Public Comment on IOSCO Report: Leverage

1 February 2019

CONSULTATION
AFG's RESPONSE

association française de la gestion financière

The Association Française de la Gestion financière (AFG) represents and promotes the interests of third-party portfolio management professionals. It brings together all asset management players from the discretionary and collective portfolio management segments. These companies manage at end 2017 €4,000 billion in assets, including €1,950 billion in French funds and €2,050 billion in discretionary portfolios and foreign funds.

The AFG's remit:

- Representing the business, financial and corporate interests of members, the entities that they manage (collective investment schemes) and their customers. As a talking partner of the public authorities of France and the European Union, the AFG makes an active contribution to new regulations,
- Informing and supporting its members; the AFG provides members with support on legal, tax, accounting and technical matters,
- Leading debate and discussion within the industry on rules of conduct, the protection and economic role of investment, corporate governance, investor representation, performance measurement, changes in management techniques, research, training, etc.
- Promoting the French asset management industry to investors, issuers, politicians and the media in France and abroad. The AFG represents the French industry – a world leader – in European and international bodies. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA), of PensionsEurope and of the International Investment Funds Association (IIFA).

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Public Comment on IOSCO Report: Leverage.

Executive Summary

The Association Française de la Gestion financière (AFG) welcomes the occasion given to comment on the IOSCO's consultation on Leverage.

Our members, as users of derivatives, have a long experience in calculating and monitoring leverage, which is capped by the regulation for the vast majority of funds/AUMs. The European framework is deeply fine-tuned so as to capture amplification of underlying risk (meaningful at portfolio level) as well as to give information on global exposure footprint (meaningful on a systemic risk monitoring level).

As a general remark, it should be acknowledged what are the primary objectives of IOSCO's report. As always, we are ready to contribute to global work on leverage calculations and definitions, but this work should be without prejudice to strong and appropriate frameworks that have been already developed through years and that proved to efficiently work in practice. This is the case today of the European leverage calculations framework, which is with no doubt ahead of the curve and may appear somewhat sophisticated, where this is only the expression of appropriateness and adaptation to different asset classes, instruments used and strategies.

AFG's first comment is that we certainly and globally agree on the principle of the 2-step approach as proposed by the IOSCO's consultation paper. In the meantime, some adjustments should be made to the proposed framework:

- Regarding step 1:

One characteristic a global framework on leverage should have is clarity on the main metric categories and the objective they try to achieve/deliver.

Our members believe that is appropriate to keep only the GNE and NNE. AFG thus advises to not retain the Adjusted GNE in the framework as the perceived benefits are not outweighing the risk of confusion leading to a less clear global framework as well as uncertainties in the implementation of "adjustments" from one jurisdiction (or region) to another. We also believe that a two set of measures (GNE + NNE) corresponds to the FSB mandate to IOSCO to set measures for leverage. Indeed, FSB acknowledged that one measure alone could not respond appropriately to the issue of measuring leverage within funds.

    o Regarding the NNE:

More specifically, regarding Netting rules based on the "first approach" mentioned at the bottom of p. 8, we agree with it, but it is appropriate for IOSCO to use the rules refined in the CESR Guidelines released in 2010 (CESR Guidelines on Risk Measurement and the

Calculation of Global Exposure and Counterparty Risk for UCITS), which have been positively tested over many years in practice with satisfaction by both regulators and fund managers.

AFG does not see merit in the “second approach” proposed by IOSCO at the end of p.8: it is not enough to reason by asset class or by sub-asset class: tenors must also be taken into account. Also, IOSCO should not follow too “subjective” proposals (at the top of p. 9, methods proposed seem to us too unclear).

Regarding Hedging, we think the proposed method should be refined. Generally speaking about the NNE, we think that the CESR Guidelines[1] method has proved to be appropriate and granular enough to be a good example to follow.

- Analysis of Metrics by Asset Class:

One important concern of our members is linked to the additional data crunching work which may be asked from them, knowing that they are already providing leverage calculations as well as inventories to Banque de France or Luxembourg Central Bank for instance.

Our members believe that additional data and/or reporting should not be asked, and in the case this is asked, it should be proved that it is useful and is efficient regarding to the complexity of calculation. Our members believe that the vest way to deal with the asset class issue is to gather similar funds/strategies.
Supplementary data points:

AFG strongly disagrees as only a few European jurisdictions ask for such supplementary data points (e.g. only Luxembourg for UCITS; and it is only quarterly for AIFs). AIF data is collected by ESMA, this is a good starting point.

Questions

➢ 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, AFG agrees with arguments given. GNE is a simple additive measure that overstates the actual leverage. We understand GNE as the “fat” figure that disregards voluntarily the economic sense of the trades (the same figure may represent a hedged risk portfolio as well as a portfolio that amplifies/doubles the risk exposure).

Our recommendation is that it is appropriate as a first step measurement in order to disqualify for the further step of analysis all funds or portfolios which have a GNE below a threshold, say 3 times net assets.

Question 2

Do respondents see merit in scoping out of step 1 assessments certain

[1] CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS

funds, such as for example, smaller funds? Please elaborate.

Yes, the scoping out is useful in order to focus more efficiently on substantial leverage.

AFG thinks that from IOSCO's systemic risk perspective, funds which structurally and from a regulatory standpoint have a low leverage, e.g. the UCITS, UCITS like AIFs, US mutual funds, etc. should be scoped out.

Another approach could be to scope out:

- First, funds with AuM under 100 million euros;
- Second, with regards to the GNE figure, funds with a leverage below 300%,
- And third, with regards to the NNE figure, funds with a leverage below 300%.

This 3 – layer scoping out is useful because it ignores irrelevant amounts that have no influence on the monitoring of the possible sources of systemic risk (first layer on smaller funds).The GNE figure is provided by all the other funds, which permits to aggregate amounts and follow trends. Also, as the GNE overstates the leverage figure, a second layer of scoping out funds with a leverage below 300% permits to easily filter those funds that have in absolute raw figures such low figures of exposure that bear no interest to be subject to further analysis. The third layer is useful to perform as it permits to further filter the "evident" false positives of the precedent layer on the basis of a more accurate calculation of the risk amplification (taking into account of the netting and hedging features as the FSB mentioned). This third layer corresponds also to the frontier set by the European legislators between substantial leverage versus lower leverage under AIFMD knowing that they have precisely worked with the objective of monitoring systemic risk.

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?

Yes. This is not a metric interesting at the individual fund level, but the aggregated feature is interesting from a monitoring in time point of view.

➢ 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?

Our members think that the Adjusted GNE is not an appropriate method. It is not efficient nor brings clarity to the framework. It requires more work to do than the GNE measure without providing additional information. Moreover, the adjusted GNE does not represent the economical real footprint of the portfolio.

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?

Our members think that the Adjusted GNE is not an appropriate method. It is not efficient nor brings clarity to the framework. It requires more work to do than the GNE measure without providing additional information. Moreover, the adjusted GNE does not represent the economical real footprint of the portfolio.

As part of step 1 and with a view to keep the test simple and understandable, AFG members oppose the idea to introduce a measurement of the volatility of underlying assets when assessing leverage.

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?

Our members think that the Adjusted GNE is not an appropriate method. It is not efficient nor brings clarity to the framework. It requires more work to do than the GNE measure without providing additional information. Moreover, the adjusted GNE does not represent the economical real footprint of the portfolio.

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?

Our members think that the Adjusted GNE is not an appropriate method. It is not efficient nor brings clarity to the framework. It requires more work to do than the GNE measure without providing additional information. Moreover, the adjusted GNE does not represent the economical real footprint of the portfolio.

- **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.

Yes. This is meaningful at portfolio level.

AFG members believe that is appropriate to complement the GNE with the NNE and vice versa. Gross exposure permits aggregation and monitoring in time whereas the NNE brings light on the real capacity of amplification of the underlying market risk taking into account the offsetting if risks.

We also believe that a two set of measures (GNE + NNE) corresponds to the FSB mandate to IOSCO to set measures for leverage. Indeed, FSB acknowledged that one measure alone could not respond appropriately to the issue of measuring leverage within funds.

This kind of two set of measures framework has been tested in the European framework for years with convincing results.

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.

AFG members agree to use a set of GNE and NNE, but not the Adjusted GNE. We believe ESMA's CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS have proved their efficiency in practice as they are fine-tuned so as to grasp the underlying risk that is amplified by leverage. This kind of two set of measures framework has been tested in the European framework for years with convincing results.

Rules on netting are consistent as they are explicit. The tradeoff is between having consistent and appropriate rules on one side and the search of the perceived "perfect" but less appropriate as too simplistic measure on the other side.

Regarding the difference between the use of a 10 year equivalent and a duration target, AFG does not see the necessity to choose one over another. The objective is to convert into an equivalent of the underlying asset and both approaches are corresponding. The target duration is more precise, when the 10 year equivalent is more easy to implement. Each measure is relative to a specific market and we are very happy with the European setup, thus there is room to approve both ways so as to preserve market specificity where maximum harmonization is not essential.

Question 10

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

Our members agree to exclude currency hedges. But they think that the proposed conditions are too complicated to implement. A more principles based approach is perceived as the only way to deal appropriately with the subject. The idea is to net hedges where they do not add any incremental exposure, leverage and/or other market risks given the prerequisite that the strategy is not an arbitrage one.

For the sake of example, please see what rules have been implement with success in

Europe (extract form the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS):

> *Hedging*
>
> *1. Hedging arrangements may only be taken into account when calculating global exposure if they offset the risks linked to some assets and, in particular, if they comply with all the criteria below :*
>
> *(a) investment strategies that aim to generate a return should not be considered as hedging arrangements;*
>
> *(b) there should be a verifiable reduction of risk at the UCITS level.*
>
> *(c) the risks linked to financial derivative instruments, i.e., general and specific if any, should be offset;*
>
> *(d) they should relate to the same asset class; and*
>
> *(e) they should be efficient in stressed market conditions.*
>
> *2. Notwithstanding the above criteria, financial derivative instruments used for currency hedging purposes (i.e. that do not add any incremental exposure, leverage and/or other market risks) may be netted when calculating the UCITS global exposure.*
>
> *3. For the avoidance of doubt, no market neutral or long/short investment strategies will comply with all the criteria laid down above.*

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?

No, we don't think so.The GNE has already captured a perimeter of funds that is larger than the perimeter of funds really bearing leverage risk.

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?

We have difficulty to see what this section about proxies means and what implications/benefits it might have.

- **Questions on GNE, Adjusted GNE or NNE**

Question 13

GNE represents the gross market exposure of a fund which is calculated by summing the absolutes 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.

Regarding GNE, there is no reason to include cash for leverage (see AIFs for instance: cash is not in): does cash generate risk?

For the sake of comprehension, cash is used to offset derivatives in the NNE calculations (as it is reproducing the holding of a funded asset); but as such the cash alone does not bring leverage.

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.

AFG believes that the current value of the assets purchased with the borrowings could be retained. The overarching principle is in fact to retain risky assets only. Regarding real estate type of assets, loan to value metrics are beong considered the most appropriate ones by AFG members. .

Also, we recall that temporary cash borrowing of less than 10% is authorised in UCITS as it is not considered as a source of leverage for the fund (the intention/use is not to reinvest). Our answer above relates to strategies/funds that are authorized to use borrowing for investment purposes (source of leverage).

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?

Using the same counterparty has no relevance in terms of leverage risk. Therefore, this is not an issue to take into account for GNE calculations.

Closed out positions are not a netting arrangement. A closed out position means zero position from a credit risk perspective. They should be always disregarded by nature.

- **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.

Our members are already providing for a line-by-line report ("inventories") to central banks (e.g. BCL, BdF), on a monthly basis. AFG members think that there is no need to go further.

Our members believe that the vest way to deal with the asset class issue is to gather similar funds/strategies.

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?

AFG thinks that allocating exposure across major asset classes such as equities, commodities, credit, interest rates, or currencies, provide sufficient information. Our members believe that the vest way to deal with the asset class issue is to gather similar funds/strategies.

In addition, the line-by-line reporting to some national central banks allows them to aggregate the data on different axes if they wish to.

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?

No, we don't believe that all aspects are to commingled when leverage risk is monitored. Counterparty risk is a very different type of risk and is monitored and /or constrained through other means. In addition, no linear measure will grasp correctly non linear aspects, this is an intrinsic flaw that is overcome with the use of risk based measures as VaR measures.

➢ 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?

No. AFG members believe this is not appropriate in the step 1 framework, that should remain simple and efficient in the objective of filtering funds that really need further assessment in terms of leverage risk.

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?

No. AFG members believe this is not appropriate in the step 1 framework, that should remain simple and efficient in the objective of filtering funds that really need further assessment in terms of leverage risk.

➢ Questions on step 1

Question 21

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

No.

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

AFG members consider that these metrics are too complex to look at step 1. They refer to specific cases and depend on too many hypothesis. It is thus not adapted for the step 1 objectives as they are not enough corresponding to global/general features.

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.

We agree on a combination: GNE + NNE. We so not consider useful to add the Adjusted GNE.

No need for supplementary data points that would complicate the results and the collection burden.

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?

Raw data exists already in the fund portfolios themselves that are already reported to central banks today on a monthly basis (e.g. BCL, BdF). Collecting the raw data permits to use it in different combinations. In Europe, the UCITS/AIFM framework has the merit to already collect data corresponding to the main features of a GNE & NNE framework.

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?

No, the proposed framework is very complete.

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?

In order to facilitate the cross-border dialogue, a consistent framework of GNE + NNE could facilitate a centralization of information at cross-border level.

Regarding the step 2, AFG does not see merit in assessing counterparty risk, as counterparty risk is already assessed by banking supervisors and through various holistic pieces of legislation (e.g. DFA/ EMIR, etc.) and portfolio constraints.

- **Questions on 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?

Yes. Risk based measures are capturing the amplification of underlying risks taking into account the effect of the combination of positions (that hedge or on the contrary overexpose). This is only discreetly approached by the NNE (which is not a continuous measure).

In our view, step 2 cannot propose a one size fits all as it would be ineffective. IOSCO should list possible metrics as a toolbox for NCAs that will be able to adapt to their domestic market.

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?

AFG agrees for assessing market risk, but conversely we don't see any need for assessing others types of risk such as counterparty risk, which is a very different type of risk that is grasped through a different set of measures/constraints. Some metrics listed by IOSCO are well known and used by AFG members such as VaR measures.

If you need any further information, please don't hesitate to contact me at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

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