MEMO# 31595

February 4, 2019

ICI Files Comment Letter on IOSCO Leverage Consultation

[31595]

February 4, 2019 TO: ICI Members
ICI Global Members
Derivatives Markets Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee SUBJECTS: Derivatives
International/Global
Trading and Markets RE: ICI Files Comment Letter on IOSCO Leverage Consultation

Last week, ICI filed the attached comment letter responding to the Board of the International Organization of Securities Commissions' ("IOSCO") request for comment on a proposed framework to assess investment funds' use of leverage.[1] The proposed framework would be carried out in two steps. Under the first step, national securities regulators would apply certain metrics to measure leverage within funds in their respective jurisdictions. The goal of the first step is to serve as a screening tool that efficiently excludes from any further consideration funds that are unlikely to pose risks to the financial system. The second step would involve further analysis of the remaining subset of funds. ICI's response strongly supports IOSCO's proposed framework, which seeks to assist regulators in consistently calculating and analyzing investment fund leverage for financial stability purposes.[2] It also provides several specific comments to improve the proposed Step 1 and Step 2 analyses.

General Comments

The letter strongly supports IOSCO's approach of conducting a two-step analysis and the flexibility that it would provide each national securities regulator to determine what information should be calculated, collected, and analyzed. The letter agrees with IOSCO that a single measure simply cannot appropriately reflect the extent of leverage of all types of funds. It also agrees with the merits of a two-step approach in which regulators can use certain measures to exclude a large number of funds in the first step, then further analyze the remaining funds for potential financial stability risks in the second step. The letter, however, cautions IOSCO to ensure that it does not mischaracterize Step 1 as a means to identify funds that potentially pose a risk to financial stability. Rather, the first step only should be used as way to efficiently exclude funds that are unlikely to pose risks to the financial system, as the Step 1 measures do not provide meaningful insight as to whether the identified funds do pose risks to financial stability.

The letter also supports the regulatory flexibility provided to national securities regulators to determine what funds to analyze as part of Step 2 and which Step 2 analyses to perform. National securities regulators are in the best position to assess fund leverage within their jurisdiction to determine what, if any, additional analyses should be performed to identify potential risks to financial stability. Though the leverage metric data collected may not be identical among jurisdictions, the letter agrees with IOSCO that there is substantial overlap in the information covered so that any data collected still will be enormously useful for analyzing potential financial stability risks across jurisdictions.

Specific Comments on Step 1 and Step 2 Analyses

In addition, the letter makes the following specific comments to improve the proposed Step 1 and Step 2 analyses:

Comments on Step 1

Leverage metrics

- **IOSCO should eliminate the use of unadjusted gross notional exposure as a leverage metric.** Unadjusted gross notional exposure is not a good indicator of a fund's overall economic risk or degree of leverage and may present an incomplete and potentially misleading view of a fund's overall market exposure.
- **IOSCO should permit funds to adjust interest-rate derivatives to a ten-year bond equivalent.** Although not perfect, adjustments to a ten-year bond equivalent would better reflect the derivatives' risk without the more pronounced overstatement associated with unadjusted gross notional exposures. In addition, adjusting interest rate derivatives relative to a ten-year bond equivalent would provide a practical, uniform way of adjusting duration that could apply to more funds than adjusting durations to a fund's target duration.
- Netting and hedging transactions:
    - **IOSCO should define permissible netting arrangements and permit netting of close-out and offsetting transactions.** IOSCO should clearly define permissible netting arrangements to produce more consistent and comparable results. Netting arrangements should include any close-out and offsetting transactions to reflect the true economic exposure of the portfolio.
    - **IOSCO should permit netting using a duration equivalency model.** Netting using a duration equivalency model would scale gross notional exposures and sum the long and short adjusted gross notional exposures for positions with the same underlying asset. The approach is simpler and more exact than the consultation's proposed netting using maturity buckets because of the more precise duration sensitivity of the adjustments.
    - **IOSCO should define permissible hedging arrangements and exclude "direct hedging" arrangements.** Similar to clearly defining netting arrangements, clearly defining hedging arrangements would produce more consistent and comparable results. IOSCO also should exclude any "direct hedging" arrangements, which are akin to offsets that reduce or eliminate fund exposures, to better reflect the true economic exposure of the portfolio.

Asset classification table

- **ICI strongly supports the use of an asset classification table.** Separating fund holdings by asset class is crucial because different asset classes have different levels of risk. Similarly, separating asset classes by long and short positions reflects a fund's true position in an asset class. Together, the table is a critical element of the consultation that would enable regulators to compile information from Step 1 in a straightforward and meaningful way to more easily evaluate financial stability risks.

- **IOSCO should modify the table to eliminate the aggregate "Totals" row and "Percent of Net Asset Value ("NAV")" columns.** Aggregated notional exposures among different asset classes in a "Totals" row would provide little useful information and could be misleading. Also, the percent of NAV columns are misleading and erroneously suggest that there is a meaningful measure of leverage relative to NAV that reflects the risks that regulators are concerned with.

Supplementary data points

- **IOSCO should include as many of the supplementary data points as possible in Step 1.** This would help to properly exclude from Step 2 funds that do not warrant a more extensive risk-based analysis.
- **IOSCO should caution regulators not place too much emphasis on any one data point (*e.g.*, size of a fund).**

Comments on Step 2

- **ICI generally agrees with the proposed Step 2 risk-based measures.** The proposed market and counterparty risk measures could provide insightful information on leverage-related risks.
- **IOSCO should consider adding a stress-based leverage/worst-loss measure as part of the Step 2 metrics.** This type of risk-based measure could demonstrate at a high level how a fund's portfolio might react under common market stress events and shed light on the fund's expected resilience in stressed markets.
- **ICI supports IOSCO's non-exhaustive list of Step 2 supplementary data points and its overall approach on data points.** Although several supplementary data points appear as both Step 1 and Step 2 measures, including them as potential measures under each step allows a national securities regulator that does not employ a supplementary data point as part of Step 1 to consider it for Step 2.

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Attachment

endnotes

[1] *See* IOSCO, IOSCO Report: Leverage (November 2018), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD615.pdf. For a summary of the consultation, *please see* ICI Memorandum No. 31511 (Dec. 3, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31511.

[2] The letter adds that regulated funds currently have legal and regulatory limitations on their ability to use leverage and that those limitations, together with other structural and regulatory features, make it unlikely for a regulated fund to transfer leverage-related risks to its counterparties or the financial system at large.