FSB FINANCIAL STABILITY BOARD

Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

Witten/Herdecke University

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?**

   While the FSB's description of the financial stability risks from leverage in NBFI is concise and certainly helpful to grasp the essence of leverage in NBFI, it still lacks a qualitative dimension with respect to climate-related risks. This is because such risks may materialise in asset classes and portfolio positions where classical (backward-looking) risk management models and tools did not anticipate risks. This may result in sudden changes in 'leverage' or leveraged positions as defined by the FSB, because exposures that were deemed sound and low-risk may suddenly be subject to devaluation, causing leverage ratios to rise since net-asset value drops while net-liabilities remain stable. This is aggravated by the fact that there's an utter lack of transparency in some parts of NBFI (particularly hedge funds, private credit, privat equity and family offices!), particularly in terms of cross-border holdings that often originate from so-called financial secrecy jurisdictions or 'offshore financial centres'. This leads to a lack of macroprudential supervision of cliate-realted risks in NBFI that regulators should urgently address.

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?**

   Regulatory and supervisory authorities should consider financed emissions by NBFI in relation, e.g., IEA net-zero emissions 2050 scenarios or the ECB's transition plan benchmark scenario. Any deviation from such scenarios poses leverage towards economic sectors that will be phased-out in the short-to-medium term and thus may pose significant and financially material risks. Apart from transition risks, even regionally impactful fincancial fallout from certain physical risks events (such as the recent LA wildfires) may cause financial instability due to a globally diversified exposure of NBFI insitutions (such as re-insurers and primary insurers) to such risks.

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

Securitisation of GHG-emissions intensive loans (ABS issuance) as well as holdings of such ABS - with a particular focus on so-called 'proved-developed-producing' reserves ABS that use oil & gas wellbores as underlying asset;

Private credit issuance to the fossil fuel industry as well as private equity M&A activity in the fossil fuel sector. Supervisors should pay attention to these activities' refinancing structure, especially 'collateralised loan obligation' (CLO) issuance banks financing such activity via syndicated leveraged loans (senior debt tranches), junk bonds, as well as institutional investor capital placed in such private credit funds via 'limited partnership' (LP) share structures that effectively outsource the attached risks to those investors instead of the funds themselves.

Corporate bond issuance by the fossil fuel industry poses another form of NBFI financial leverage that may exacerbate climate-related risks and should be monitored more closely, also due to banks underwriting role.

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

Securitisation conduits, SPVs; CLO managers; private credit funds; private equity funds; hedge funds.

(iii) concentration and crowded trading strategies

Hedge funds recently began to pitch so-called 'weighted emissions risk transfers' to banks, essentially offering them carbon-risk credit default swaps (CDS) that would compensate banks holding loans with high financed GHG-emissions in case of default (asset stranding), i.e., the materialisation of climate-related risks. Whether these NBFI entities have the capital structure and balance sheet capacity to absorb such potentially immense losses is of utmost importance to macroprudential financial supervision and regulation.

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?**

   From an academic perspective, there should be at least a quarter-annually disclosure outstanding aggregated volumes of asset classes/sectors of concern, as well as aggregated balance sheet data indicating the most important positions on the asset and liability sides of market participants' balance sheets.

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?**

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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?**

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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?**

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

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

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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?**

    With regard to exposures to climate-related risks, such limits would effectively address the problem of NBFI over-leverage to GHG-intensive sectors.

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?**

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

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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?**

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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?

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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?**

    First of the question: I do think so, yes. Second part: the average maturity structure of the counterparty's funding (liability) side should be disclosed, alongside the financed emissions on the asset side, as a proxy for climate-related risk exposure.

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?**

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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?**

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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?**

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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?**

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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?**

    Definitely for private credit funds - they do essentially the same as banks, but outside the regulatory framework.

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