FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

Investment Association

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 IA recognises that leverage, if not properly managed, can be a factor in financial stability risks – in particular, the presence of high leverage in the financial system can amplify the effects of systemic risks in stressed market conditions. Leverage can be difficult to measure accurately and meaningfully, especially synthetic leverage that arises from the use of derivatives. This means that competent authorities such as central banks and securities regulators do not always have full transparency of the risks posed by all market participants.

Since the 2008 global financial crisis (GFC), competent authorities have sought to mitigate solvency risks arising from global derivatives markets through moving more transactions to central clearing and introducing margin (initial and variation) and reporting requirements. These measures have undoubtedly reduced counterparty risk in the system, but have increased liquidity risks, as in times of stress counterparties often have to liquidate assets in order to meet margin payments. These second order risks are often attributed to leverage although do not arise directly from leverage. It is the IA's long held view that margining practices and requirements need to be revisited to mitigate some of the liquidity risks that have emerged from margining requirements, eg allowing more asset types to be posted as margin.

The description of the financial stability risks from leverage in NBFI is not wholly accurate or comprehensive. The narrative suggests that NBFI leverage was a causing or dominant factor in each of the crises mentioned. With the exception of the Archegos episode, this was not the case. Each of the events described were originated and primarily driven by externa shocks that originated outside the financial system. The market turmoil in March 2020 was driven primarily by the rapid shutdown of economies by governments in the face of a global pandemic, and uncertainty around the outcome. Though asset sales to meet margin calls to unwind leveraged positions, market volatility in this period can be as much attributed to other causes, such as market repricing of risks due to increased uncertainty in the event of the pandemic and operational challenges, particularly traders needing to switch to trading from their mobiles without their colleagues immediately on hand to consult, Heads of Desk to confirm risk limits, and a lack of access to essential market information. It is disingenuous to think that had leverage levels been lower we would not have seen a similar level of market turmoil, given the nature of the global pandemic.

Similarly, the Commodities crisis in March 2022 can ultimately be attributed to the supply shock arising from the Russian invasion of the Ukraine. While the role that leveraged Liability Driven Investment (LDI) strategies played in the September 2022 UK gilt market turmoil is certainly apparent, the turmoil was a reflection of the structural issues within the long-dated index linked gilt markets.

The Archegos collapse can be more readily attributed to the excessive leverage deployed in its investment strategies across multiple prime brokers. Even then, this was very much the actions of a single family office, subject to little regulation and led by an individual who was subsequently convicted of fraud, not a series of participants. It worth also noting that Paul, Weiss' report commissioned by Credit Suisse found that although risk controls and processes were followed, and information on these risks was obtained, senior managers persistently failed to address risks connected with trades made by Archegos – "the business was focused on maximising short-term profits and failed to rein in, and, indeed, enabled Archegos' voracious risk-taking" . The Archegos case has rightly been scrutinised by authorities seeking to understand how future risk events can be mitigated, but we caution against attributing too much from the actions of one non-regulated entity, since found to have committed criminal offences, and applying these to other more tightly regulated NBFI entities.

Overall, we recommend that at this stage the FSB and other international standard setters focus more on improving their knowledge and understanding of leverage across the whole NBFI sector, concentrating in particular on those areas that are more lightly regulated or not regulated at all. We caution against implementing market wide policies that may not only fail to mitigate perceived risks arising from leverage but may have other damaging consequences, such as a decline in the use of derivatives for risk mitigation purposes.

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?**

Metrics must be selected that are meaningful and measure the risk effects arising from leverage, not just the level of activity being undertaken. As the consultation report acknowledges, derivatives are used by market participants, including asset managers, for a range of purposes that do not increase the incremental risk exposure, such as to mitigate portfolio risks or to gain efficient market exposure. The measures used need to distinguish between synthetic exposure from derivatives use that incrementally increases market exposure and use that does not increase market exposure or event reduces portfolio risks.

Gross measures of leverage are relatively straight-forward to calculate, but they do not distinguish between these uses. Nor do they consider directionality. Gross financial (or balance sheet) leverage typically reflects fairly accurately additional leverage arising from borrowing, where this is used for investment purposes and not temporary borrowing used for operational purposes such as cash flow management. But gross synthetic leverage can at best identify the level of derivative use, either within a product, by an entity or in aggregate. It will not give an accurate picture of the overall risk – the lack of consideration of directionality typically results in the economic exposure arising from the derivatives being significantly overstated.

Adjusted gross leverage, which adjusts the notional exposure of interest rate derivatives by duration, only partially reduces this overstatement. Reliance on these metrics for any purposes beyond identifying where derivatives activity is taking place, and the size of that activity, could result in damaging measures that overly restrict the use of derivatives for risk mitigation and efficient portfolio management purposes, such as hedging.

Net measures, such as the commitment approach used in the UK and EU's Alternative Investment Fund Manager Directive (AIFMD), provide a more accurate, if not perfect, measure of the true economic exposure arising from the use of derivatives. These therefore provide a better indication of the true risk exposure of a fund. They are, however, more difficult to calculate, as transactions have to be assessed for their directionality, and whether these are offsetting risks in the portfolio. For some NBFI entities or products that are not using derivatives to a material extent, a net calculation may not be necessary or proportionate.

Risk-based measures such as absolute and relative Value-at-Risk (VAR), although not strictly speaking a measure of leverage, have also proved effective at managing overall global exposure limits where derivatives are used more extensively, notably in the Undertakings for Collective Investment in

Transferable Securities (UCITS) Directive. Once modelled, the risk exposure of the portfolio can be readily monitored to ensure this is contained within defined limits.

The US, the EU and the UK, along with a number of other jurisdictions, already have reporting frameworks in place to gather information on leverage on investment funds, hedge funds and other asset management activities, and most have frameworks for other highly regulated NBFIs such as insurers and pension funds. With appropriate information sharing mechanisms in place, these should already provide strong information to central authorities and standard setting bodies on the extent of leverage and where it being deployed by highly-regulated NBFIs. Introducing new measures will be highly disruptive to existing regimes, requiring extensive system changes and process development, in addition to client education. Unless new measures represent a demonstrable improvement to all stakeholders, we suggest the focus should be on utilising existing metrics that are reported, and identifying and focusing on less regulated areas of NBFI where there is less visibility and a lack of reporting.

Finally, the IA considers that authorities and standard setting bodies continue to use the two step approach set out by IOSCO in its 2019 Final Report on Recommendations for a Framework Assessing Leverage in Investment Funds . This allows the majority of investment funds, which do not employ leverage to any significant extent, to be screened out. Regulators can then focus on more advanced screening of those funds that employ leverage to a significant extent (usually considered in EU/UK frameworks to be three times leverage or more using the commitment method). This approach has been operationalised in Europe under Article 25 of the AIFMD. Although the specifics of each NBFI sector would need to be properly assessed, the two step model may provide the basis for assessing leverage in other sectors and ensuring the focus is on areas of high leverage.

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

As noted in our response to question 2, the IA considers the existing leverage measures for investment funds used in the EU to be adequate.

For market wide measures, such as concentration and crowded trading strategies, we suggest that better utilisation is made of existing market reporting frameworks, particularly in respect of derivatives reporting (eg EMIR in Europe), transaction reporting (eg MiFID transaction reporting) and securities financing transactions reporting (eg SFTR), the latter of which captures key transactions such as derivatives. This, complemented by manager/fund level reporting such as AIFMD Annex IV reporting, should enable regulators to identify concentration risks in the market.

Global agreements and mechanisms should be established to allow information to be more readily shared between different authorities and regulators, at least in aggregated form. In addition to removing barriers to information sharing, the IA also reiterates its long-standing support for inclusion of Legal Entity Identifiers (LEIs) to be mandatory in all regulatory reporting. LEIs have become widely established and accepted, and the inclusion of these will make it easier for authorities to analyse risks that affect particular entities, or groups of entities across a range of reported information, without having to impose additional reporting requirements on asset managers and other NBFIs already subject to extensive regulatory reporting.

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

As noted in our response to question 2, the IA considers the existing leverage measures for investment funds used in the EU to be adequate.

For market wide measures, such as concentration and crowded trading strategies, we suggest that better utilisation is made of existing market reporting frameworks, particularly in respect of derivatives reporting (eg EMIR in Europe), transaction reporting (eg MiFID transaction reporting) and securities financing transactions reporting (eg SFTR), the latter of which captures key transactions such as derivatives. This, complemented by manager/fund level reporting such as AIFMD Annex IV reporting, should enable regulators to identify concentration risks in the market.

Global agreements and mechanisms should be established to allow information to be more readily shared between different authorities and regulators, at least in aggregated form. In addition to removing barriers to information sharing, the IA also reiterates its long-standing support for inclusion of Legal Entity Identifiers (LEIs) to be mandatory in all regulatory reporting. LEIs have become widely established and accepted, and the inclusion of these will make it easier for authorities to analyse risks that affect particular entities, or groups of entities across a range of reported information, without having to impose additional reporting requirements on asset managers and other NBFIs already subject to extensive regulatory reporting.

(iii) concentration and crowded trading strategies

As noted in our response to question 2, the IA considers the existing leverage measures for investment funds used in the EU to be adequate.

For market wide measures, such as concentration and crowded trading strategies, we suggest that better utilisation is made of existing market reporting frameworks, particularly in respect of derivatives reporting (eg EMIR in Europe), transaction reporting (eg MiFID transaction reporting) and securities financing transactions reporting (eg SFTR), the latter of which captures key transactions such as derivatives. This, complemented by manager/fund level reporting such as AIFMD Annex IV reporting, should enable regulators to identify concentration risks in the market.

Global agreements and mechanisms should be established to allow information to be more readily shared between different authorities and regulators, at least in aggregated form. In addition to removing barriers to information sharing, the IA also reiterates its long-standing support for inclusion of Legal Entity Identifiers (LEIs) to be mandatory in all regulatory reporting. LEIs have become widely established and accepted, and the inclusion of these will make it easier for authorities to analyse risks that affect particular entities, or groups of entities across a range of reported information, without having to impose additional reporting requirements on asset managers and other NBFIs already subject to extensive regulatory reporting.

Recommendation 3

4. **What types of publicly disclosed information (e.g. transaction volumes, outstanding amounts, aggregated regulatory data) are useful for market participants to enhance their liquidity or counterparty credit risk management? Are there trade-offs in publicly disclosing such information and, if so, what would be the most important elements to consider? What is the appropriate publication frequency and level of aggregation of publicly disclosed information?**

While the IA broadly welcomes proposals to increase trade transparency, including the development of a consolidated tape for equity and fixed income markets in the EU, we have concerns on proposals to publicly

disclose information relating to factors such as market concentration. Publicly disclosing levels of concentration, or susceptibility of particular asset classes or products to redemptions caused by margin calls could trigger the types of events such as market withdrawals that central authorities and regulators are seeking to avoid. It could also allow some informed investors to trade against other investors subject to regulatory constraints that force them to hold particular assets or pursue particular strategies, or discourage some potential investors from entering that market. Asset managers have a fiduciary duty to act in the best interests of their clients and should not be required to make public disclosures that potentially harm the interests of their clients.

Initiatives to improve the transparency of market transactions, such as the development of a consolidated tape in markets where this is not yet available, are to be supported. The IA also considers that transparency improvements could also improve liquidity in short-term funding markets, which are critical for the Money Market Funds (MMFs) which are used by many NBFIs for holding liquidity.

Nonetheless, the broader implications of public information disclosure should be properly examined before any recommendations are made around the public disclosure of information related to risk factors such as concentration. We consider that it would be preferable for central authorities and regulators to monitor these, and if they discover potential concentrations or crowded trading strategies in particular markets, these are fed back discretely to market participants who are immediately impacted so mitigating measures can be agreed and enacted in a controlled manner that avoids any shocks.

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?**

   There are areas in these recommendations that need clarification. For example, where the recommendations refer to entity-based measures, it is not clear whether the intention is to target certain NBFIs such as asset managers or the products or mandates they are managing. While the asset manager might interface with the market, it is not typically the asset manager entity where risks arise. Asset managers use an agency based model, and rarely have any exposure on their own balance sheets. Typically these remain either with their client, whose mandate they are managing, or a the level of the product they are managing, such as an investment fund. An asset manager with a large market footprint does not necessarily pose a larger risk at the asset manager entity level than a smaller one – this will come down to the nature of the activities they are undertaking, and the level at which those risks. Entity-level measures aimed at the asset manager would therefore have minimal impact on reducing systemic risks while constraining the activities and services provided by those asset managers, potentially leaving them at a disadvantage to others.

   A careful clarification is therefore required when referring to entity-level measures, as to what is the entity the measures are aimed at. In the case of asset management, the appropriate entity for any measures is likely to be at product-level, for example the real estate fund leverage limits or LDI yield buffers referenced in the consultation, so it would arguably be more appropriate to refer to these as product-level measures. Of course, this consideration is likely to vary significantly between different NBFI types.

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 do not agree with all of the activity-based measures being proposed, which do not take into consideration the differences between types of NBFIs and the risks they pose. These measures may be counterproductive. Minimum haircuts in SFTs, including government bond repos, will increase frictions for NBFIs seeking to access repo markets and increase costs for them. The recent report by the Bank of England on its System Wide Exploratory Scenario (SWES) Exercise identified the central importance to supporting core markets in times of stress. We also consider that increasing mandatory central clearing in SFTs and derivatives markets is likely to be counterproductive, at least in the short term. Moving repos to mandatory central clearing is likely to significantly increase the costs and complexity of these transactions, noting that many of these are for short maturities, such as overnight. We suggest that the impact of moving US Treasury Repos to central clearing be explored before extending mandatory clearing to other jurisdictions, and the features of those markets, which will likely differ from the US, be properly considered before determining whether a model in the US can be applied in those jurisdictions. Central clearing will increase liquidity demand, which can already be strained, with no provision for additional liquidity supply. For example, there are not the same options to store and transfer liquidity through reverse repo and sponsored repo programs in Europe that there are in the US. In a similar vein, we do not see an argument for enhanced margining requirements between NBFIs specifically and their derivatives counterparties, over and above those already in place in leading jurisdictions such as the US and Europe (EU and UK).

A more productive approach would be to consider reforms to margining that make it easier for regulated NBFIs to pose a broader range of assets as collateral, so collateral can be provided without the second order effects that arise from the sale of assets in key markets. In the Bank of England's SWES report, it noted that insurers in particular had been able to negotiate "dirty" CSAs, which allowed them to post assets as collateral in non-cleared derivatives transactions, which reduced selling pressures in the stress scenario. Broadening the ability of regulated NBFIs to use similar CSAs would contribute to reducing the amplification effect that margin calls can create in stressed market conditions. New technologies, such as tokenisation of assets, could facilitate the efficient posting of assets as collateral. The IA published a case study of the potential use case of tokenised MMFs for posting collateral in March 20244.

The IA also supports enhancing transparency in margin calculation methodologies by CCPs and non-cleared counterparties. These would allow NBFIs to better anticipate collateral needs in times of stress. Increasing the transparency of margining models would reduce uncertainty in times of stress, allowing NBFIs to better prepare for margin calls without holding excessive liquidity levels that create cash drag, and would avoid excessive selling of assets in times of stress that are higher than needed to meet margin calls. It would also allow for more accurate stress testing of portfolios and derivatives exposures.

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 consider dynamic approaches to minimum margin and haircut arrangements set by regulators to be a feasible measure. This would require mechanisms to enable the transfer of information, analysis, coordination and decision-making at authority level at a speed that seems unlikely to be achievable in the

short term. Moreover, the possibility of dynamic margin and haircut arrangements could be pro-cyclical under stressed market conditions, driving market behaviour and increasing selling pressure, particularly if NBFIs anticipate minimum margin and haircuts increasing and sell up assets to shore ready liquidity.

The IA notes that it is already common practice for bank counterparties to impose margin and haircut addons in non-cleared transactions based on risk factors such as concentration. However, the bank counterparty has more immediate access and knowledge of the NBFI counterparty, its relative footprint, the regulatory requirements it is subject to, and other relevant risk information that it can use to make a judgement. Different counterparties are likely to make different decisions, based on their assessments, hence a market-wide impact is less likely. It is difficult to see how dynamic margin and haircut requirements could not be indiscriminate and affect wider behaviour, would could exacerbate rather than mitigate systemic risks.

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

Please refer to our responses to questions 6 and 7.

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

We do not have a specific comment on this question – both the setting of margin levels and haircuts are part of the overall margining framework, the first with the intention to cover counterparty risk, the second to allow for potential losses on the value of assets being held as collateral in the event they have to be liquidated. We do however consider that the current margining frameworks, for example in EMIR, are sufficient.

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?

We consider that direct and indirect leverage limits should only be deployed where particular risks require these measures. We do not consider that direct or indirect leverage limits should be applied across all NBFIs, only where risks are identified that justify the application of limits.

As noted in our response to question 5, it is important that the recommendations are clear on what the entity is. For example, we would not expect leverage limits to be applied to asset manager entities, who are managing assets as agents either for other clients, or within products such as investment funds. Imposing leverage limits on asset manager entities themselves based on some strategies they manage might constrain the asset manager in respect of other products and service they offer and put that asset manager at a competitive disadvantage. In respect of asset management, product-level measures may be a better descriptor.

A number of regulated fund frameworks already limit leverage directly or indirectly, particularly those for retail investors. For example, the EU UCITS Directive does not allow borrowing, except under a derogation that allows temporary borrowing for operational purposes only, and limits the global exposure from derivatives to the value of the scheme property. Typically, only funds that are restricted to professional investors are not restricted by the amount of leverage they are able to deploy, and even in the case of those funds, they will normally specify their own maximum levels of leverage in their constitutional documents or their fund rules. The EU and UK AIFMD frameworks, under which non-UCITS funds in the EU and UK must comply, require a risk management function to be established that is independent of the portfolio management function, and for the AIFM to have strong risk management policies in place in respect of the management of key risks such as liquidity management and leverage.

We therefore consider that it is only a small number of cases in asset management, or in respect of investment funds, which will require direct or indirect leverage limits to be deployed. Article 25 of the AIFMD allows national competent authorities to impose restrictions on leverage, either directly or indirectly, in respect of an AIF or a cohort of AIFs, whether managed by the same or different AIFMs, where the leverage used in the investment strategies of these funds poses financial stability risks. This article has been deployed by regulators in Ireland and Luxembourg – the former in respect of limiting leverage and redemption terms of domestic real estate funds, and both regulators in terms of imposing yield buffers on Liability Driven Investment (LDI) funds.

The IA does not consider that it would be appropriate to impose leverage limits across all NBFI types. Any proposals to impose direct or indirect leverage limits on any particular NBFI, or group of NBFIs, will require careful assessment of the particulars of individual cases. There is a danger of focusing leverage limits on those NBFIs where there is greater regulatory transparency, which are likely to be those NBFIs that are already highly regulated and already have robust systems and controls and strong risk management frameworks. If these are inappropriately targeted with leverage limits, there is a risk that alternative solutions may be found that would allow for the adoption of similar strategies in less regulated vehicles, creating more risks for the financial system that are less visible to regulators.

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?

As noted in our response to question 10, we consider that entity-based measures should only be adopted where significant leverage risks have been identified for particular NBFIs or groups of NBFIs, and should be calibrated based on detailed assessments of the risks posed in those particular products. These should be limited to sectors that are employing net leverage on a significant basis. In particular, these should not impose any restrictions on the use of derivatives for efficient portfolio management or hedging purposes, activities that do not increase the economic risk exposure of the product or strategy.

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

Please note our response to question 10.

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?

We do not consider the activity-level measures proposed should be introduced, given the indiscriminate nature of these measures. The combination of activity-level measures and entity-level measures proposed in the consultation report could impose significant frictions on the use of derivatives and securities financing transactions, damaging strategies that are largely intended to manage and mitigate risks for end investors.

We suggest that instead the FSB and standard setting bodies should seek to understand those less regulated NBFI sectors where regulators have less transparency over the risks being undertaken.

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?**

The IA welcomes the updated guidelines for banks' counterparty credit risk (CCR) management published in December 2024 by the Basel Committee for Banking Supervision (BCBS), replacing its previous guidelines issued in January 1999. These point to key practices, many of them of which had already been adopted by a number of banks, including the need to:

(i) conduct comprehensive due diligence at both initial onboarding, as well as on an ongoing basis;

(ii) develop a comprehensive credit risk mitigation strategy to effectively manage counterparty exposures;

(iii)measure, control and limit CCR using a wide variety of complementary metrics; and (iv) build a strong CCR governance framework.

CCR is most appropriately managed at the level of the bank offering the credit or derivatives exposure – they are best placed to manage risks. That said, we recognise that in order for banks to properly assess their risk exposures to NBFIs, they need to be able to obtain sufficient information on their counterparties, including arrangements their counterparties have with other banks or prime brokers. In the case of asset managers, the information provided should be restricted to the product or client mandate to which the credit is being provided – the asset manager should not have to disclose arrangements they have with other counterparties in respect of other products or mandates that are separate from the product or mandate to which the bank or prime broker is providing credit.

We should note that actual positions with other prime brokers will be considered commercially sensitive information by NBFIs. The information on arrangements with other prime brokers that a NBFI is required to provide should not extend to a level of granularity that compromises commercial sensitivities

It is important that NBFIs such as asset managers remain permitted to using more than one bank or prime broker for their derivatives and securities financing transactions. This is so that they can continue to have access to these facilities even if one prime broker experiences disruption and is unable to provide these (such as Lehman Brothers in 2008) or decides to limit the facilities they are willing to offer, such as repo. Measures proposed to ensure CCR can be properly managed by banks and prime brokers should not prevent the use of multiple prime brokers by NBFIs.

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?**

Broadly, the IA considers that the banks and prime brokers providing the facilities are in the best position to determine the information they need to assess their CCR. As noted in question 14, this will likely extend to some information on exposures the NBFI entity, or the product or mandate they are managing has, with other banks or prime brokers. However, the NBFI should only be required to provide relevant information, such as exposures from the same product or mandate to which that bank/prime broker is exposed, not arrangements the NBFI may have in respect of other products or mandates that are segregated from the product or mandate to which the facilities are being provided. Nor should the manager be expected to share commercially sensitive information, such as actual position data.

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 IA understands that asset managers already provide significant information to the banks and prime brokers with which they have arrangements. In addition to the potential costs of setting up systems to provide more granular information, these requirements would risk asset managers sharing confidential information on their investment strategies to another market participant, potentially breaching client sensitivities as well as disclosing valuable intellectual property. We would caution against introducing any arrangements that violated these principles, but should a change in requirements result in the need to share potentially sensitive information, proper protections for the providers of that information must built in, including mandating Chinese walls to prevent the information being used by trading divisions at the bank/prime broker.

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?**

    Please refer to our response to question 16.

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?**

    The IA understands that in practice arrangements already exist between prime brokers and their counterparties to provide additional notifications around key thresholds during times of market stress, eg when the Net Asset Value of the fund falls below a specified level. These measures are determined by prime brokers according to their risk policies and risk appetites. These allow prime brokers to focus on those counterparties that pose the greatest risk in times of stress, when resources are inevitably constrained.

    It is not clear to us that this is an area that needs an additional layer of regulation on top of existing arrangements. We recommend instead that central authorities and regulators focus instead on supervision of entities under existing frameworks, such as the BCBS updated guidelines for Counterparty Credit Risk Management that were mentioned previously, ensuring robust risk management frameworks are in place.

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?**

We are not of the view that regulatory requirements are needed in this area, but should these be considered by authorities, or the authorities wish to consider guidelines, which would be preferable, we would recommend that a cross-industry working group is convened consisting of representatives from all types of market participants, both banks/prime brokers and NBFI. This is to ensure that any regulations or guidelines in this areas, that these not only satisfy the information needed by banks/prime brokers for risk management purposes, but also are proportionate for NBFIs, and crucially do not require the disclosure of commercially sensitive information that may cut across their fiduciary responsibilities to their clients or their intellectual property on the investment strategies they are employing.

Any minimum disclosures should consider thresholds based on the level of leverage employed, so only NBFI counterparties who are employing high levels of net leverage are in scope. These are the entities most likely to pose risks to banks/prime brokers in times of stress (though as noted elsewhere the level of risk posed will depend on a number of factors, in particular whether derivatives are being employed to gain incremental risk exposure or to manage risks, eg by hedging). Furthermore, even entities employing significant levels of leverage may not have the same experiences in the same stress event, depending on how the leverage is being managed relative to the broader portfolio. Alerts on key metrics such as Net Asset Value (NAV) falls will enable Prime Brokers to determine which of their counterparties need to provide more information. Applying enhanced information requirements across all counterparties, as well as being disproportionate to those counterparties not experiencing problems, could also be a distraction for banks/prime brokers in times of stress, resulting in them being deluged with volumes of information that are not needed when they need to be able to focus on where their key risks are, assess information on those areas and act quickly.

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?**

While conceptually the “same risk, same regulatory treatment” principle may at face value appear reasonable, we have concerns about how this may be applied across NBFIs. As noted elsewhere in our report, there are significant structural differences between not only banks and NBFIs, but between different sectors in NBFIs, which materially affect the systemic risks they pose. What can appear to be the “same risk” often is not on closer examination due to differences in liability structures. For example, asset managers do not typically assume risks on their own balance sheets. The impact that would arise from the collapse of a large asset manager will not be nearly as material as for an entity with the same market footprint that assumes risk on its own balance sheet, eg a bank or an insurer. Furthermore, the assets in asset management products, such as investment funds, are segregated from those of the manager and other products, allowing risks to be contained much more readily and acting as a natural firebreak to prevent the spread of systemic risk.

The effects on the overall financial system and real economy of disruptions and collapses of institutions can vary significantly. For example, the collapse of a bank or an insurer will affect a far greater number of economic participants who rely on their services than the collapse of a commodities broker or family office.

The diversity of the financial sector, particularly NBFIs, means that measures that might be appropriate for one type of institution are not necessarily appropriate for another type of institution, even though on face value the risks may appear similar. For example, capital buffers which are widely used in banking are not suitable for most asset management products or services – these not only damage the proposition of the product or service but do not mitigate risks in asset management, and can even create the potential for run risks if buffer levels are seen to fall.

It is important that the particulars of each entity, product or service are properly understood before applying measures, particularly when considering measures that have been used in other parts of the financial system.

FSB Consultation Report on Leverage in Non-bank Financial Intermediation

Response to consultation

Submitted on 28 February 2025 via the online form on www.fsb.org and by email to fsb@fsb.org.

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the opportunity to contribute to the FSB's consultation report on leverage risks in non-bank financial intermediation (NBFI). We recognise that that leverage, if not properly managed, can amplify financial stability risks, especially in stressed market conditions. However, significant measures have already been taken to mitigate these risks, in particular the introduction of margin requirements and central clearing post the Global Financial Crisis (GFC) of 2008, and new regulations targeting key sectors in NBFI such as the Alternative Investment Fund Manager's Directive (AIFMD) in the EU, also adopted in the UK, which have strengthened risk management requirements, leverage disclosures and reporting to national competent authorities.

Some post-GFC reforms, in particular around mandatory margin requirements and central clearing, have helped to address counterparty risks but have increased liquidity risks. To date, central clearing and non-cleared margin rules have favoured the provision of margin as cash. In times of stress, when margin calls typically increase, this has resulted in many market participants having to sell assets in order to raise liquidity to meet margin calls, regardless of the direction of the market. This has exacerbated price falls. These second order risks are often attributed to leverage although do not arise directly from leverage. The Bank of England's recent report on its System Wide Exploratory Scenario (SWES) Exercise identified price-insensitive selling pressures on key markets, such as sterling corporate bonds, that are not quickly cleared by buyers entering the market to take advantage of falling prices. We argue that more needs to be done to encourage margin exchange mechanisms that allow a wider range of assets to be posted.

The Investment Association

Camomile Court, 23 Camomile Street, London, EC3A 7LL
www.theia.org

peter.capper@theia.org

@InvAssoc @The Investment Association

A challenge for considering leverage in NBFIs is that some leverage measures do not accurately reflect the overall risk exposures arising from the use of derivatives. While financial or balance sheet leverage, arising from borrowing, is relatively easy to measure, synthetic leverage arising from exposure through derivatives or securities financing transactions is more difficult to accurately measure. Derivatives are frequently used by NBFIs for efficient portfolio management and to hedge portfolio risks. These uses do not increase the incremental economic risk exposure, and in the case of hedging reduce portfolio risks. Gross measures can be useful for identifying which parties are using derivatives more extensively, but they tend to overstate the actual risk exposure of the derivatives used. For this reason, the IA favours net measures of leverage when assessing leverage risks, such as the Commitment method, which better reflect the risk exposures being taken. Even net measures though can end up overstating economic risk exposures for some types of funds, particularly fixed income and multi-asset funds, since some hedging transactions cannot be netted. For this reason, net measures should also be complemented by portfolio risk measures such as Value-at-Risk.

NBFI is a very broad category, and includes sectors that are already highly regulated, and subject to significant scrutiny by national competent authorities, and those where there is little or no regulation and low transparency of activities. Asset managers and their products, such as investment funds, are subject to high levels of regulation, through the AIFMD in the EU/UK and similar frameworks in other regions such as the US and Asia. We suggest that a first priority for the FSB and other standard setting bodies should not be to layer on additional requirements to already highly regulated sectors, but first to focus on areas of NBFI where risks are less transparent and less well understood.

The proposals in the consultation for activity-based measures, such as minimum haircuts in securities financing transactions, including government repos, and enhanced margin requirements could create frictions resulting in financial stability risks for markets. The second key finding of the Bank of England's SWES report identified the central role of repo market resilience to supporting core markets in stress. The activity-based measures recommended in the report risk creating significant frictions in these repo markets, making it harder and more expensive for NBFIs to access these in times of stress.

We have concerns about how the "same risk, same regulatory treatment" principle may be applied when it comes different market participants and different products. The diversity of the financial sector means that measures appropriate for one type of institution may not be suitable for another. We recommend that blanket measures are avoided, and the particulars of each entity, product, or service be properly understood before applying measures on any specific sector.

Finally, we emphasise the important role of strong governance and risk management practices. This has been a key area of development by highly regulated NBFIs, such as asset managers. Risks cannot always be accurately predicted, and regulation cannot prevent all risks from occurring. Strong and clearly articulated governance and risk management procedures allow regulated NBFIs to monitor and control the leverage risks they take in line with carefully defined policies, adjust these in varying economic conditions and take prompt actions in the interests of their investors during times of market stress. Strong governance and risk management practices are also an essential component for banking counterparties, for example in the due diligence practices of prime brokers. The role of governance and risk management frameworks in managing leverage risks should not be ignored in any measures.

Responses to Questions

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 IA recognises that leverage, if not properly managed, can be a factor in financial stability risks – in particular, the presence of high leverage in the financial system can amplify the effects of systemic risks in stressed market conditions. Leverage can be difficult to measure accurately and meaningfully, especially synthetic leverage that arises from the use of derivatives. This means that competent authorities such as central banks and securities regulators do not always have full transparency of the risks posed by all market participants.

Since the 2008 global financial crisis (GFC), competent authorities have sought to mitigate solvency risks arising from global derivatives markets through moving more transactions to central clearing and introducing margin (initial and variation) and reporting requirements. These measures have undoubtedly reduced counterparty risk in the system, but have increased liquidity risks, as in times of stress counterparties often have to liquidate assets in order to meet margin payments. These second order risks are often attributed to leverage although do not arise directly from leverage. It is the IA's long held view that margining practices and requirements need to be revisited to mitigate some of the liquidity risks that have emerged from margining requirements, eg allowing more asset types to be posted as margin.

The description of the financial stability risks from leverage in NBFI is not wholly accurate or comprehensive. The narrative suggests that NBFI leverage was a causing or dominant factor in each of the crises mentioned. With the exception of the Archegos episode, this was not the case. Each of the events described were originated and primarily driven by externa shocks that originated outside the financial system. The market turmoil in March 2020 was driven primarily by the rapid shutdown of economies by governments in the face of a global pandemic, and uncertainty around the outcome. Though asset sales to meet margin calls to unwind leveraged positions, market volatility in this period can be as much attributed to other causes, such as market repricing of risks due to increased uncertainty in the event of the pandemic and operational challenges, particularly traders needing to switch to trading from their mobiles without their colleagues immediately on hand to consult, Heads of Desk to confirm risk limits, and a lack of access to essential market information. It is disingenuous to think that had leverage levels been lower we would not have seen a similar level of market turmoil, given the nature of the global pandemic.

Similarly, the Commodities crisis in March 2022 can ultimately be attributed to the supply shock arising from the Russian invasion of the Ukraine. While the role that leveraged Liability Driven Investment (LDI) strategies played in the September 2022 UK gilt market turmoil is certainly apparent, the turmoil was a reflection of the structural issues within the long-dated index linked gilt markets.

The Archegos collapse can be more readily attributed to the excessive leverage deployed in its investment strategies across multiple prime brokers. Even then, this was very much the actions of a single family office, subject to little regulation and led by an individual who was subsequently convicted of fraud, not a series of participants. It worth also noting that Paul, Weiss' report commissioned by Credit Suisse found that although risk controls and processes were followed, and information on these risks was obtained, senior managers persistently failed to address risks connected with trades made by Archegos – "the business was focused on maximising short-term profits and failed to rein in, and, indeed, enabled Archegos' voracious risk-taking"[1]. The Archegos case has rightly been scrutinised by authorities seeking to understand how future risk events can be mitigated, but we caution against attributing too much from the actions of one non-regulated entity, since found to have committed criminal offences, and applying these to other more tightly regulated NBFI entities.

[1] https://www.paulweiss.com/practices/litigation/internal-investigations/news/credit-suisse-publishes-independent-review-of-archegos-losses?id=40637

Overall, we recommend that at this stage the FSB and other international standard setters focus more on improving their knowledge and understanding of leverage across the whole NBFI sector, concentrating in particular on those areas that are more lightly regulated or not regulated at all. We caution against implementing market wide policies that may not only fail to mitigate perceived risks arising from leverage but may have other damaging consequences, such as a decline in the use of derivatives for risk mitigation purposes.

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?

Metrics must be selected that are meaningful and measure the risk effects arising from leverage, not just the level of activity being undertaken. As the consultation report acknowledges, derivatives are used by market participants, including asset managers, for a range of purposes that do not increase the incremental risk exposure, such as to mitigate portfolio risks or to gain efficient market exposure. The measures used need to distinguish between synthetic exposure from derivatives use that incrementally increases market exposure and use that does not increase market exposure or event reduces portfolio risks.

Gross measures of leverage are relatively straight-forward to calculate, but they do not distinguish between these uses. Nor do they consider directionality. Gross financial (or balance sheet) leverage typically reflects fairly accurately additional leverage arising from borrowing, where this is used for investment purposes and not temporary borrowing used for operational purposes such as cash flow management. But gross synthetic leverage can at best identify the level of derivative use, either within a product, by an entity or in aggregate. It will not give an accurate picture of the overall risk – the lack of consideration of directionality typically results in the economic exposure arising from the derivatives being significantly overstated.

Adjusted gross leverage, which adjusts the notional exposure of interest rate derivatives by duration, only partially reduces this overstatement. Reliance on these metrics for any purposes beyond identifying where derivatives activity is taking place, and the size of that activity, could result in damaging measures that overly restrict the use of derivatives for risk mitigation and efficient portfolio management purposes, such as hedging.

Net measures, such as the commitment approach used in the UK and EU's Alternative Investment Fund Manager Directive (AIFMD), provide a more accurate, if not perfect, measure of the true economic exposure arising from the use of derivatives. These therefore provide a better indication of the true risk exposure of a fund. They are, however, more difficult to calculate, as transactions have to be assessed for their directionality, and whether these are offsetting risks in the portfolio. For some NBFI entities or products that are not using derivatives to a material extent, a net calculation may not be necessary or proportionate.

Risk-based measures such as absolute and relative Value-at-Risk (VAR), although not strictly speaking a measure of leverage, have also proved effective at managing overall global exposure limits where derivatives are used more extensively, notably in the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive. Once modelled, the risk exposure of the portfolio can be readily monitored to ensure this is contained within defined limits.

The US, the EU and the UK, along with a number of other jurisdictions, already have reporting frameworks in place to gather information on leverage on investment funds, hedge funds and other asset management activities, and most have frameworks for other highly regulated NBFIs such as insurers and pension funds. With appropriate information sharing mechanisms in place, these should already provide strong information to central authorities and standard setting bodies on the extent of leverage and where it being deployed by highly-regulated NBFIs. Introducing new measures will be highly disruptive to existing regimes, requiring extensive system changes and process development, in addition to client education. Unless new measures represent a demonstrable improvement to all stakeholders, we suggest the focus should be on utilising existing metrics that are reported, and identifying and focusing on less regulated areas of NBFI where there is less visibility and a lack of reporting.

Finally, the IA considers that authorities and standard setting bodies continue to use the two step approach set out by IOSCO in its 2019 Final Report on Recommendations for a Framework Assessing Leverage in Investment Funds[2]. This allows the majority of investment funds, which do not employ leverage to any significant extent, to be screened out. Regulators can then focus on more advanced screening of those funds that employ leverage to a significant extent (usually considered in EU/UK frameworks to be three times leverage or more using the commitment method). This approach has been operationalised in Europe under Article 25 of the AIFMD. Although the specifics of each NBFI sector would need to be properly assessed, the two step model may provide the basis for assessing leverage in other sectors and ensuring the focus is on areas of high leverage.

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?

As noted in our response to question 2, the IA considers the existing leverage measures for investment funds used in the EU to be adequate.

For market wide measures, such as concentration and crowded trading strategies, we suggest that better utilisation is made of existing market reporting frameworks, particularly in respect of derivatives reporting (eg EMIR in Europe), transaction reporting (eg MiFID transaction reporting) and securities financing transactions reporting (eg SFTR), the latter of which captures key transactions such as derivatives. This, complemented by manager/fund level reporting such as AIFMD Annex IV reporting, should enable regulators to identify concentration risks in the market.

Global agreements and mechanisms should be established to allow information to be more readily shared between different authorities and regulators, at least in aggregated form. In addition to removing barriers to information sharing, the IA also reiterates its long-standing support for inclusion of Legal Entity Identifiers (LEIs) to be mandatory in all regulatory reporting. LEIs have become widely established and accepted, and the inclusion of these will make it easier for authorities to analyse risks that affect particular entities, or groups of entities across a range of reported information, without having to impose additional reporting requirements on asset managers and other NBFIs already subject to extensive regulatory reporting.

Recommendation 3

4. What types of publicly disclosed information (e.g. transaction volumes, outstanding amounts, aggregated regulatory data) are useful for market participants to enhance their liquidity or counterparty credit risk management? Are there trade-offs in publicly disclosing such information and, if so, what would be the most important elements to consider? What is the appropriate publication frequency and level of aggregation of publicly disclosed information?

While the IA broadly welcomes proposals to increase trade transparency, including the development of a consolidated tape for equity and fixed income markets in the EU, we have concerns on proposals to publicly

[2] FR18/2019 Recommendations for a Framework Assessing Leverage in Investment Funds

disclose information relating to factors such as market concentration. Publicly disclosing levels of concentration, or susceptibility of particular asset classes or products to redemptions caused by margin calls could trigger the types of events such as market withdrawals that central authorities and regulators are seeking to avoid. It could also allow some informed investors to trade against other investors subject to regulatory constraints that force them to hold particular assets or pursue particular strategies, or discourage some potential investors from entering that market. Asset managers have a fiduciary duty to act in the best interests of their clients and should not be required to make public disclosures that potentially harm the interests of their clients.

Initiatives to improve the transparency of market transactions, such as the development of a consolidated tape in markets where this is not yet available, are to be supported. The IA also considers that transparency improvements could also improve liquidity in short-term funding markets, which are critical for the Money Market Funds (MMFs) which are used by many NBFIs for holding liquidity.

Nonetheless, the broader implications of public information disclosure should be properly examined before any recommendations are made around the public disclosure of information related to risk factors such as concentration. We consider that it would be preferable for central authorities and regulators to monitor these, and if they discover potential concentrations or crowded trading strategies in particular markets, these are fed back discretely to market participants who are immediately impacted so mitigating measures can be agreed and enacted in a controlled manner that avoids any shocks.

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?

There are areas in these recommendations that need clarification. For example, where the recommendations refer to entity-based measures, it is not clear whether the intention is to target certain NBFIs such as asset managers or the products or mandates they are managing. While the asset manager might interface with the market, it is not typically the asset manager entity where risks arise. Asset managers use an agency based model, and rarely have any exposure on their own balance sheets. Typically these remain either with their client, whose mandate they are managing, or a the level of the product they are managing, such as an investment fund. An asset manager with a large market footprint does not necessarily pose a larger risk at the asset manager entity level than a smaller one – this will come down to the nature of the activities they are undertaking, and the level at which those risks. Entity-level measures aimed at the asset manager would therefore have minimal impact on reducing systemic risks while constraining the activities and services provided by those asset managers, potentially leaving them at a disadvantage to others.

A careful clarification is therefore required when referring to entity-level measures, as to what is the entity the measures are aimed at. In the case of asset management, the appropriate entity for any measures is likely to be at product-level, for example the real estate fund leverage limits or LDI yield buffers referenced in the consultation, so it would arguably be more appropriate to refer to these as product-level measures. Of course, this consideration is likely to vary significantly between different NBFI types.

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 do not agree with all of the activity-based measures being proposed, which do not take into consideration the differences between types of NBFIs and the risks they pose. These measures may be counterproductive. Minimum haircuts in SFTs, including government bond repos, will increase frictions for NBFIs seeking to access repo markets and increase costs for them. The recent report by the Bank of England on its System Wide Exploratory Scenario (SWES) Exercise[3] identified the central importance to supporting core markets in times of stress. We also consider that increasing mandatory central clearing in SFTs and derivatives markets is likely to be counterproductive, at least in the short term. Moving repos to mandatory central clearing is likely to significantly increase the costs and complexity of these transactions, noting that many of these are for short maturities, such as overnight. We suggest that the impact of moving US Treasury Repos to central clearing be explored before extending mandatory clearing to other jurisdictions, and the features of those markets, which will likely differ from the US, be properly considered before determining whether a model in the US can be applied in those jurisdictions. Central clearing will increase liquidity demand, which can already be strained, with no provision for additional liquidity supply. For example, there are not the same options to store and transfer liquidity through reverse repo and sponsored repo programs in Europe that there are in the US. In a similar vein, we do not see an argument for enhanced margining requirements between NBFIs specifically and their derivatives counterparties, over and above those already in place in leading jurisdictions such as the US and Europe (EU and UK).

A more productive approach would be to consider reforms to margining that make it easier for regulated NBFIs to pose a broader range of assets as collateral, so collateral can be provided without the second order effects that arise from the sale of assets in key markets. In the Bank of England's SWES report, it noted that insurers in particular had been able to negotiate "dirty" CSAs, which allowed them to post assets as collateral in non-cleared derivatives transactions, which reduced selling pressures in the stress scenario. Broadening the ability of regulated NBFIs to use similar CSAs would contribute to reducing the amplification effect that margin calls can create in stressed market conditions. New technologies, such as tokenisation of assets, could facilitate the efficient posting of assets as collateral. The IA published a case study of the potential use case of tokenised MMFs for posting collateral in March 2024[4].

The IA also supports enhancing transparency in margin calculation methodologies by CCPs and non-cleared counterparties. These would allow NBFIs to better anticipate collateral needs in times of stress. Increasing the transparency of margining models would reduce uncertainty in times of stress, allowing NBFIs to better prepare for margin calls without holding excessive liquidity levels that create cash drag, and would avoid excessive selling of assets in times of stress that are higher than needed to meet margin calls. It would also allow for more accurate stress testing of portfolios and derivatives exposures.

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 consider dynamic approaches to minimum margin and haircut arrangements set by regulators to be a feasible measure. This would require mechanisms to enable the transfer of information, analysis, coordination and decision-making at authority level at a speed that seems unlikely to be achievable in the

[3] The Bank of England's system-wide exploratory scenario exercise final report | Bank of England
[4] MMF Tokenisation - Collateral Opportunities Mar24.pdf

short term. Moreover, the possibility of dynamic margin and haircut arrangements could be pro-cyclical under stressed market conditions, driving market behaviour and increasing selling pressure, particularly if NBFIs anticipate minimum margin and haircuts increasing and sell up assets to shore ready liquidity.

The IA notes that it is already common practice for bank counterparties to impose margin and haircut add-ons in non-cleared transactions based on risk factors such as concentration. However, the bank counterparty has more immediate access and knowledge of the NBFI counterparty, its relative footprint, the regulatory requirements it is subject to, and other relevant risk information that it can use to make a judgement. Different counterparties are likely to make different decisions, based on their assessments, hence a market-wide impact is less likely. It is difficult to see how dynamic margin and haircut requirements could not be indiscriminate and affect wider behaviour, would could exacerbate rather than mitigate systemic risks.

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

Please refer to our responses to questions 6 and 7.

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

We do not have a specific comment on this question – both the setting of margin levels and haircuts are part of the overall margining framework, the first with the intention to cover counterparty risk, the second to allow for potential losses on the value of assets being held as collateral in the event they have to be liquidated. We do however consider that the current margining frameworks, for example in EMIR, are sufficient.

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?

We consider that direct and indirect leverage limits should only be deployed where particular risks require these measures. We do not consider that direct or indirect leverage limits should be applied across all NBFIs, only where risks are identified that justify the application of limits.

As noted in our response to question 5, it is important that the recommendations are clear on what the entity is. For example, we would not expect leverage limits to be applied to asset manager entities, who are managing assets as agents either for other clients, or within products such as investment funds. Imposing leverage limits on asset manager entities themselves based on some strategies they manage might constrain the asset manager in respect of other products and service they offer and put that asset manager at a competitive disadvantage. In respect of asset management, product-level measures may be a better descriptor.

A number of regulated fund frameworks already limit leverage directly or indirectly, particularly those for retail investors. For example, the EU UCITS Directive does not allow borrowing, except under a derogation that allows temporary borrowing for operational purposes only, and limits the global exposure from derivatives to the value of the scheme property. Typically, only funds that are restricted to professional investors are not restricted by the amount of leverage they are able to deploy, and even in the case of those funds, they will normally specify their own maximum levels of leverage in their constitutional documents or their fund rules. The EU and UK AIFMD frameworks, under which non-UCITS funds in the EU and UK must comply, require a risk management function to be established that is independent of the portfolio management function, and for the AIFM to have strong risk management policies in place in respect of the management of key risks such as liquidity management and leverage.

We therefore consider that it is only a small number of cases in asset management, or in respect of investment funds, which will require direct or indirect leverage limits to be deployed. Article 25 of the AIFMD allows national competent authorities to impose restrictions on leverage, either directly or indirectly, in respect of an AIF or a cohort of AIFs, whether managed by the same or different AIFMs, where the leverage used in the investment strategies of these funds poses financial stability risks. This article has been deployed by regulators in Ireland and Luxembourg – the former in respect of limiting leverage and redemption terms of domestic real estate funds, and both regulators in terms of imposing yield buffers on Liability Driven Investment (LDI) funds.

The IA does not consider that it would be appropriate to impose leverage limits across all NBFI types. Any proposals to impose direct or indirect leverage limits on any particular NBFI, or group of NBFIs, will require careful assessment of the particulars of individual cases. There is a danger of focusing leverage limits on those NBFIs where there is greater regulatory transparency, which are likely to be those NBFIs that are already highly regulated and already have robust systems and controls and strong risk management frameworks. If these are inappropriately targeted with leverage limits, there is a risk that alternative solutions may be found that would allow for the adoption of similar strategies in less regulated vehicles, creating more risks for the financial system that are less visible to regulators.

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?

As noted in our response to question 10, we consider that entity-based measures should only be adopted where significant leverage risks have been identified for particular NBFIs or groups of NBFIs, and should be calibrated based on detailed assessments of the risks posed in those particular products. These should be limited to sectors that are employing net leverage on a significant basis. In particular, these should not impose any restrictions on the use of derivatives for efficient portfolio management or hedging purposes, activities that do not increase the economic risk exposure of the product or strategy.

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

Please note our response to question 10.

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?

We do not consider the activity-level measures proposed should be introduced, given the indiscriminate nature of these measures. The combination of activity-level measures and entity-level measures proposed in the consultation report could impose significant frictions on the use of derivatives and securities financing transactions, damaging strategies that are largely intended to manage and mitigate risks for end investors.

We suggest that instead the FSB and standard setting bodies should seek to understand those less regulated NBFI sectors where regulators have less transparency over the risks being undertaken.

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?

The IA welcomes the updated guidelines for banks' counterparty credit risk (CCR) management published in December 2024 by the Basel Committee for Banking Supervision (BCBS), replacing its previous guidelines issued in January 1999. These point to key practices, many of them of which had already been adopted by a number of banks, including the need to:

(i) conduct comprehensive due diligence at both initial onboarding, as well as on an ongoing basis;
(ii) develop a comprehensive credit risk mitigation strategy to effectively manage counterparty exposures;
(iii) measure, control and limit CCR using a wide variety of complementary metrics; and
(iv) build a strong CCR governance framework.

CCR is most appropriately managed at the level of the bank offering the credit or derivatives exposure – they are best placed to manage risks. That said, we recognise that in order for banks to properly assess their risk exposures to NBFIs, they need to be able to obtain sufficient information on their counterparties, including arrangements their counterparties have with other banks or prime brokers. In the case of asset managers, the information provided should be restricted to the product or client mandate to which the credit is being provided – the asset manager should not have to disclose arrangements they have with other counterparties in respect of other products or mandates that are separate from the product or mandate to which the bank or prime broker is providing credit.

We should note that actual positions with other prime brokers will be considered commercially sensitive information by NBFIs. The information on arrangements with other prime brokers that a NBFI is required to provide should not extend to a level of granularity that compromises commercial sensitivities

It is important that NBFIs such as asset managers remain permitted to using more than one bank or prime broker for their derivatives and securities financing transactions. This is so that they can continue to have access to these facilities even if one prime broker experiences disruption and is unable to provide these (such as Lehman Brothers in 2008) or decides to limit the facilities they are willing to offer, such as repo. Measures proposed to ensure CCR can be properly managed by banks and prime brokers should not prevent the use of multiple prime brokers by NBFIs.

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 iii types of information and what level of granularity should (and should not) be included in this minimum set and why?

Broadly, the IA considers that the banks and prime brokers providing the facilities are in the best position to determine the information they need to assess their CCR. As noted in question 14, this will likely extend to some information on exposures the NBFI entity, or the product or mandate they are managing has, with other banks or prime brokers. However, the NBFI should only be required to provide relevant information, such as exposures from the same product or mandate to which that bank/prime broker is exposed, not arrangements the NBFI may have in respect of other products or mandates that are segregated from the product or mandate to which the facilities are being provided. Nor should the manager be expected to share commercially sensitive information, such as actual position data.

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 IA understands that asset managers already provide significant information to the banks and prime brokers with which they have arrangements. In addition to the potential costs of setting up systems to provide more granular information, these requirements would risk asset managers sharing confidential information on their investment strategies to another market participant, potentially breaching client sensitivities as well as disclosing valuable intellectual property. We would caution against introducing any arrangements that violated these principles, but should a change in requirements result in the need to share potentially sensitive information, proper protections for the providers of that information must built in, including mandating Chinese walls to prevent the information being used by trading divisions at the bank/prime broker.

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?

Please refer to our response to question 16.

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?

The IA understands that in practice arrangements already exist between prime brokers and their counterparties to provide additional notifications around key thresholds during times of market stress, eg when the Net Asset Value of the fund falls below a specified level. These measures are determined by prime brokers according to their risk policies and risk appetites. These allow prime brokers to focus on those counterparties that pose the greatest risk in times of stress, when resources are inevitably constrained.

It is not clear to us that this is an area that needs an additional layer of regulation on top of existing arrangements. We recommend instead that central authorities and regulators focus instead on supervision of entities under existing frameworks, such as the BCBS updated guidelines for Counterparty Credit Risk Management that were mentioned previously, ensuring robust risk management frameworks are in place.

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?

We are not of the view that regulatory requirements are needed in this area, but should these be considered by authorities, or the authorities wish to consider guidelines, which would be preferable, we would recommend that a cross-industry working group is convened consisting of representatives from all types of market participants, both banks/prime brokers and NBFI. This is to ensure that any regulations or guidelines in this areas, that these not only satisfy the information needed by banks/prime brokers for risk management purposes, but also are proportionate for NBFIs, and crucially do not require the disclosure of commercially sensitive information that may cut across their fiduciary responsibilities to their clients or their intellectual property on the investment strategies they are employing.

Any minimum disclosures should consider thresholds based on the level of leverage employed, so only NBFI counterparties who are employing high levels of net leverage are in scope. These are the entities most likely to pose risks to banks/prime brokers in times of stress (though as noted elsewhere the level of risk posed will depend on a number of factors, in particular whether derivatives are being employed to gain incremental risk exposure or to manage risks, eg by hedging). Furthermore, even entities employing significant levels of leverage may not have the same experiences in the same stress event, depending on how the leverage is being managed relative to the broader portfolio. Alerts on key metrics such as Net Asset Value (NAV) falls will enable Prime Brokers to determine which of their counterparties need to provide more information. Applying enhanced information requirements across all counterparties, as well as being disproportionate to those counterparties not experiencing problems, could also be a distraction for banks/prime brokers in times of stress, resulting in them being deluged with volumes of information that are not needed when they need to be able to focus on where their key risks are, assess information on those areas and act quickly.

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?

While conceptually the “same risk, same regulatory treatment” principle may at face value appear reasonable, we have concerns about how this may be applied across NBFIs. As noted elsewhere in our report, there are significant structural differences between not only banks and NBFIs, but between different sectors in NBFIs, which materially affect the systemic risks they pose. What can appear to be the “same risk” often is not on closer examination due to differences in liability structures. For example, asset managers do not typically assume risks on their own balance sheets. The impact that would arise from the collapse of a large asset manager will not be nearly as material as for an entity with the same market footprint that assumes risk on its own balance sheet, eg a bank or an insurer. Furthermore, the assets in asset management products, such as investment funds, are segregated from those of the manager and other products, allowing risks to be contained much more readily and acting as a natural firebreak to prevent the spread of systemic risk. The effects on the overall financial system and real economy of disruptions and collapses of institutions can vary significantly. For example, the collapse of a bank or an insurer will affect a far greater number of economic participants who rely on their services than the collapse of a commodities broker or family office.

The diversity of the financial sector, particularly NBFIs, means that measures that might be appropriate for one type of institution are not necessarily appropriate for another type of institution, even though on face value the risks may appear similar. For example, capital buffers which are widely used in banking are not suitable for most asset management products or services – these not only damage the proposition of the product or service but do not mitigate risks in asset management, and can even create the potential for run risks if buffer levels are seen to fall.

It is important that the particulars of each entity, product or service are properly understood before applying measures, particularly when considering measures that have been used in other parts of the financial system.