

EFAMA RESPONSE TO THE IOSCO CONSULTATION REPORT ON LEVERAGE

I. GENERAL REMARKS

EFAMA is the voice of the European investment management industry. EFAMA represents through its 28 member associations, 62 corporate members and 25 associate members more than EUR 25 trillion in assets under management of which EUR 15.6 trillion managed by 60,174 investment funds at end 2017. Close to 32,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 28,300 funds composed of AIFs (Alternative Investment Funds).

Before responding to the questions of this consultation we would like to present the general views of the European asset management industry in respect to the regulatory efforts taken both at the EU and the international level seeking to identify consistent measures of leverage and facilitating more meaningful monitoring for financial stability purposes. EFAMA responded to the previous FSB consultation paper on how to address risks to global financial stability associated with certain potential structure vulnerabilities which may result from asset management activities¹, on the basis of which the FSB report and Policy Recommendations were published, including Recommendation 10 on identifying and/or developing consistent measures of leverage². Moreover, EFAMA published together with AMIC an own initiative Position Paper on the Use of Leverage in Investment Funds in Europe³. This Paper presents how the European legislative regime, notably the UCITS and AIFMD legislative frameworks, but also other rules, for instance in EMIR, offer a robust framework to address the risks related to leverage in investment funds and puts forward a number of recommendations to improve monitoring and analysis of leverage risk.

EFAMA members are supportive of the international regulators efforts to assess the robustness of the existing regulatory frameworks that monitor the use of leverage in investment funds and enhance consistency at the global level via common measures. At the same time EFAMA stresses that these efforts should build upon existing regulatory frameworks and best practices and aim at measures that are appropriate and proportionate. We also acknowledge the need for further transparency concerning the information to be collected by national regulators, which should be data that can help regulators draw meaningful conclusions for the purposes of

¹ EFAMA response to the FSB Consultative Document

Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, September 2016 https://www.efama.org/Publications/Public/EFAMA_Reply_FSB_Structural_Vulnerabilities.pdf

² FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, January 2017 <http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>

³ EFAMA/AMIC Joint Paper, Use of Leverage in Investment Funds in Europe, July 2017

https://www.efama.org/Publications/Public/170719_AMIC%20EFAMA%20leverage%20paper.pdf

monitoring financial stability. Moreover and given the extensive and granular reporting requirements for asset managers (as foreseen for instance in the EU regulatory framework) it is important to build upon existing meaningful information already available to regulators, whereas the cost of collecting new data should be also taken into account.

Definition of leverage – addressing misconceptions

It is however important to stress that the use of leverage is not per se and therefore cannot be considered automatically as a risk. As stated in the joint AMIC/EFAMA Position Paper, leverage is a technique aimed at managing the economic exposure of an investment fund by borrowing money or securities from counterparties or by using derivative instruments such as options, futures or swaps. Such activities aim to improve the efficient management of the funds' portfolio or to optimise investment returns, reason for which, leveraged activities are often integral to an investment strategy, as they are used to improve asset allocation and portfolio diversification decisions.

We, therefore, welcome the neutral definition included in this consultation paper referencing leverage as a financial technique expressed as a ratio of the fund's market exposure over its net asset value and not as a standalone source of risk. Concretely, we support the statement at the consultation paper that *"a fund's use of derivatives alone – which can increase certain measures of market exposure – should not, therefore, be seen as a solely synonymous with the amplifications of risks and returns"*.

Key factors for assessing risks related to leverage

When considering challenges and risks linked to the use of leverage, it is important to identify a number of key factors, such as how much leverage is used, for which purposes and under which conditions and/or constraints. Only via such an assessment can regulators be efficient in their monitoring of the use of leverage in investment funds for financial stability purposes.

In this respect, a key starting point is that existing data and evidence show that leverage in the European investment fund sector is low with total leveraged assets much less than twice the amount of equity⁴, whereas the use of high leverage is rare in AIFs. These conclusions coming mainly from central banks and systemic risk authorities in Europe are not surprising, on the one hand because the investment fund activities differ significantly from that of banks in terms of their business model (e.g. no proprietary trading) and risks posed to counterparties and on the other hand because the EU regulatory framework sets a series of requirements to constrain the use of leverage in investment funds.

⁴ European Commission Report on the Operation of the Alternative Investment Fund Managers Directive, FISMA/2016/105(02)/C, Submitted 10 of December 2018 (page 86) / ECB Occasional Paper, Shadow Banking in the euro area: risks and vulnerabilities in the investment fund sector, June 2016 (page 26) / ESRB EU Shadow Banking Monitor 27 July 2016 (page 11) / ESRB, Assessing shadow banking-non-bank financial intermediation in Europe, No 10/ July 2016, point 3.2.1 Leverage (page 34) / ESRB, Macro- prudential policy beyond banking: an ESRB strategy paper, July 2016 (page 5)

Moreover, in most cases leverage employed in funds is associated with hedging the inherent risks of fully-funded investments or to gain exposure to certain assets with more flexibility and/ or at a lower cost. Leverage is also associated with other types of efficient portfolio management techniques, into which asset managers usually enter to ensure the smooth running of their portfolios, as well as to generate additional returns for the fund (whereas at the same time these can further support market liquidity).

As mentioned above, when assessing the potential risks that the use of leverage may pose it is also crucial to take into consideration the regulatory framework in which the fund is operating and its robustness in imposing requirements and processes that can address potential risks. In this context, the current EU regulatory framework offers a set of methods addressing in depth and in a comprehensive way the use of leverage in investment funds, including tools available to regulators to monitor leverage in funds for systemic risk purposes. In addition, it is important to stress that for some types of funds, as UCITS, the existing regulatory framework in EU sets constraints as to the use of leverage and prescribes limitation in leveraged positions, i.e. UCITS are not allowed to borrow more than 10% of the fund's NAV and the total global exposure given by derivatives used by a UCITS fund can never exceed the total net value of its portfolio.

A robust EU regulatory framework

As presented in detail in the joint EFAMA/AMIC Position Paper⁵ the EU framework consists of the Alternative Investment Fund Managers Directive⁶, the UCITS Directive⁷, and the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS⁸ and foresees a matrix of calculation methods, namely the gross method, the commitment method, and the VaR metrics. In this way, the EU model consists of a mix of methods that allows for a risk-based approach and for flexibility to cover the potential gaps and inefficiencies of each of the suggested models. AIFM and UCITS Directives also impose regulatory requirements and processes on sound and effective risk management, which must be consistent with the risk profiles and rules of the funds which are managed. In addition to the regulatory provisions directly aimed at measuring leverage used in investment funds and assessing risks related to potential economic over-exposure of investment funds, there are other more holistic regulatory provisions addressing such risks. In particular, the use of financial derivative transactions is subject to significant regulation. These measures foreseen in EMIR include mandatory central clearing of derivative contracts, daily valuation and mandatory exchange of margin for non-cleared derivative contracts, mandatory reporting to trade repositories, and recovery and resolution of CCPs.

This regulatory framework has proven its risk-resilience and value through the diverse market events that have taken place since the implementation of the AIFM and UCITS Directives. It has allowed regulators to ascertain that leverage levels remained relatively low and constant over time and that wider regulatory framework

⁵ See footnote 3

⁶ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and associated Level 2 legislation: Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU (hereafter referred to as AIFM Directive)

⁷ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (hereafter referred to as the UCITS Directive)

⁸ CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS CESR/10-788 28 July 2010 (hereafter referred to as the CESR Guidelines)

governing European investment funds has not led to potential systemic risk occurring in EU-domiciled investment funds since the global financial crisis.

To date, no other part of the world has developed such a comprehensive and tested framework. Therefore, we consider that the EU regulatory framework can serve as the reference point for further developing a matrix of consistent leverage measures at the international level.

Altogether, considering the low levels of leverage in the European investment funds sector, the use of leverage mainly for risk-hedging purposes and the comprehensive EU regulatory framework, EFAMA is convinced that the majority of investment funds employing leverage in Europe do not pose financial stability risks, which is something that needs to be taken into full consideration for the development of appropriate and proportionate measures of leverage for financial stability purposes.

EFAMA welcomes the 2-step approach, but stresses the need for appropriate and proportionate measures to be included in each step

In terms of the suggested approach by IOSCO, EFAMA agrees in principle with the proposal to carry out a framework for the calculation and analysis of leverage in funds in two steps (hereafter the "2-step approach"), with the aim to identify first which funds may pose risk to financial stability on the basis of the use of leverage (step 1) and then further analyse this particular subset of funds (step 2). As already mentioned, we do not consider that every fund using leverage is a source of risk to financial stability and we are convinced that the majority of the European funds industry isn't substantially leveraged and therefore should be filtered out at step-1.

Only a small subset of investment funds merits further analysis at step-2 and the right criteria need to be in place at step-1 to appropriately identify those funds. Even then, it is important to stress that funds identified for a further assessment at step-2 are not to be automatically considered as posing such risks, as there is further assessment to take place on the basis of the investment strategy, the risk profile, the level of interconnectedness and the specific characteristics of the asset management business model.

However, before further assessing the criteria and measures proposed at the first step of the 2-step approach, we already wish to underline that it would be pragmatic for IOSCO regulators to exclude from the overall approach those funds that do not employ substantial leverage or are too small to pose risks to financial stability. In particular investment funds that are subject to exhaustive and robust regulatory requirements and constraints in respect to the use of leverage - such as UCITS funds in Europe that are submitted to a cap regarding the use of leverage via derivatives and borrowing and the 40 Act funds in the US - are prohibited of a substantial leverage. In this regard, we suggest exempting from the scope of step-1 funds with regulatory constraints that ensure non-substantial levels of leverage and /or too small funds.

Concerning measures to be included in both steps, EFAMA agrees with IOSCO's acknowledgement of the underlying tensions between achieving precise leverage measures and arriving at sufficiently simple, robust metrics that can be applied in a consistent manner to the wide range of funds used in different jurisdictions. Indeed, we believe it isn't feasible to find one single measure that can be applied across all strategies, can allow

for a simple straightforward understanding of the result and for comparing results between different funds, while at the same time presenting a complete and realistic picture of the true exposures of the fund. Different measures are proposed in this consultation paper, each one of them capturing some of the risks and addressing some of those challenges. Therefore, for any measures to be consistent and reliable, they need to allow for a proper and more detailed analysis of the positions held by a fund and the risks they pose.

We welcome the idea of a set of measures of leverage given the different challenges of calculating leverage across such a wide range of portfolios with different investment strategies and significantly different risks in size, nature and characteristics associated to their underlying assets. We believe that a matrix of different measures is a feasible way to achieve a better representation of a fund's economic exposure on micro-level and allow regulators to draw the right conclusions for financial stability purposes.

Concerning the measures proposed for step-1, EFAMA members firmly support the measures foreseen in the European regulatory framework, i.e. the gross method and the commitment approach. As already mentioned above, this framework has proven its risk-resilience and value through the diverse market events since the global financial crisis and is among the more advanced ones at the global level.

In respect to the Gross Notional Exposure (GNE) we agree that it can be a measure that is relatively easy to calculate and apply on a reasonably consistent basis across different types of funds, but at the same time we welcome IOSCO's acknowledgment that as it doesn't account for netting and hedging relationships it may overstate exposures and the extent to which a fund's net asset value will change in response to market changes. This metric can be a baseline as to a fund's market footprint, but cannot be used as a standalone measure, as it doesn't allow for a comprehensive representation of the fund's exposures and cannot quantify the actual risks associated with different types of derivatives or the purpose for which they are being used.

Therefore, the assessment based on the GNE needs to be complemented by other metrics in order to avoid overstating the market risk of funds. The use of the Net Notional Exposure (NNE) can account for some netting and hedging relationships and consider positions that eliminate all or part of the risks linked to other positions. In this way NNE can help correct some of the GNE limitations. In particular in the case of netting, the existing EU framework on the commitment approach (mainly the CESR Guidelines and the AIFMD Delegated Regulation both of which with a granular approach) provides very useful criteria as to the measures for including netting at an aggregate level, which have been positively tested over years in practice with satisfactory results both for regulators and asset managers. On the definition of hedges, we strongly recommend that any further considerations related to the hedging arrangements developed by IOSCO are aligned with the well-defined rules in the mentioned CESR Guidelines. This will also prevent a further calculation of the Net Notional Exposure, which would imply additional burden and costs.

Moreover, we take note of the suggested in the consultation paper metric of using GNE with further adjustments for interest rate derivatives and options. In the EU the AIFMD Delegated Regulation includes conversion methodologies for derivative instruments for the calculation of the exposure of an AIF in accordance with the gross method⁹, including delta adjustments for options, to avoid overstate the market risk of funds. We agree

⁹ Article 7 and Annex II of the AIFMD Delegated Regulation ("Gross method for calculating the exposure of the AIF" and "Conversion Methodologies for derivative instruments")

with these particular adjustments proposed in the AIFMD framework, however, we also see that the use of gross method alone, even with these adjustments, cannot sufficiently address the challenge of overstating the market risk of funds.

It is for that reason that the EU framework foresees the commitment approach to complement the gross method. As already mentioned, EFAMA firmly supports the combination of measures that is suggested in the European regulatory framework and we believe this can serve as the reference point for further developing a matrix of consistent leverage measures at the international level.

Also, regarding the proposed analysis of metrics by asset class, we would like to stress that there are extensive reporting requirements at the EU level covering a wide range of data, but this type of analysis by asset class is not required. Instead, many EFAMA members are already providing for a line-by-line report ("inventories") to their prudential authorities. Going further and adding a different reporting layer would bring important burden and costs, which should be avoided, given that the level of existing reporting is already granular and detailed. Moreover, this type of aggregation by asset class cannot be relevant when reporting net notional exposures. The best way to aggregate by asset class is to gather similar funds/strategies.

In relation to measures foreseen for step-2, we welcome IOSCO's suggestion to perform risk-based analyses to better understand leverage-related risks potentially posed by funds identified in step-1. We also agree with the discretion provided to regulators to determine which funds to analyse in step-2 and which analyses to perform exercising their judgement, as the appropriate risk-based assessment depends on the characteristics and the investment strategies of each fund. The reference to market risks in Appendix C, e.g. portfolio sensitivity or VaR, is also a very useful listing of options.

Last but not least, EFAMA fully understands the need for consistent data as a key tool for regulators to be able to monitor potential risks related to the use of leverage in funds, but we also consider that this exercise should build upon existing reporting templates such as those under AIFMD Annex IV, as these are sufficient to meet this objective. For that reason, we would be highly skeptical of any further effort to extensively redesign existing reporting requirements apart from targeted changes to remove duplicative or ambiguous fields. Furthermore, we believe that it is even more important to ensure improved data sharing among regulators in order to enhance their leverage measurement both at the EU and the global scale.

II. RESPONSES TO THE QUESTIONS OF THE CONSULTATION

Chapter 2 – Step 1: Analysis of potential metrics

Questions on GNE

Question 1

Do respondents agree with the discussion above concerning the information that can be provided by this metric as well as its limitations?

Yes, EFAMA agrees with the analysis in respect to GNE, concretely as to what this metric represents, as well as its pros and cons. As mentioned in our general remarks, GNE is simple in terms of computation and less complicated than other metrics. However, it can easily lead to “false positives”, as it doesn’t provide an insight into risks and actual economic exposures (mainly due to lack of reflection on the purposes of derivatives’ use).

For that reason, EFAMA stresses that GNE can be used as a first indication of the aggregated sum of derivatives and borrowing used in the fund, but cannot be a standalone measurement of the risks related to leverage. It is also important to note that further aggregating the gross notional exposures across the financial system would not lead to a meaningful figure for regulators, as this would not provide insight into the risks and economic exposures across funds.

Question 2

Do respondents see merit in scoping out of step 1 assessments certain funds, such as for example, smaller funds? Please elaborate.

EFAMA agrees with the 2-step approach suggested by IOSCO and considers appropriate to use step-1 as a screening method to identify which funds may pose risks to financial stability on the basis of their use of leverage and with the aim to focus at the following step (step 2) only on this particular subset of funds that presents such risks. At the same time, it is important that the overall approach of IOSCO regulators is pragmatic and efficient and takes into account a number of key factors, such as how much leverage is used, for which purposes and under which conditions and/or constraints.

In this respect and given the low levels of leverage in the European investment fund sector (as mentioned in our general remarks), it would be pragmatic for IOSCO regulators to exclude from the overall approach those funds that do not employ substantial leverage due to regulatory prohibitions or are too small to pose risks to financial stability. In this regard, we suggest exempting from step-1 funds with regulatory constraints that ensure non-substantial levels of leverage, such as UCITS funds in Europe that are submitted to a cap regarding the use of leverage via derivatives and borrowing and the 40 Act funds in the US, as well as too small funds.

The thresholds used in AIFMD’s lighter authorization regime can also be among the criteria used for scoping out certain funds, i.e. (a) AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million, (b) AIFs whose assets under management in total do not exceed a threshold of EUR 500 million when the portfolios of AIFs consist of AIFs that are unleveraged

and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF (AIFMD, article 3 para 2).

As already stressed before, UCITS funds in Europe that are submitted to a cap regarding the use of leverage via derivatives and borrowing should be a priori scoped out. Moreover, the approach taken by some regulators concerning the risk reporting requirements for UCITS could also be used for the scoping out of certain UCITS (and in the case when regulators consider that the leverage cap doesn't apply), for instance those with total net assets at the reporting reference date lower than EUR 500 million or UCITS using the Value-at-Risk (VaR) method for calculating the global exposure with an arithmetic average leverage (calculated as the sum of the notionals of the derivatives used) over the reference semester greater than or equal to 250% of the UCITS total net assets¹⁰.

We would also suggest that funds with low leverage on a GNE basis should be left out from providing further input on NNE basis. In addition, in the context of a pragmatic and balanced approach, EFAMA also supports that the existing proportionality foreseen in national regimes concerning the reporting requirements (data quantity and frequency) in respect to leverage, should also continue applying for different types of investment funds.

Question 3

Is this an appropriate metric to use as part of this two-step framework? Does it provide any information that is not provided by the other potential step 1 metrics discussed below?

As mentioned in our response to Q1, GNE can be used as a first indication of the aggregated sum of derivatives and borrowing used in the fund, but cannot be a standalone measurement of the risks related to leverage. Therefore, it is already necessary to use at step-1 an additional measure that would help identify the actual risks related to the use of leverage in a fund.

Questions on Adjusted GNE

Question 4

Do respondents agree with the discussion above concerning the information that can be provided by this metric as well as its limitations?

We take note of the suggested adjustments for interest rate derivatives and options and their potential advantages for helping to address some of the inefficiencies related to the GNE. However, we consider it important to rely on a more advanced measure that can capture in a more comprehensive way the fund's exposures and the actual risks associated with different types of derivatives or the purpose for which they are being used. In the EU the AIFMD Delegated Regulation includes conversion methodologies for derivative instruments for the calculation of the exposure of an AIF in accordance with the gross method, including delta adjustments for options, to avoid overstate the market risk of funds.

We agree with these particular adjustments proposed in the AIFMD framework, however, we also see that the use of gross method alone, even with these adjustments, cannot sufficiently address the challenge of overstating

¹⁰ CSSF, Guidelines on the UCITS risk reporting - December 2018, Key Principles and Instructions – Reporting Scope http://www.cssf.lu/fileadmin/files/Metier_OPC/GuidelinesUCITSreporting122018.pdf

the market risk of funds. We consider, therefore, the EU framework takes the right approach by including the commitment method in combination with the gross method.

Moreover, moving from these already established metrics would bring in practice important additional burden and costs via further adding reporting layers to the existing ones.

Question 5

Do respondents agree with the proposed adjustments of the gross notional exposure? To what extent would these adjustments provide improvements to the listed metrics and address the concern that metrics based on gross market exposure could overstate a fund's market exposure? Would respondents favour further adjustments and if so which one(s)? For example, should a measure of adjusted gross notional exposure consider adjusting a derivative's notional amount based on the volatility of the underlying reference asset? If so, what would be an appropriate measure of volatility? What other adjustments would be appropriate and why?

The adjustment foreseen for interest rate derivatives, in particular in terms of 10-year bond equivalents and the delta adjusting for options can present partial benefits from a conceptual point of view. In the case of interest rate derivatives, presenting their notional amounts in terms of 10-year bond equivalents is a step closer to a measure of the market risk and in theory may further allow for comparisons between interest rate derivatives of similar exposure to changes in interest rates but with different unadjusted notional amounts. At the same time though the reference to the 10-year bond sensibility overlooks evidence that the yield curve doesn't move without distorting its shape.

On the adjustment based on the fund's target duration, we believe this also presents difficulties, mainly as it leads to complex calculations.

For options the proposed delta adjustments are already foreseen in the AIFMD framework¹¹, taking into consideration that changes in the price movement of the underlying equivalent do not mean an equivalent price movement of the options. It should, however, also be kept in mind that towards maturity date and depending of the relation between exercise price and the current market price of the underlying, options may be sensitive to other factors.

However, as mentioned in our response to Q1 and Q3, GNE is to be considered as a first indication of the aggregated sum of derivatives and borrowing used in the fund but cannot be a standalone measurement of the risks related to leverage. Therefore, it is important to rely at step-1 on a more advanced measure that can capture in a more comprehensive way all of the fund's exposures and actual risks associated with different types of derivatives. In this respect and although we agree with the particular adjustments proposed in the AIFMD framework, we also see that the use of gross method alone cannot sufficiently address the challenge of overstating the market risk of funds. It is for that reason that the EU framework foresees the commitment approach to complement the gross method. EFAMA firmly supports the combination of measures as suggested

¹¹ See footnote 9

in the European regulatory framework and we believe this can serve as the reference point for further developing a matrix of consistent leverage measures at the international level.

For the same reasons, we don't see the need in proposing further adjustments to the GNE, such as based on the volatility of the underlying reference asset. GNE is to be a simple to calculate and understand measure.

Question 6

With respect to the duration adjustment, do respondents agree that it would be appropriate to express interest rate derivatives as ten-year bond equivalents? Would respondents favour adjusting the fund's interest rate derivatives relative to its target duration rather than a ten-year bond equivalent? If the "10-year-bond equivalent" approach were preferred, which reference bond(s) should be used depending on market? If the "fund's target duration" were preferred, what should be done with the funds that have no target duration? Are there alternative approaches that should be considered? Which ones and why?

We see more benefits in presenting interest rate derivatives as 10-year bond equivalents rather than adjusting derivatives relative to the fund's target duration, however we see cons in the 10-year bond equivalence as well. Moreover, we don't consider this adjustment as a sufficient way to address the concerns related to GNE. Please see our response to the previous question.

Question 7

Are there any funds that could be missed as a result of an analysis using adjusted gross notional exposure metrics but may warrant further regulatory attention? For example, a fund that invests significantly in investments with embedded leverage (e.g., an inverse floating rate note) may have a low gross notional exposure while nonetheless having highly volatile returns. As another example, if options are delta adjusted, would this raise the concern that a deeply out-of-the money option (with a corresponding low delta) could be given a very low adjusted gross notional exposure value but could represent a significant risk? If respondents agree with this risk, how could it be mitigated?

EFAMA believes that the existing EU regulatory framework and in particular the AIFMD Delegated Regulation and the CESR Guidelines already provide significant amount of details on how to convert each financial derivative instrument position into a market value of an equivalent position in the underlying asset, the types of financial derivative instruments that may be excluded from the global exposure calculation and the kind of hedging and netting arrangements that are permitted.

Questions on NNE

Question 8

Do respondents agree that information about a fund's net exposure, when used in conjunction with metrics based on gross market exposure, may provide additional information about a fund's potential leverage? Please elaborate.

EFAMA agrees with NNE being the metric that complements GNE, as it can account for some netting and hedging relationships and consider positions that eliminate all or part of the risks linked to other positions. In this way

NNE can help correct some of the GNE limitations, in particular the overstatement of fund's exposures and of the extent to which a fund's net asset value will change in response to market changes.

In the EU the UCITS level 2 legislation along with the CESR Guidelines, as well as the AIFMD Delegated Regulation include a detailed set of rules for the calculation of the net exposures under the commitment method and the conversion of each derivative instrument position into an equivalent position in the underlying asset, define netting and hedging arrangements and contain a description of which of these arrangements are permitted. This regulatory framework has proven its risk-resilience and value through the diverse market events that have taken place since the implementation of the AIFM and UCITS Directives. It has allowed regulators to ascertain that leverage levels remained relatively low and constant over time and that wider regulatory framework governing European investment funds has not led to potential systemic risk occurring in EU-domiciled investment funds since the global financial crisis. Therefore, we consider that the EU regulatory framework can serve as the reference point for developing a matrix of consistent leverage measures at the international level and in particular a comprehensive framework for the calculation of the net notional exposures.

Question 9

To what extent should netting assumptions be considered to ensure that netting conventions applied may not impair consistent calculation of one fund's net exposure to another and from one jurisdiction to the other? We invite respondents to comment on the approach set forth in Appendix A.

The existing EU framework on the commitment approach (i.e. AIFMD level 2 provisions on the commitment method and the CESR Guidelines) provides very useful criteria as to the measures for including netting at an aggregate level, which have been positively tested over years with satisfactory results both for regulators and asset managers.

We agree with the definition of netting as included in Appendix A of the IOSCO consultation paper, i.e. as a combination of trades on derivative instruments and/or security positions referring to the same underlying asset with the result that it eliminates fully or partially the risks linked to such portfolio positions netted off or offsets the economic exposures of the portfolio with regards to the same underlying assets and regardless of the transacting counterparties.

We also support the netting based on maturity buckets approach set forth in Appendix A, as this is the one closely linked to the EU Regulations. We agree with IOSCO that this standard is simple to implement and therefore we consider that this would also help achieve IOSCO regulators' objective for greater comparability across funds and jurisdictions. Furthermore, we acknowledge there are limitations as to how accurate such measurement can be regarding the inherent risk and we take note of the proposed netting based on the duration equivalence.

However, as in the case of netting applied on adjusted duration what isn't taken into consideration is that the yield curve doesn't move without distorting its shape, which leads to different variations in different duration points. It seems therefore that either approach has pros and cons (simplicity versus accuracy concerning the inherent risk). Netting based on maturity buckets is a tested approach that offers a simple to implement standard. As such, it can more efficiently help achieve the key goal in step-1, which is to identify funds that may

pose risks to financial stability rather than a fully risk-based analysis – this will apply for funds selected for further assessment in step-2.

Question 10

Do respondents agree with the proposed conditions of currency hedging arrangements?

EFAMA agrees that there are additional challenges in determining positions that can be expected to have inverse price relationships. On the definition of hedges, we agree with the suggestion included in page 9 of the consultation paper. In the EU, the CESR Guidelines and the AIFMD Delegated Regulation provide a set of additional criteria under which hedging positions can be taken into account. We strongly recommend that IOSCO develops further conditions related to the hedging arrangements based on these criteria. This will also prevent a further calculation of the Net Notional Exposure, which would imply additional burden and costs.

We agree that it is easier to determine positions as currency hedges on the basis of objective data points and we support excluding currency hedging arrangements from the NNE calculation. As to the proposed conditions for currency hedging arrangement to be excluded, we consider they don't necessarily take into account the effectiveness of currency trade practices and can be overly complicated to implement. Instead, we would suggest adopting the approach foreseen in the EU regulations, i.e. "derivative instruments used for currency hedging purposes and that do not add any incremental exposure, leverage or other risks shall not be included in the calculation" of the NNE.

Question 11

Are there any funds that may warrant further regulatory attention but that could be missed as a result of an analysis using NNE based on the approach proposed in Appendix A?

We believe that the combination of metrics suggested in the EU regulatory framework can capture all funds that may pose risk to financial stability and therefore warrant further regulatory attention at step-2.

Question 12

Would information that serves as a proxy for potential offsetting relationships be informative when evaluating a fund's potential leverage? How comparable would these proxies be across jurisdictions? Do respondents believe the examples discussed above would be informative? Are there other proxies that would be informative?

Given that the information used as proxies for potential offsetting relationships would be based on data collected by local regulators and that there is no consistent collection of such data or common assessment method among different jurisdictions, these proxies cannot meet the objective of a comparable measure. In addition, the proxies mentioned in the consultation paper, such as fund's exposures on long and short positions, seem to be collected and relevant on an asset class basis and not at the level of the portfolio. EFAMA, therefore, sees limited benefits in respect to the use of proxies for the evaluation of the fund's potential leverage and their comparability across different jurisdictions.

Questions on GNE, Adjusted GNE or NNE

Question 13

GNE represents the gross market exposure of a fund which is calculated by summing the absolute values of the notional amounts of a fund's derivatives by asset class plus the value of the fund's other investments by asset class, as noted above. Should cash and cash equivalents be included in the calculation of exposure, or not? Please explain.

Cash and cash equivalents in base currency of the fund should be excluded from the calculation of exposure as they don't add risky exposures to the fund. Cash may only be used within the NNE calculations to the extent its amount offsets an equivalent amount generated by derivatives' use (CESR Guidelines).

The AIFMD Delegated Regulation foresees that for the calculation of the exposure of an AIF in accordance with the gross method, the AIFM shall exclude the value of any cash and cash equivalents which are highly liquid investments held in the base currency of the AIF, that are readily convertible to a known amount of cash, are subject to an insignificant risk of change in value and provide a return no greater than the rate of a three-month high quality government bond. We suggest a similar approach to be taken by IOSCO.

Question 14

Should the greater of the cash borrowed and the current value of the assets purchased with the borrowings be retained when calculating the metrics or should it consider, once cash is reinvested that the value of the corresponding investment should be used? In some jurisdictions, regulatory calculations include the greater of the amount of cash borrowed or the value of the investments purchased with the borrowing. For example, if a fund borrows \$100 and invests all of it in securities that later decline in value to \$50, under this approach the calculation would include the greater amount of the cash borrowing, rather than the value of the security. Please elaborate.

This approach seems to be consistent with the AIFMD rules for the calculation of the fund's exposure in accordance with the gross method which shall include exposures resulting from the reinvestment of cash borrowings, expressed as the higher of the market value of the investment realised or the total amount of the cash borrowed. It is, however, important to note that in practice matching the assets purchased with the amount borrowed isn't as straightforward, as the fund manager doesn't usually match decision on portfolio allocation with specific sources of funding and positions maybe added to or sold at a later stage. It may therefore be practical to retain the current market value of the risky assets purchased.

Question 15

GNE and adjusted GNE discussed above, are both presented on a gross basis, that is, the metrics represent the sum of the absolute values of long and short positions and by asset class, without any netting or hedging. Where positions are closed out with the same counterparty and result in no credit or market exposure to the fund, should they be excluded from these metrics? This would be consistent with data reporting on the SEC's Form PF, for which advisers do not include these closed-out trades when reporting the aggregate value of all derivatives positions. For example, if a fund enters into a future contract to sell a given commodity, and then

enters into a contract to buy the same commodity for the same delivery month on the same futures exchange in order to eliminate the fund's exposure under both contracts, should the metrics exclude those contracts' notional amounts from any exposure figure?

Closed out positions are not netting arrangements. EFAMA considers that they result in no exposure in terms of credit or market risk and have nothing to do with the counterparty risk. We therefore agree with their exclusion from GNE and adjusted GNE.

Presentation of GNE, Adjusted GNE or NNE by asset class

Question 16

Would notional exposure metrics allocated across asset classes allow for more effective step 1 screening for leverage and leverage-related risks than aggregating a fund's exposure into a single figure? That is to say, would this approach more effectively achieve the goal of step 1—efficiently excluding from consideration funds that are unlikely to pose significant leverage-related risks and which thus do not warrant further analysis? Do respondents further believe that the additional inclusion of a "total" aggregated number could be of interest under the proposed approach? Please elaborate.

EFAMA doesn't believe that such analysis of the exposures allocated by asset class can replace the calculation of the level of leverage used at the fund's level, as this type of aggregation across asset classes cannot work in the case of net notional exposures.

Moreover, the existing in the EU regulatory requirements are extensive and cover a wide range of data, but not on an asset class basis. Under the current EU regulatory regime UCITS and AIFs submit detailed report on the use of leverage at the level of the fund, as well as for systemic risk purposes. This already allows national and European regulators to act in exceptional circumstances and when necessary to ensure the stability and integrity of the financial sector. Moreover, many EFAMA members report on a line-by-line basis ("inventories") to their prudential authorities.

Given the important burden and costs that additional requirements will bring, we see no merits in adding to the current reporting. Instead, we call regulators to build upon existing data that are granular and targeted also at the effective monitoring of systemic risk and to avoid additional layers of reporting requirements.

Question 17

How granular should the split of asset classes be? Would the more granular presentations in Form PF and AIFMD requirements, for example, be most informative? Should the answer depend on the type of fund or regulations that apply to the fund's use of leverage (i.e., more granularity where the regulatory scheme permits greater leverage)? Would allocating exposure across major asset classes such as equities, commodities, credit, interest rates, or currencies, provide sufficient information?

EFAMA considers that allocating exposure across major asset classes (equities, commodities, interest rates, credit, property, cash, currencies) should be sufficient. As mentioned in our previous response for jurisdictions

such as the EU, where granular reporting requirements are in place, the focus should be on available data and avoiding additional reporting layers.

Question 18

Would it be helpful to examine other details that could supplement the allocation of a fund's exposure by asset class - for example, identifying the types of derivatives instruments in which a fund invests? Different derivatives instruments can have different risks associated with them, such as different counterparty risk, or a linear risk profile (e.g. futures) versus a non-linear risk profile (e.g., options). A fund's allocation of exposure across asset classes also could include the relevant counterparty, or those counterparties to which the fund has significant exposure. Would this information be useful in evaluating potential impacts of a dealer or central counterparty coming under market stress? Do respondents think that such additional data points would provide useful information, taking into account allocation of exposure across asset classes? What other data points might be helpful in this regard?

EFAMA doesn't see the added value of including additional data points in the allocation of a fund's exposure by asset class, as this may lead to duplications of reported data or to data not directly relevant for the measurement of leverage. For instance, the counterparty exposure is already reported separately from leverage risks and while leverage is a measure of market risk, counterparty exposures are linked to default risks. We, therefore, strongly oppose the inclusion of such additional data and details in the analysis of metrics by asset classes.

Questions on supplementary data points**Question 19**

Would these data points supplement step 1 metrics in a relevant manner? Do respondents believe that certain of these supplementary data points should be given more or less weight than others? Which ones and why?

EFAMA doesn't see the need for supplementary data points at step-1 as this would further complicate the process and could impede the objective for comparable results. Moreover, apart from the fund portfolio composition, the strategy and the size of the fund, the other data points suggested, such as the availability of assets to meet calls for margin or collateral and the counterparty exposures, are already reported and assessed separately and are not relevant for measuring leverage used in funds, at least at step-1. It may be useful for regulators to take into account such data at step-2 during the risk assessment process of the sub-set of funds identified after the first step.

Question 20

Are there other useful data points that would supplement step 1 metrics? Do respondents consider these or other data points as part of their leverage risk management? If so, which ones and how do respondents use them?

Please see our previous response.

Questions on step 1

Question 21

a) Should we consider other metrics than the one consulted on? If so, which one(s) and why?

b) What's your view of the metrics detailed in appendix B?

As mentioned above the metrics to be used at step-1 should be a combination of gross and commitment approach as foreseen in the EU framework. We don't see any other measures as relevant for this step.

In relation to stress test-based leverage/ worst loss measure, they present important subjectivity and are more complex in comparison to NNE and certainly to GNE. Moreover, they may not be suitable for all types of funds. Therefore, we don't believe these are metrics to be included in step-1, but they may be useful for identifying certain risks in step-2.

Chapter 3 – Articulation of one or more step 1 metrics with supplementary data points

Question 22

Do respondents agree that none of the metrics analysed can alone provide an accurate measure of leverage of a given fund or a group of funds? Would a combination of the suggested metrics or one of such metrics with supplementary data point suffice to meaningfully monitor leverage and identify funds that may need further risk assessment regardless of the market conditions? Please elaborate.

As already mentioned in our general remarks each metric analysed presents different pros and cons and no single measure of leverage can address the challenge of simplicity and accuracy at the same time. EFAMA, therefore, believes that a matrix of different measures is a feasible way to achieve a better representation of a fund's economic exposure and allow regulators to draw the right conclusions for financial stability purposes.

This combination of metrics should include GNE, which is to be used as a first indication of the aggregated sum of derivatives and borrowing used in the fund, but cannot be a standalone measurement of the risks related to leverage. In the EU the AIFMD Delegated Regulation includes conversion methodologies for derivative instruments for the calculation of the exposure of an AIF in accordance with the gross method, including delta adjustments for options, to avoid overstate the market risk of funds. We agree with these particular adjustments proposed in the AIFMD framework, however, we also see that the use of gross method alone, even with these adjustments, cannot sufficiently address the challenge of overstating the market risk of funds. It is for that reason that the EU framework foresees the commitment approach to complement the gross method.

EFAMA firmly supports the combination of measures that is suggested in the European regulatory framework and we believe this can serve as the reference point for further developing a matrix of consistent leverage measures at the international level.

Question 23

What are the challenges associated with the collection of data for each metric and/or of the supplementary data points suggested? Is the information readily available?

Duplication of reporting templates, as well as additional burdensome reporting requirements can be the main challenges linked to data collection. Moreover, further data sharing among regulators is a key challenge towards enhancing the leverage measurement at global scale.

Under the current EU regulatory regime, UCITS and AIFs submit detailed report on the use of leverage at the level of the fund, as well as for systemic risk purposes. This already allows national and European regulators to act in exceptional circumstances and when necessary to ensure the stability and integrity of the financial sector. We, therefore, call for building upon existing data that are granular and targeted also towards the effective monitoring of systemic risk and to avoid additional layers of reporting requirements.

Question 24

Are there other approaches, rather than the two-step framework and alternatives identified above, that respondents believe we should consider? If so, what are these approaches and what are their advantages and limitations?

EFAMA agrees with the 2-step approach aiming at identifying funds that may pose risk to financial stability on the basis of the use of leverage (step 1) and then further analysing this particular subset of funds on the basis of risk assessment (step 2). We don't consider that every fund using leverage is a source of risk to financial stability and we are convinced that the majority of the European funds industry isn't substantially leveraged and therefore should be filtered out in step-1. Only a small subset of investment funds merit further analysis in step-2 and for that the right criteria need to be in place in step-1 to appropriately identify which those funds are.

We do not believe other approaches should be considered.

Question 25

Is there one or more step 1 metrics, or specific supplementary data points, or both, that may be effective in facilitating a cross-border regulatory dialogue if collected across jurisdictions? If so, which metrics and/or data points and why?

EFAMA strongly supports to include in step-1 the measures foreseen in the European regulatory framework, i.e. the gross method and the commitment approach.

Chapter 4 - Analysing Funds in Step 2

Question 26

Do respondents believe that step 2 effectively reflects the inherent limitations in step 1 measures by recognising that, in step 2, regulators seeking to identify leverage-related risks may need to perform risk-based analyses that move beyond step 1 metrics? Why or why not?

EFAMA agrees with the step-2 acting as a mitigant of the limitations of metrics used in step-1 and welcomes the more risk-based sophisticated models suggested at this stage. Metrics such as VaR, stress tests and stressed VaR

can define in a more accurate way the exposures of the fund. At the same time, we like to stress that the decision to further assess a fund under step-2 doesn't automatically deem this fund as posing risks to financial stability.

Moreover, it is welcome that regulators are given the discretion to exercise their judgement as to which funds they wish to further focus on at step-2 and which analyses to perform. This is crucial given the broad universe of investment strategies with risks that are significantly different in size, nature and characteristics associated to their underlying assets. Therefore, what would be useful is for IOSCO to suggest a range of possible models/metrics available to regulators to use in step-2, as well as to provide Guidance for funds that will be captured in the scope of step-2 on how to undertake risk-based assessment.

Question 27

What types of more tailored or bespoke analyses do respondents believe would be most effective in step 2? Are there analyses that respondents perform, or data points that respondents consider, as part of their leverage risk management that they believe regulators should consider as potential step 2 approaches? Which ones and why?

The bespoke analyses depend on many different factors such as the investment strategy and its objectives, the fund's size, the scope of the fund industry in each jurisdiction etc.

There is a reference to two particular types of risks in the consultation, counterparty and market risk.

For the first, the existence of risk for the counterparties of a fund cannot meaningfully be embedded in the fund leverage calculation methodologies as the nature of the counterparty risk and the fund's leverage risk are different and separate. Usually, counterparty risk, in terms of an investment fund, is understood as the exposure that the fund gains via a transaction with a counterparty. However, it is our understanding that, in the context of the latest regulatory debate at the international level, the focus is put on how to embed the risk that the fund might generate for its counterparties. This would mean measuring leverage by judging the transaction from the opposite perspective, i.e. based on the exposure that the counterparty gains by transacting with the fund.

The examples provided in Appendix C are using templates produced for the banking sector disregarding the fact that the level of leverage in funds is substantially lower and their business model different in comparison to banks, which would render the application of similar risk analysis not fit and overly burdensome.

If the aim is to assess the extent to which the failure of a fund can transmit financial distress to its counterparties, it would seem much more consistent to start from assessing the current interconnections of funds and their counterparties. In particular, the risk that a fund generates for its counterparties is not related to the proportion of leverage it takes. The two risks are not linked, and they must be considered in the wider scope of all risks a fund generates, through an overall risk assessment matrix.

This assessment of the risk that the fund generates for its banking counterparties can already be done today via existing reporting requirements at the counterparties' level. In particular according to the Basel requirements related to the measurement of the counterparty exposures, banks already have to analyse counterparty risk as

it is part of banks' counterparty risk management procedures. Furthermore, at the fund level in Europe, the AIFMD has an Annex IV reporting obligation which requires the reporting of the fund's top five counterparties. This requirement has also been included in the UCITS fund reports in some jurisdictions in the EU.

Counterparty risk is currently already addressed in several pieces of EU legislation:

- The UCITS Directive: there are counterparty limit ratios (10%, 5%, etc.) and national regulators often require reporting of counterparty exposures (as seen in the example given in the table above);
- The AIFMD: counterparty limits must be set and counterparty exposures must be reported to ESMA and ESRB;
- The Securities Financing Transactions (SFT) Regulation¹², which allows for capturing funds as counterparties (among others) for SFTs; and
- The European Market Infrastructure Regulation (EMIR)¹³ which allows for capturing funds as counterparties (among others) in the case of all OTC derivatives.

Therefore, it is our view that this level of reporting represents a more effective way of ascertaining where material counterparty risk may lie.

Concerning market risks, the suggested examples in Appendix C, such as the portfolio's sensitivity and Value at Risk are already well-established practices among the EFAMA members.

Brussels, 1 February 2019

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¹² REGULATION (EU) 2015/2365 on transparency of securities financing transactions and of reuse

¹³ REGULATION (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories