IOSCO Consultation Paper on Leverage. February 2019.

In January 2017, the Financial Stability Board (FSB) issued a report entitled "*Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*", which sets out 14 strategic recommendations to address structural vulnerabilities from the asset management activities (vulnerabilities in collective investment schemes).

These 14 recommendations specifically address the possible systemic risks associated with certain vulnerabilities which may result from asset management activities. The threats identified primarily relate to the mismatch between the liquidity of fund investments and redemption terms and conditions for fund units; leverage within investment funds; operational risks and challenges in transferring investment mandates in stressed conditions and securities lending activities of asset managers and funds. Of all these recommendations, those relating to leverage are considered to be the most significant.

The investment funds referred to in the FSB document include traditional collective investment schemes (investment companies and investment funds), real estate funds, hedge funds and funds that invest in commodities.

Of the aforementioned 14 recommendations, numbers 10, 11 and 12 address leverage and, in this context, the aforementioned FSB report indicates that IOSCO should develop these recommendations and, in particular, recommendations 10 and 12.

These three recommendations established the following:

Recommendation 10: IOSCO should identify and/or develop consistent measures of leverage in funds to facilitate more meaningful monitoring of leverage for financial stability purposes, and help enable direct comparisons across funds and at a global level. IOSCO should also consider identifying and/or developing more risk-based measure(s).

In developing these measures, IOSCO should give consideration to appropriate netting and hedging assumptions and where relevant build on existing measures.

Recommendation 11: Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which may pose significant leverage-related risks to the financial system.

Recommendation 12: IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the consistent measures it develops.

IOSCO prepared this report in order to comply with **Recommendation 10 of the FSB report**. The IOSCO report focuses exclusively on this recommendation and is open for public consultation until 1 February 2019, with the main aim of obtaining a universal methodology for calculating leverage.

The report highlights that the use of leverage by investment funds brings with it potential risks to both investors and financial markets. While leverage may amplify investment fund returns, it can also amplify losses. The use of leverage may also, in certain circumstances, impair the proper functioning of markets via different contagion channels. Securities regulators and supervisors, in accordance with their respective mandates, therefore have an interest in monitoring the use of leverage by investment funds.

This paper, in addition to the two-step objectives listed below, contains a total of 27 questions to be answered by the sector. These answers will be used to draw up a framework to help the regulators and/or supervisors of securities markets to calculate and analyse global leverage of investment funds.

The aim is to establish a framework that is as standardised and consistent as possible to facilitate calculation and analysis by regulators. This framework should also make it possible to compare results between different jurisdictions. In this regard, it should be noted that while some jurisdictions, notably the United States and European Member States, require detailed reporting on leverage metrics, others do not have such reporting or have it in a metric that does not allow comparison with other jurisdictions.

This work has been undertaken at the request of the FSB and therefore focuses on the potential risk that might be generated in investment funds if they fail to comply with their payment obligations with counterparties. In other words, the metric focuses on the possible systemic risk generated in investment funds that might spread to the rest of the financial system as a result of the impact that a default by investment funds would have on the financial institutions acting as counterparty.

In order to carry out this task, the consultation paper proposes a two-step approach:

– The first step should allow regulators to identify investment funds that may pose a risk to financial stability through a series of metrics proposed in the paper. This first step would be a filter that will make it possible to exclude those investment funds that are unlikely to transmit risks to the sector.

– The second step will consist of a risk-based analysis of the investment funds identified in the first step. The measures and analyses necessary for this step will be determined by each jurisdiction based on the characteristics and strategies of the investment funds analysed. IOSCO does not therefore prescribe what metrics or tools are necessary for this analysis, leaving this fully to the discretion of each jurisdiction.

The paper focuses mainly on the first step. It also invites feedback on the second step as well as the structuring of the two-step approach. To this end, IOSCO has attempted to find a metric that will be applicable irrespective of the leverage strategy or methods used by the investment fund, that avoids model risk and that facilitates the identification of funds which may pose a risk to financial stability.

For this purpose, the following metrics are proposed:

– GNE (Gross Notional Exposure). The sum of the absolute values of the notional amounts of the fund's derivatives.

– GNE+ (Adjusted Gross Notional Exposure), adjusting by the delta in options and by the duration in fixed-income instruments. Two possibilities are put forward relating to these duration adjustments: either using a 10-year-bond equivalent approach (US system) or adjusting with regard to the fund's target duration (European system).

– NNE (Net Notional Exposure). This allows netting between long and short positions. On this point, it also mentions the possibility of using the methodology applicable to UCITS that allows netting based on maturity buckets or netting of 10-year-bond equivalent positions.

The paper proposes performing the calculation by classifying by asset type (equity, equity derivatives, fixed income, credit derivatives, commodities, etc.) and broken down into long or short positions instead of calculating one single data point. This might allow the regulators and supervisors of securities markets to distinguish between investment firms exposed to high-risk assets and those with lower risk.

Reporting models for the three metrics are presented in the paper. In all three, derivatives are classified into different categories according to the underlying (equity, credit, foreign exchange, interest rate, commodity, other, etc.). Within each category, the data of the GNE, GNE+ or NNE must be included, distinguishing between short and long positions.

Nevertheless, IOSCO admits that these metrics alone do not necessarily show all the information necessary to enable the securities market regulator or supervisor to filter and identify the investment funds that might pose significant risks to financial stability. Accordingly, the NNE may supplement the results obtained using the GNE or the adjusted GNE. To this end, it proposes supplementary data points for the results already obtained, such as the percentage of a portfolio that is long and short, posted collateral, holding of cash or cash equivalents, the size of the investment fund or performing an analysis in terms of the VaR.

The second step will entail a more detailed analysis of investment funds identified as a possible source of systemic risk in the first step. The aim is therefore to perform a risk-based analysis that will mitigate the limitations inherent to the previously-applied metric. In this regard, IOSCO has identified certain risks common to all jurisdictions, such as counterparty and market risks. In this context, it will be the regulators or supervisors of securities markets that will freely decide which investment funds move on to this second step, as well as which metric and which analysis will be performed. In making these determinations, a securities market regulator or supervisor may consider, among other factors, the size of the industry, the nature of each regulator's focus and mission and the extent to which other domestic regulations may seek to address leverage-related risks.

Link of interest:

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