports, and financial statement disclosures. For example, US regulated funds are required to report data regarding their monthly portfolio investments to the SEC. [3] These data are extensive and include general information regarding total assets and liabilities, portfolio level risk metrics, and derivatives transactions and exposures. Funds also provide a specific schedule of portfolio investments, which includes data that is useful for supervising leverage regarding a fund's debt, reverse repurchase agreements, and derivatives transactions (if any).

[1] For this reason, we do not recommend that authorities look to metrics such as gross notional amount to monitor leverage risk. Summing the absolute notional values of transactions could overstate risk because the measure does not (1) differentiate between transactions that have the same notional amount, but whose underlying reference assets differ and entail potentially very different risks; (2) account for offsetting or hedging

transactions; (3) take into account the directionality of positions; or (4) provide a direct measure of risk or leverage in a reasonable or consistent manner.

[2] IOSCO, Recommendations for a Framework Assessing Leverage in Investment Funds: Final Report (13 December 2019).

[3] SEC, Form N-PORT.

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

   See response to Question 2.

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

   See response to Question 2.

   (iii) concentration and crowded trading strategies

   See response to Question 2.

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?**

   There is a tension between providing transparency through public disclosures and protecting regulated funds and their shareholders from those who may try to "front run" portfolio trades or take a "free ride" on the fund's intellectual property. The current approach in the U.S., where most information is made public quarterly, strikes an appropriate balance between providing information to investors and protecting funds and markets from opportunistic behaviour. Under this approach, regulated funds furnish disclosures regarding their expected level of leverage, if material, including through derivatives transactions, in their prospectuses, shareholder reports, financial statement disclosures, and other filings. These disclosures are tailored for each fund and include, if material:

   (a) types of derivatives transactions used;

   (b) extent of derivatives use;

   (c) purpose of using derivatives;

   (d) benchmark portfolio that is used; and

   (e) anticipated ways that the expected leverage level could materially exceed the limits and the impact on risk profile/volatility/strategy of the fund.

   Certain data related to a regulated fund's VaR calculations that are included in the monthly portfolio investment report are non-public, but the SEC makes public the vast majority of the data for every third month of a fiscal quarter, including the fund's full portfolio holdings. From

this information, the public can gain good insight into a fund's holdings and compute their own leverage ratios every quarter. Certain funds also voluntarily provide additional disclosure on a more frequent basis.

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?**

   Recommendations 4 and 5 identify a range of measures that could be used to monitor leverage in different sectors of NBFI. We recommend that further assessments to determine appropriate measures for monitoring leverage and to determine whether additional policies are needed to address leverage risks be sector specific. This will ensure that any established policies are appropriately designed to mitigate such risks. Please see our response to Question 20 for more detailed comments on the appropriate calibration of leverage policies for NBFI participants.

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?**

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?**

   We do not support dynamic changes to minimum margin and haircut requirements. If investors know that there is a risk that changes to a threshold are imminent, it is likely to spark a procyclical market response that exacerbates market stress. Instead, we recommend that the goal be to foster the resilience and integrity of the financial system through the promotion of fair, efficient, and transparent markets and price discovery.

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

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

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?**

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?**

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

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?**

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?**

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?**

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 our response to Question 4, we highlight the tension between providing transparency and protecting regulated funds and their shareholders from those who may try to "front run" portfolio trades or take a "free ride" on the fund's intellectual property. The current approach in the U.S., where most information is made public, strikes an appropriate balance between providing information to investors and protecting funds and markets from opportunistic behaviour. This approach includes limitations on disclosing non-public information to certain individuals or entities who may trade on the basis of the information, generally securities market professionals such as stock analysts or holders of the issuer's securities. These regulations limit disclosure of non-public portfolio holding information to third parties when the fund has a legitimate business purpose for doing so and the recipients are subject to a duty of confidentiality, including a duty not to trade on the public information. [1] Thus, U.S. regulated funds may be reluctant to divulge material non-public information about the fund to investors, prime brokers, and other counterparties because they often do not owe a duty to of confidentiality to the fund and do not typically enter into confidentiality arrangements with funds.

    [1] Examples of appropriate sharing include disclosure for due diligence purposes to an investment adviser that is in merger or acquisition talks with the fund's current adviser; to a newly hired investment adviser or sub-adviser prior to commencing its duties; or to a rating agency for use in developing a rating.

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?

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?**

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?**

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?**

We have concerns regarding the application of Recommendation 8 and the principle of "same risk, same regulatory treatment" to the entire broad spectrum of NBFI participants. While we appreciate the recognition in the Consultation that "[c]ongruent treatment should not imply identical treatment," [1] the approach is overly simplistic in this context and could result in outcomes that frustrate the FSB's goal of reducing systemic risk.

Different NBFI sectors use leverage differently and therefore different risks and levels of risk are associated with the use of leverage. Given this variance, we encourage the FSB to amend the one-size-fits-all approach to leverage across all NBFI participants so that the recommendations are calibrated to sector-specific leverage risks. Overly broad policies that distort the market and discourage investment in regulated funds risk potentially driving capital to less-regulated, higher risk channels and undermining rather than supporting financial stability. A more tailored approach also can be more effective, mitigating the potential for policies that are redundant and/or conflict with existing, more detailed rules in some sectors.

To be clear, as our members are significant investors and participants in the global markets, ICI has a keen interest in ensuring that financial regulators have the ability to monitor for and address potential risks to financial system stability. The Consultation's examples demonstrate the history of past systemic crises arising when financial institutions have taken on excessive leverage. [2] We therefore strongly support the goal of facilitating more meaningful monitoring of leverage, including for financial stability purposes.

[1] Consultation at 30.

[2] ICI has supported authorities' ability to more meaningfully monitor leverage, since virtually all earlier systemic crises have arisen because of excessive leverage. See, e.g., ICI, Letter from Paul Schott Stevens to Secretariat of the FSB, Re: Consultative Document; Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (21 September 2016).

The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

28 February 2025

Financial Stability Board
Centralbahnplatz 2
Basel CH-4002
Switzerland

Submitted electronically in response to online form and by email

Re: *Leverage in Non-Bank Financial Intermediation*

Dear Financial Stability Board Secretariat:

The Investment Company Institute[1] is submitting its views on the Financial Stability Board's (FSB) consultation on leverage in non-bank financial intermediation (NBFI).[2] Our responses to the Consultation specifically address mutual funds, UCITS, and related fund structures that our members manage,[3] which are integral in supporting economic growth, fostering capital formation, and providing the benefits of collective investment to a wide range of investors, particularly long-term individual investors.

As discussed in our attached responses to the Consultation's questions, we note as an overarching theme, that the activities of NBFIs, including regulated funds, cover a broad range of market participants, products, and services. It is important to distinguish between different financial vehicles and the regulatory frameworks that govern them when assessing systemic risks and vulnerabilities and establishing policies to mitigate identified systemic risks.

NBFI participants do not use leverage identically, and different risks and levels of risk are associated with these varied uses. However, the proposed recommendations would apply to all NBFI participants, without accounting for the diversity of risks, an approach that could undermine, rather than support the FSB's financial stability goals. We therefore encourage the FSB to revise the report to account for the variation in risk and amend this one-size-fits-all

[1] The Investment Company Institute (ICI) is the leading association representing the global asset management industry in service of individual investors. ICI members are located in Europe, North America and Asia and manage fund assets of $47.8 trillion, including UCITS, mutual funds, exchange-traded funds (ETFs), closed-end funds, unit investment trusts (UITs) and similar funds in these different jurisdictions. ICI has offices in Brussels, London, and Washington, DC.

[2] FSB, Leverage in Non-bank Financial Intermediation (18 December 2024) (the Consultation).

[3] Collectively referred to herein as regulated funds.

approach to leverage policy so that the recommendations are calibrated to sector-specific leverage risks.

Our members are regulated funds that are comprehensively regulated, and the robust regulatory frameworks include strict controls on leverage to ensure that the economic risk associated with a fund's use of leverage remains low. Management of leverage is fully incorporated as a component of regulated funds' broader risk management, with regulations providing comprehensive and specific risk management obligations for regulated fund managers that are subject to detailed oversight requirements. These guardrails prevent the build-up of leverage in the regulated fund sector, making it very unlikely that regulated funds' use of leverage could pose a risk to financial stability.

For example, in the U.S. and E.U., regulated funds' ability to take on debt, use reverse repurchase agreements, and enter into derivatives transactions is significantly constrained. In addition, regulated funds generally are prohibited from engaging in the types of leverage activities under scrutiny in the Consultation.[4] This underscores the importance of distinguishing NBFI participants when assessing risk, rather than collapsing these diverse participants into a single category, based on the non-risk-based distinction of whether they are or are not a bank.

Given the strict regulatory requirements, many regulated funds use little to no leverage. Some regulated funds use derivatives as important and practical portfolio management tools that can hedge risks, improve efficiency, enhance liquidity, and reduce costs for their shareholders. Like borrowing and the use of reverse repurchase agreements, regulated funds must generally comply with strict limitations on the resulting exposure to leverage from the use of derivatives and must comprehensively manage derivatives risks.

To be clear, as our members are significant investors and participants in the global markets, we support the FSB's focus on leverage. ICI has a keen interest in ensuring that financial regulators have the ability to monitor for and address potential risks to financial system stability and there is a long history of systemic crises arising when financial institutions have taken on excessive leverage.[5] It is highly unlikely, however, that these concerns will stem from regulated funds.

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[4] The Investment Company Act limits mutual funds in the U.S. to only borrowings from banks and requires them to maintain assets after the borrowing of at least 3 times the borrowing (*i.e.*, at least 300 percent asset coverage, commonly referred to as 33 percent leverage). These funds must treat reverse repurchase agreements and other similar financing transactions consistent with asset coverage requirements for borrowings or treat them as derivatives pursuant to a value-at-risk (VaR) test, described briefly below

In the E.U. the UCITS Directive requires borrowings to be temporary and they cannot exceed 10 percent of total assets. To enter into reverse repurchase agreements, a fund must be able to recall the assets or the full amount in cash at any time.

In both the U.S. and E.U., regulated funds using derivatives must adhere to limits based on a VaR test and must test their compliance with the mandated limits at least daily. VaR measures provide an indication of whether a fund is using derivatives to leverage a fund's portfolio. These tests are designed to restrict leverage risk based on the potential for extreme but infrequent losses, for example, by calculating the maximum potential loss within a period of approximately one month that has a 1 percent chance of occurring (*i.e.*, using a 99 percent confidence interval).

[5] In addition to these examples, ICI has supported authorities' ability to more meaningfully monitor leverage, since virtually all earlier systemic crises have arisen because of excessive leverage. *See, e.g.,* ICI, Letter from Paul Schott

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We appreciate your consideration of ICI's comments. If you have questions or would like to discuss our comments further, please contact me or Kirsten Robbins.

Sincerely,

/s/ Tracey Wingate

Tracey Wingate
Head of Global Affairs
Investment Company Institute

Attachment Investment Company Institute Response to Leverage in Non-bank Financial Intermediation

Stevens to Secretariat of the Financial Stability Board, Re: Consultative Document; Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (21 September 2016).

Investment Company Institute Response to Leverage in Non-bank Financial Intermediation

Questions without a response have been omitted.

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?***

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These guardrails prevent the build-up of leverage in the fund sector, making it very unlikely that regulated funds' use of leverage could pose a risk to financial stability.

Data on global leverage trends further demonstrate that regulated funds' leverage is low. IOSCO compiles and analyses these data annually, and in the most recent report, found that "all leverage measures for [regulated funds] remain low," [1] which echoes the findings of earlier reports. IOSCO has further observed that regulated funds mainly have long exposures to cash securities assets and that their "[t]otal borrowings represent a trivial amount in terms of the total NAV [net asset value]." [2] Similarly, the EC has noted that "on average EU [regulated fund]s are not highly leveraged." [3] In its annual report, CSSF states that Luxembourgish UCITS' "usage of leverage remain[s] generally low in comparison to the regulatory limit" and that UCITS' usage of reverse repo and securities lending is low. [4]

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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?***

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To assist meaningfully the evaluation of financial stability risks, any measure of leverage must focus on risk. Each measure should incorporate some form of risk assessment or adjustment. Risk assessments and adjustments may be imperfect and may continue to overstate a portfolio's true risk but ensuring that each measure considers some element of risk would reduce the likelihood of misidentifying entities that do not pose financial stability risks. [1] In this vein, IOSCO has developed a risk-based framework to facilitate monitoring leverage in investment funds across jurisdictions. [2]

In addition, regulated funds are transparent with their investments, including their use of derivatives. Regulatory frameworks also generally include requirements for regulated funds to report information regarding leverage data to supervisors and to make public disclosures regarding their expected level of leverage, including their derivatives usage in their prospectuses, shareholder reports, and financial statement disclosures. For example, US regulated funds are required to report data regarding their monthly portfolio investments to the SEC. [3] These data are extensive and include general information regarding total assets and liabilities, portfolio level risk metrics, and derivatives transactions and exposures. Funds also provide a specific schedule of portfolio investments, which includes data that is useful for supervising leverage regarding a fund's debt, reverse repurchase agreements, and derivatives transactions (if any).

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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? (ii) specific types of entities, such as hedge funds, other leveraged investment funds, insurance companies and pension funds? (iii) concentration and crowded trading strategies?***

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