INVEST EUROPE

Response to FSB Consultation

on Leverage in Non-bank Financial Intermediation

Recommendation 1: Risk identification and monitoring

Recommendation 1: *Authorities should have a domestic framework to identify and monitor vulnerabilities related to NBFI leverage and associated financial stability risks in an effective, frequent and timely manner. The domestic framework should be proportionate to the financial stability risks that such vulnerabilities may pose, particularly in core financial markets. Authorities should regularly review their domestic framework and enhance it as appropriate, including the risk metrics utilised, and take steps to improve international consistency in the definition and calculation of those metrics.*

Is the description of the financial stability risks from leverage in NBFI accurate and comprehensive? Are there additional vulnerabilities or risk dimensions related to NBFI leverage that authorities should consider for monitoring purposes?

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

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

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

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

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

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

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

Banks and private credit may provide lending to facilities:

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

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

There has been much public confusion about the use of these facilities and we would be happy to describe these further to the FSB.

What are the most effective risk metrics that should be considered by authorities to identify and monitor financial stability risks arising from NBFI leverage?

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

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

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

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?

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

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

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

***Recommendation 2**: Authorities should review their domestic framework to assess data challenges, including on (i) authorities' usage of available data, (ii) the quality, frequency and timeliness of available data, (iii) authorities' access to relevant data and (iv) potential data gaps within existing reporting*

Recommendation 3: Public disclosure

***Recommendation 3**: Authorities should review the level of granularity, frequency, and timeliness of existing public disclosures and determine the degree to which additional or enhanced disclosures should be provided to the public, either by (i) authorities, including disclosure based on regulatory reporting data, (ii) the relevant financial market infrastructure providers or (iii) directly by financial entities, balancing the costs and benefits of doing so. This includes dissemination by authorities of data and information on aggregate market positioning and transaction volumes based on existing regulatory reporting. Such additional or enhanced disclosures should be designed and calibrated to increase transparency especially about concentration risk and crowdedness, with the aim to support market participants' ability to manage risks from NBFI leverage and estimate counterparty exposures and liquidation costs.*

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

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

The FSB should continue to acknowledge that forcing private fund managers to disclose public

information could have significant consequences on the functioning of their industry, and affect the much needed confidentiality of deals.

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

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

Recommendation 4 & 5: Types of measures

***Recommendation 4**: Authorities should take steps to address the financial stability risks from NBFI leverage that they identify in core financial markets. Activity-based and entity-based measures and measures aimed at addressing concentration that amplifies risks related to NBFI leverage, should be reviewed periodically and enhanced where appropriate, including to address risks from a system wide perspective. The measures should be selected and calibrated to be effective and proportionate to the identified financial stability risks. Where existing legal and regulatory frameworks do not provide the necessary policy measures to address identified financial stability risks, authorities should consider adjusting or widening the scope of such frameworks, where appropriate.*

***Recommendation 5**: When selecting policy measures to address financial stability risks from NBFI leverage in core financial markets, authorities should evaluate a wide range of measures, including both activity and entity-based measures, as well as concentration related measures. Authorities' choice of measures should be based on the nature and drivers of identified risks, taking into account their expected effectiveness and any potential costs or unintended consequences, as well as measures taken in other jurisdictions to address similar risks. Activity-based measures include (i) minimum haircuts in SFTs, including government bond repos, (ii) enhanced margining requirements between non-bank financial entities and their derivatives counterparties, and (iii) central clearing mandates in SFT and derivatives markets. Entity-based measures include (i) direct limits on leverage, and (ii) indirect leverage constraints linked to risks that non-bank financial entities are exposed to. Concentration measures include (i) concentration add-ons for margins and haircuts in connection with exposures of non-bank financial entities in derivatives and SFT markets, (ii) concentration and large exposure limits, and (iii) large position reporting requirements.*

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

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

Are there ways to design and calibrate entity-based measures to increase their risk sensitivity and/or their effectiveness in addressing financial stability risks from NBFI leverage?

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

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

Recommendation 6: Counterparty credit risk management

***Recommendation 6**: Authorities should ensure the timely and thorough implementation of the BCBS's guidelines on counterparty credit risk which represents an important element of a comprehensive policy response to financial stability risks stemming from NBFI leverage. Authorities, in cooperation with SSBs, should monitor, including from a systemic perspective, ongoing and future developments in the way NBFI leverage is provided to ensure that the regulatory framework remains appropriate for the consistent treatment of risks.*

Recommendation 7: Private disclosure

***Recommendation 7**: Authorities, in cooperation with SSBs, should review the adequacy of existing private disclosure practices between leveraged non-bank financial entities and leverage providers, including the level of granularity, frequency, and timeliness of such practices. Where appropriate, they should consider developing mechanisms and/or minimum standards to enhance the effectiveness of these disclosure practices.*

What are the main impediments that leverage users face in sharing additional or more granular data with their leverage providers? Is there a risk that a minimum recommended set of disclosures may lead leverage users to limit the information they share with their leverage providers to that minimum set?

The FSB should acknowledge that managers are already subject to intense scrutiny, including from the need to give their lenders information required under law to these lenders. It is

unclear how additional data could represent a real improvement to the current data. On the contrary, we know from experience that regulators do not already make use of the entire set of data that is at their disposal.

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

Should such a minimum set of disclosures rely on harmonised data and metrics to ensure transparency and efficiency in the use of such information for risk management purposes? Do respondents agree that such a minimum set of disclosures should be based on the list of principles outlined in the consultation report? If not, which principles should be added, deleted or amended?

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

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?

NA

Recommendation 8: Harmonisation/congruence of rules

Recommendation 8: *Authorities should adopt the principle of "same risk, same regulatory treatment" and identify incongruences in the regulatory treatment of NBFI leverage resulting from similar exposures, financial instruments or structures that may distort incentives and result in regulatory arbitrage. Where incongruences are identified, authorities, in cooperation with SSBs, should analyse the underlying causes to determine whether and how to address the identified incongruences, having regard to the treatment of similar situations in other jurisdictions, so that domestic remediation efforts do not create new disparities that could transfer risk across borders.*

Are there areas where the principle of "same risk, same regulatory treatment" should be more consistently applied? Are there circumstances in which the principle should not apply or should not apply comprehensively?

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

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

Recommendation 9: *When addressing risks created by NBFI leverage that may emanate from, transmit to, or otherwise impact markets and market participants in other jurisdictions, authorities should engage proactively with their peers to facilitate coordinated crisis and/or policy responses, to the extent legally and operationally feasible. To enhance system wide risk monitoring across jurisdictions, authorities should proactively establish information sharing agreements, such as through MoUs, and regular communication channels or engagement processes, where they determine that doing so would assist in their ability to identify and assess relevant market risks, especially during crises. Authorities should also share aggregate data on leverage in key non-bank financial sectors on a best effort basis and make use of harmonised data and metrics as much as possible when exchanging information with each other.*