

COMMITTEE ON CAPITAL MARKETS REGULATION

August 26, 2019

Randal K. Quarles, Chair
Financial Stability Board
c/o Bank of International Settlements
CH-4002, Basel
Switzerland

Dr. Shane Worner
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid, Spain

Re: Public Comment on IOSCO Report: Leverage; Public Comment on Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

Dear Sirs:

The Committee on Capital Markets Regulation (the “**Committee**”) is grateful for the opportunity to comment on the International Organization of Securities Commissions’ (“**IOSCO**”) report on leverage¹, which sets forth “a proposed framework to help measure leverage used by investment funds that in some circumstances could pose financial stability risks” (“**IOSCO Leverage Report**”).² The Committee is also grateful for the opportunity to comment on the Financial Stability Board’s (“**FSB**”) report, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (“**FSB Asset Management Report**”).³

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean Emeritus, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

¹ The Bd. of the Int’l Org. of Sec. Comm’ns, *IOSCO Report: Leverage* (Nov. 2018) (hereinafter, the “**IOSCO Leverage Report**”), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD615.pdf>.

² Int’l Org. of Sec. Comm’ns, *IOSCO seeks feedback on proposed feedback for assessing leverage in investment funds* (Nov. 14, 2018), <https://www.iosco.org/news/pdf/IOSCONEWS515.pdf>.

³ Fin. Stability Bd., *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (Jan. 17, 2017) (hereinafter, the “**FSB Asset Management Report**”), <https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>.

The IOSCO Leverage Report is intended to develop a proposed framework to “help measure leverage used by investment funds which in some cases could pose financial stability risk.”⁴ The IOSCO Leverage Report was issued in response to Recommendation 10 in the FSB Asset Management Report,⁵ which asks IOSCO to:

“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) to complement the initial measures with a view to enhance authorities’ understanding and monitoring of risks that leverage in funds may create. In both cases, IOSCO should consider appropriate netting and hedging assumptions and where relevant build on existing measures.”⁶

The Committee recommends that the FSB and IOSCO remain focused on an activities-based approach to identifying any potential systemic risk posed by investment funds and not seek to identify individual investment funds that could pose a financial stability risk. Indeed, the Committee appreciates efforts by the FSB and IOSCO to develop a proposed framework to measure the use of leverage by investment funds to determine whether it constitutes a systemically risky activity. However, the Committee believes it is critical to apply any such leverage measures solely on an asset class-by-asset class basis and not on an aggregated basis across asset classes held by an investment fund, as there are vast differences in the relative riskiness of underlying asset types that would make a single aggregated measurement of an investment fund’s leverage meaningless and misleading. The Committee further believes any leverage measures used by regulators should *net* short and long positions within the same asset class in order to accurately measure risk. Additionally, regarding interest rate swaps, the Committee supports making adjustments to account for duration. Finally, the Committee has reviewed the leverage measures being considered by IOSCO and among them, finds that Net Notional Exposure, which would account for netting and hedging arrangements, to be the most appropriate measure of risk.

The FSB and IOSCO Should Remain Focused on an Activities-Based Approach to Addressing Systemic Risk Posed by Investment Funds

The Committee has long supported an activities-based approach to addressing any potential systemic risk posed by investment funds and/or the asset management industry because, “systemic risk in capital markets is not confined to or concentrated in a few discrete entities. Rather, it shifts with capital flows, which themselves are driven by investor preferences and other market dynamics.”⁷ Furthermore, as the Committee noted in its 2013 letter to the U.S. Financial Stability Oversight Council (“FSOC”), “systemic risk...cannot be addressed by designating particular funds

⁴ See supra note 2. “The first step would use the measures of leverage identified and/or developed, with a view to identify and analyse funds that may pose a risk to financial stability.” IOSCO Leverage Report at 1.

⁵ See FSB Asset Management Report.

⁶ *Id.* at 27.

⁷ Letter from Comm. on Capital Mkts. Regulation to Fin. Stability Oversight Council, 2 (Mar. 16, 2015) https://www.capmktsreg.org/wp-content/uploads/2015/03/2015_03_16_FSOC_Notice_on_Asset_Management_Products_Activities.pdf.

or complexes as systemically important, because investors in designated entities could simply shift their capital to...[other investment funds] with substantially similar characteristics.”⁸

The Committee believes that the failure of any individual investment fund or asset manager would not pose systemic risk.⁹ First, investment funds are not a major provider of short-term funding to large banking institutions, so the failure of an individual investment fund would not cause a funding shortage at the largest banking institutions.¹⁰ Furthermore, large banking institutions are not major investors in investment funds,¹¹ so the failure of an investment fund would not pose systemic risk through direct losses to large banking institutions.¹² Individual investment funds are also frequently liquidated without any systemic implications.¹³ Moreover, the asset management industry is well diversified with over 30 asset management firms managing more than \$500 billion in assets under management (“AUM”) globally.¹⁴ The aggregate AUM of the top 20 global asset managers constitutes far less than half (46.6%) of total global AUM.¹⁵ Therefore, the failure of any given asset manager would not pose systemic risk concerns.

Nonetheless, it is plausible that the excessive use of leverage across the investment fund industry, coupled with inadequate risk-management practices, could be a systemically risky *activity* that could lead to steeper asset price falls than would otherwise be the case in a market downturn, and that such steeper asset price declines could contribute to a contagious run on the financial system. Therefore, establishing a standardized global measurement of leverage may be a worthwhile policy goal in determining whether the use of leverage across the investment fund industry is a systemically risky activity.

⁸ Letter from Comm. On Capital Mkts. Regulation to Fin. Stability Oversight Council (February 2013) https://www.capmktreg.org/wp-content/uploads/2013/02/FSOC.non-bank.SIFI_comment.ltr_.pdf

⁹ See Letter from Comm. on Capital Mkts. Regulation to Secretariat to the Fin. Stability Bd., 2 – 4 (May 29, 2015) (hereinafter, the “CCMR 2015 Comment Letter”) http://www.capmktreg.org/wp-content/uploads/2015/05/2015_05_27_FSB-IOSCO_non-bank_SIFI_comment_letter.pdf. “[I]nvestment funds are not a significant source of short-term funding to the financial system and are therefore unlikely to trigger system-wide instability.” CCMR 2015 Comment Letter at 3.

¹⁰ *Id.*

¹¹ According to the Investment Company Institute’s *2019 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, “institutional investors such as nonfinancial businesses, financial institutions, and nonprofit organizations held a relatively small portion of mutual fund assets net assets. At year-end 2018, institutions held 11 percent of mutual fund net assets,” and around a third of these institutional investors were financial institutions (defined as including credit unions, accounts of banks not held as fiduciaries, insurance companies and other financial organizations). Inv. Co. Inst., *2019 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, 58, 252 (2019), https://www.iciglobal.org/pdf/2019_factbook.pdf.

¹² See CCMR 2015 Comment Letter (expressing CCMR’s belief that “the failure of a large asset manager . . . would not pose systemic risk because its bankruptcy would not set off a chain reaction of financial institution failures...”).

¹³ For example, ICI reports that 426 investment funds were liquidated in 2016. Investment Company Institute’s *2017 Investment Company Fact Book*, 57, 27 (2017).

¹⁴ See IPE Top 400 Asset Managers 2019.

¹⁵ *Id.*

Leverage Should be Measured Exclusively by Asset Class

IOSCO proposes that regulators may consider applying exposure measurements by asset class (such as equities, commodities, credit etc.) rather than estimating the aggregate exposure of an investment fund across all asset classes.¹⁶ According to IOSCO, “this may allow regulators to see a fund’s basic asset allocation and to distinguish between funds with exposure to higher risk assets and those with exposure to lower risk assets.”¹⁷

The Committee strongly agrees that leverage should be measured on an asset class-by-asset class basis. Leverage should not be aggregated across asset classes held by an investment fund, because there are vast differences in the relative riskiness of underlying asset types that would make a single aggregated measurement of leverage or market exposure for an investment fund meaningless and misleading. We provide an illustrative example below.

Suppose Fund A has \$10 billion in exposure to a low volatility asset class (e.g. U.S. Treasuries) and \$1 billion in exposure to a higher volatility asset class (e.g. stocks). Also suppose Fund B has \$10 billion in exposure to a high volatility asset class (e.g. stocks) and a \$1 billion in exposure to a low volatility asset class (e.g. Treasuries). If regulators were to aggregate exposure across asset classes, then Fund A and Fund B would each show the same exposure of \$11 billion. However, there is clearly more risk associated with Fund B's portfolio since it is more heavily weighted towards an asset class with higher volatility. Assessing the exposure of each fund by asset class would therefore give a more accurate picture of risk and better facilitate an *activities*-based analysis of the risk posed by leverage in investment funds. By contrast, aggregating exposure across asset classes would not yield an accurate fund-by-fund analysis of risk or correctly inform an *activities*-based analysis of any potential systemic risk posed by the use of leverage in the investment fund industry.

Leverage Measures Should Net Short and Long Positions

The Committee believes it is critical that any leverage measure used by regulators *net* short and long positions in the same asset class because doing so would provide a more accurate measure of financial risk. We provide an illustrative example below.

Suppose Fund A has a \$10 billion long position in a broad market index (e.g. S&P 500 index) and also holds a \$5 billion short position in the same index. Also suppose Fund B has a \$10 billion long position in the S&P 500 index and no short positions. If regulators were to aggregate the absolute value of short and long positions, then it would appear that Fund A has \$15 billion in exposure to the S&P 500 whereas Fund B would only have \$10 billion in exposure to the S&P 500. However, Fund B’s exposure to the S&P 500 index is actually significantly higher than Fund A’s exposure to the S&P 500 index. For example, if the S&P 500 index drops 1%, Fund B would face a loss of \$100 million on its long-only position, while Fund A would only face a net loss of \$50 million (\$100 million loss on the long position, but a \$50 million gain on the short position), since the loss to Fund A’s long position is partially offset by gains to its short position. There is

¹⁶ See *id.* at 10 – 12.

¹⁷ *Id.* at 10.

clearly more risk associated with Fund B’s portfolio, which is why netting short positions and long positions in the same asset class provides a more accurate exposure measure.

IOSCO’s Proposed Leverage Measures

IOSCO proposes a series of exposure metrics to further inform its measurement of leverage: gross notional exposure (“**GNE**”), adjusted gross notional exposure (“**Adjusted GNE**”) and net notional exposure.¹⁸

GNE sums the notional amount of an investment fund’s derivatives and the value of an investment fund’s other assets.¹⁹ The Committee has previously commented that GNE is not an accurate or sensible measure of risk, size, interconnectedness, or market footprint.²⁰ Notional values vary wildly by asset class and duration and ignore netting and hedging arrangements. For those reasons, the Committee continues to believe that GNE is not useful for measuring risk in or informing calculations of leverage of investment funds.

Adjusted GNE is the same as GNE except it includes adjustments for the notional value of interest rate derivatives and options contracts.²¹ Interest rate derivatives are in particular need of adjustment because their notional amounts are much larger than the actual exposure of an investment fund to changes in interest rates and therefore are not an accurate representation.²² IOSCO proposes taking into account different durations of interest rate derivatives when measuring exposure (due to the fact that for a given notional amount, a 30-year interest rate swap presents much more risk than a 1-year interest rate swap).²³ IOSCO proposes a similar approach to options contracts.²⁴ However, much like GNE, Adjusted GNE fails to consider netting and hedging of these derivative contracts and therefore would result in estimates of exposure that may far exceed the risk borne by investment funds.²⁵ The Committee therefore also believes Adjusted GNE is not an appropriate measure of the risk in investment funds.

Net notional exposure (“**NNE**”) attempts to estimate the exposure of an investment fund by applying netting and hedging arrangements to an investment fund’s GNE or Adjusted GNE.²⁶ However, determining the circumstances under which transactions should be regarded as netted or hedged is not always clear. IOSCO suggests two potential approaches for consideration. First, a more restrictive approach whereby regulators should consider only allowing netting or hedging where instruments are referencing the same underlying asset (e.g. a specific stock or specific debt

¹⁸ The IOSCO Leverage Report defines GNE as “gross market exposure of a fund which is calculated by summing the absolute values of the notional amounts of a fund’s derivatives and the value of the fund’s other investments” without any adjustments being made to any of the values. Adjusted GNE is calculated in the same manner as GNE, “but reflects adjustments for interest rate derivatives and options.” NNE “considers the extent to which the fund’s investments may be netted.” IOSCO Leverage Report at 5 – 12. *See* IOSCO Leverage Report at Appendix A for a description of the calculation of each measure.

¹⁹ IOSCO Leverage Report at 5.

²⁰ CCMR 2015 Comment Letter at 5.

²¹ IOSCO Leverage Report at 7.

²² *Id.* at 7, 22 – 23.

²³ *Id.* at 7.

²⁴ *Id.*

²⁵ *Id.* at 7 – 8.

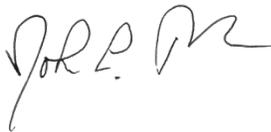
²⁶ *Id.* at 8 – 10.

instrument) and have similar maturities.²⁷ Second, a more flexible approach whereby regulators could consider any information that indicates possible netting or hedging relationships without seeking to define mechanistic rules to identify specific trades that may be netted or hedged.²⁸ Since restrictive, pre-defined rules may fail to contemplate all possible netting and hedging arrangements that should be considered, the Committee believes NNE with a flexible approach will provide a more accurate picture of risk and, therefore, is the most appropriate way to measure the exposure of investment funds.

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Thank you very much for your consideration of our views. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Prof. Hal S. Scott (hscott@law.harvard.edu), or Executive Director, John Gulliver (jgulliver@capmksreg.org), at your convenience.

Respectfully submitted,



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Co-CHAIR



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²⁷ See IOSCO Leverage Report at 1 – 4.

²⁸ *Id.*