FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

Invest Europe

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?

We broadly agree with the FSB's description of financial stability risks and we do not believe the ECB has omitted any specific vulnerabilities.

We would like to use the opportunity of this question to inform the ECB about the private equity asset class and how its interaction with lenders, whether banks and private credit, can pose (or not) financial stability concerns.

Private equity managers do not, through their funds, lend to the companies in which they have invested equity, nor do they increase the fund's exposure by borrowing capital to make the investment. As a result, private equity funds are generally unleveraged, something that is reflected in data collected by national competent authorities.

There will be a few instances where debt will be used in a private equity context:

- When debt is provided to portfolio companies in which private equity firms have invested

Banks or private credit funds may provide debt to private equity deals to finance the buying of a portfolio company (the "buyout" model). Importantly, such debt is economically provided to a corporate – the portfolio company in which the fund has invested - and not to the private equity fund itself. Moreover, any portfolio company group in which a fund has invested is managed independently. Even if a private equity fund is unsuccessful in its investment strategy, it does not pose contagion risk or have systemic risk implications in the same way as entities which are strongly inter-connected might. Importantly, such lending is under severe scrutiny from the regulator in the European Union, to the extent it has made it impossible for banks to lend to certain types of buy-out backed businesses irrespective of the fundamentals of these businesses.

- When debt is provided to the fund or to portfolio companies to help liquidity

Banks and private credit may provide lending to facilities:

o that "bridge" the time between the equity capital calls to the fund's investors the actual investments (subscription line facilities) o that are designed to avoid early exits in a difficult business environment or to support their portfolio companies' liquidity needs and fund their growth

When such a debt is provided, this is under strict conditions and under the oversight of the fund's institutional investors (and in the case of subscription line facilities backed by uncalled commitments). Some of these tools have been in place since the start of the industry, some have been developed more recently, such as NAV facilities. With the exception of the latter, none of the aforementioned uses of debt will typically qualify as leverage when utilized by a private equity fund manager. An important element for NAV facilities is that the loan to value ratio remain very low, meaning these deals, which are captured as leveraged under EU reporting rules, remain conservative by nature.

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?**

Leverage metrics remain important to assess the risks posed by fund managers. Entity-based measures, such as leverage limits at firm level, are relevant tools to determine whether significantly leveraged funds are posing a concern.

Developing further stress tests should not lead to additional requirements for firms that have already had to devote significant resources to reporting, including reporting to the banks and to credit funds in the context of existing legislation.

Most importantly, it would be important for stress tests to bring meaningful comparison. For example, the level of leverage of a closed-ended fund at the beginning of the life of the fund may artificially appear much larger than the one of an open-ended, without this representing a similar level of risk for the lender. This is because committed capital from investors that has not yet been drawn (i.e. undrawn investor commitments) is not reflected in the net asset value of the fund and therefore, interim borrowing creates an impression of exposure that does not exist. This form of borrowing is typical in the private equity industry - for quicker ways to finance investment opportunities than drawing down capital from existing investor commitments - and therefore is a common trend across closed-ended fund structures. Would stress tests not take this into consideration, we fear this could skew significantly the results of the exercise, to the detriment of its efficacy.

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

We find that leverage metrics remain the most valuable tools to determine the level of leverage of investment funds.

On this, we would like to flag that leverage metrics may sometimes give the impression to regulators that some ratios, such as the gross leverage ratio (~the AIFMD gross method) and the net leverage ratio (~the AIFMD commitment method), can result in high percentages even for what the industry considers to be relatively modest levels of leverage, i.e. 175% or 300% is a relatively low amount and is often mistaken as to be 1.75x or 3x leverage.

The FSB should acknowledge that to rely on any leverage metrics reported, the methodology for calculating such metrics must be appropriately identified and understood so that the output is reliable data for monitoring financial stability. Such methodology should primarily focus on net exposure to the risk of loss in light of the activities of the investment fund as a whole.

(iii) concentration and crowded trading strategies

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?**

   Companies seeking to raise capital from the public are generally required to disclose and report to their investors and prospective investors, i.e., the public. By contrast, private companies that raise capital by marketing to specific investors are not required to provide the same disclosure to the wider public, although they will of course provide information to these investors and finance providers, as they are bound by a duty of confidentiality to their investors. The same logic of course applies to private funds as opposed to public funds.

   The FSB should continue to acknowledge that forcing private fund managers to disclose public information could have significant consequences on the functioning of their industry, and affect the much needed confidentiality of deals.

   This is not to say that private fund managers, whether they raise capital from the public or not, should not be required in many (or most) jurisdictions to make non-public disclosures to regulators, if regulators need such information to make decisions, and obviously to their investors, something that is already well in place either through existing market mechanisms or through regulatory requirements in European jurisdictions.

   Similarly, regulators should be careful in asking information in a frequency that is meaningless for certain types of funds. In a private equity context, it is not rare that NAV figures are only updated infrequently given the illiquidity of asset classes and the lack of frequent transactions. Private equity funds typically invest in long-term assets and do not make use of leverage for price discrepancy arbitrage strategies in the same way as hedge funds. This also means that they are not exposed to the same types of risk, for example, fire sales to generate liquidity for meeting collateral or margin calls.

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?**

   NA

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?

We agree with the FSB that leverage limits at entity level can be a good solution. However, imposing these limits without appropriate (a) understanding of the methods to calculate leverage and (b) grandfathering could also cause a concern for closed-ended funds.

The situation of credit funds in the new AIFMD loan origination rules has shown that often the introduction of new rules can have a detrimental impact on a closed-ended fund structure and deals. Specific care should therefore be for the rules to start applying in a way that takes into account the situation of the fund, at the risk of developing rules that, at least for a time, could be counterproductive. In particular, the rules should take into account that closed-ended funds are typically not fully drawn at the beginning of the life of the fund, which is relevant to the risk profile of the fund but not reflected in its net asset value. Undrawn commitments should therefore be taken into account as part of any additional measures for a more accurate picture of leverage of closed-ended funds.

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?**
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?**

The calibration of entity-based measures needs to balance risk mitigation with avoiding restrictions on beneficial aspects of NBFI leverage, such as bona fide hedging activities.

Authorities should certainly consider a suite of toolkit metrics to identify and monitor vulnerabilities related to NBFI leverage. In the EU, methods used are often too simplistic to assess whether a fund is actually causing a concern, creating a situation where many funds posing little risk are considered levered, which leads to situations where regulators do not concentrate on the riskier types of activities. For example, managers subject to AIFMD, report leverage to regulators (and investors) using the gross and commitment methods, in accordance with the Level 2 regulations. These are very technical methods for calculating leverage, particularly with respect to how they apply to undrawn commitments with respect to closed-ended fund structures, which must be properly understood by policymakers when considering measures for monitoring financial stability.

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?**

    NA

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?**

    The FSB should acknowledge that managers are already subject to intense scrutiny, including from the need to give their lenders information required under law to these lenders. It is unclear how additional data could represent a real improvement to the current data. On the contrary, we know from experience that regulators do not already make use of the entire set of data that is at their disposal.

    We would therefore rather suggest streamlining and operationalising the information that needs to be and is already available to regulators, instead of creating new data points that would mirror the ones already available.

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?**

    As noted above, the FSB should acknowledge that dual regulation of managers who are subject to existing regulatory disclosures and requirements, particularly around leverage, should be avoided. In the first instance, regulators should make use of the information already reported and available to them under existing regimes.

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?**

    The principle is sound, but as noted above, we feel that there is significant work to be done by authorities to ensure that rules that are comprehensive remain meaningful. Applying the exact same requirement to every manager irrespective of the specific features of fund (for example applying the same leverage rules to closed-ended and open-ended funds) can lead to different outcomes.

    It is also unclear how the FSB could determine what is effectively the "same risk" for two entities with very different business models. It would perhaps be more meaningful to think about "same effect" on financial stability, as opposed to overall perceived level of risk.