Investment Funds: Monthly Digest

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ISSUES AND ASPECTS CONCERNING LEVERAGE BY CATEGORY III AIFS (MAY 2020 EDITION)

INTRODUCTION

Leverage is a measurable, simple tool that has been used conventionally as a universal risk metric by the funds industry across the globe. Leverage allows a fund to increase its potential gains, as well as losses, by using financial instruments and/or borrowed money to increase the fund's market exposure beyond its net asset value. Leverage can come in a variety of different forms, for example, debt or some types of derivatives when used for this purpose.[1] For an alternative investment fund ("**AIF**") based in India, Securities and Exchange Board of India ("**SEBI**") has allowed leverage but subject to certain prudential requirements. In this edition of the digest we analyse the use of leverage by AIFs and certain issues which the industry is facing in respect of the same.

Scope for 'leverage'

Under the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"), a Category III AIF, may undertake leverage, subject to a maximum limit as may be prescribed by SEBI. SEBI had, vide its circular CIR/IMD/DF/10/2013 dated July 29, 2013 ("**Leverage Circular**")[2] prescribed certain guidelines for the calculation of leverage by Category III AIFs. As per the Leverage Circular, leverage allowed by Category III AIFs is limited to two times the net asset value ("**NAV**") of such Category III AIF (on netted basis) ("**Leverage Ratio**"). Leverage Ratio is calculated by dividing total exposure of the Category III AIF by the NAV of such Category III AIF. The Leverage Circular also provides that Leverage Ratio shall be calculated at the scheme level, therefore references to 'AIF' and 'fund' shall in this article shall be construed accordingly.[3]

The Leverage Circular provides that the total exposure of the fund for the calculation of the Leverage Ratio shall generally be the sum of the market value of all the securities/ contracts held by the fund and shall not include cash and cash equivalents. Further, the total exposure at any point of time will be a sum of the spot market exposure and the derivative market exposure. The NAV be the sum of value of all securities adjusted for mark to market gains/losses (including cash and cash equivalents) and shall exclude any funds borrowed by the AIF.

The Leverage Circular also provides for offsetting of positions while computing the Leverage Ratio. The norms for such offsetting of positions is by references deferred to circular No. MFD/CIR/21/ 25467/2002 dated December 31, 2002 ("**Offsetting Circular**"). The above circulars provide for only a few types of contracts for offsetting purpose and therefore there is scope for further clarity on calculation of exposures and offsetting rules for all derivative instruments.

CALCULATION OF LEVERAGE RATIO AND OFFSETTING

Calculation of Leverage Ratio

Subject to any offsetting of positions, the Leverage Circular provides for the below guideline for calculation of total exposure for the purposes of calculation of the Leverage Ratio.

- Exposure should be the market value of all securities/ contracts held by the fund.
- Exposure for specific securities shall be as below:

Security	**Calculation of Exposure**
Futures (long and short)	Futures price * Lot size * Number of contracts
Options bought	Option premium * Lot Size * Number of contracts
Options sold	Market price of underlying script * Lot size * Number of contracts

- In case of any other derivative exposure, the exposure is proposed to be calculated as the notional market value of the contract.

OFFSETTING

Offsetting of positions for the purposes of calculation of the Leverage Ratio is allowed only for transactions entered into for hedging and portfolio rebalancing as provided in the Offsetting Circular. Below we have simplified the guidelines for acceptable transactions to be termed as transactions for hedging and portfolio rebalancing as provided by the Offsetting Circular.

Guidelines

A. Hedging

Hedging refers to derivative market positions that are designed to offset the potential losses from existing cash market positions.

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1. Hedging with futures contracts

1. Hedging is permitted by dealing in the same script, or when hedging a diversified equity portfolio, by taking a position in the sectoral index.
2. While dealing in the same script (including both cash equity and derivatives), a hedge transaction should not result in a naked short position i.e. the net position should not be a short position in the security.
3. When hedging a diversified equity portfolio with a short position in the sectoral index, it shall be ensured that the short position is not on a narrow sectoral index, for instance a diversified equity portfolio including stocks from various sectors such as auto, healthcare, banking cannot be hedged by hedging a narrower index such as 'bank nifty'. Also, the short position should be such that it does not create a naked short position in the sectoral index futures.

2. Hedging with options contracts

1. When hedging with options contracts, the notional value of hedge (the value represented by an option contract) should not exceed the underlying position in the script.
2. Covered call writing (call on already owned underlying stocks) is permitted provided that the notional value of the call should not exceed the underlying position.
3. If the position includes long calls or short puts and any combinations of options thereof, the worst-case short exposure (detailed in **Annexure 1**) (considering notional values of options) considering all expiration prices should be less than the total exposure in the underlying.

B. Portfolio Rebalancing

Portfolio Rebalancing refers to situations where a particular desired portfolio position can be achieved more efficiently or a lower cost using derivatives rather than cash market transactions.[4]

1. The general principle here would be that a fund is permitted to do using derivatives whatever it could have done directly - no more and no less.
2. The fund's derivative position in an underlying security along with the cash equity position in such security should be within the permissible investment limits.
3. When dealing in multiple option positions, the worst-case long exposure (Refer **Annexure 1**) (after netting for long and shorts) (considering notional values of options) considering all expiration prices, along with the cash equity position in the underlying, should be within the permissible investment limits.

ANALYSIS

While globally there are various methods of calculating total exposure of a fund such as gross notional exposure and net notional exposure. Gross notional exposure method is the one where gross market exposure of a fund is calculated by summing the absolutes values of the notional amounts of a fund's derivatives and the value of the fund's other investments. No adjustments are made to any of the values. Net notional exposure is a calculation metric that considers the extent to which the fund's investments may be netted thus leading to a reduction in the value of total exposure. India follows the net notional exposure method while calculating total exposure for the purposes of calculating the Leverage Ratio. While above guidelines prescribed by Offsetting Circular provide for whether a long or a short position (as the case may be) may be offset or not, there exists certain ambiguities as to how the net position may be calculated. Some examples are that the Leverage Circular does not provide offsetting mechanisms where the maturity dates of the securities are different. Further the Leverage Circular and the Offsetting Circular does not provide for the calculation of total exposure and netting thereof in case of interest rate derivatives. It is also important to note that offsetting is allowed only where the transaction has been entered into for the purposes of hedging and portfolio rebalancing. Therefore, in a scenario where the net position in a security turns out to be 'short', offsetting may not be allowed as the transaction would not be qualified as a 'hedge'. The Alternative Investment Policy Advisory Committee chaired by Mr. N. R. Narayana Murthy in its second report had provided the recommendations in respect of offsetting of positions but the same is yet to be adopted by SEBI. The recommendations have been borrowed from the applicable guidelines for Undertaking for Collective Investment in Transferable Securities (UCITS) and alternative investment funds in the European Union, and set out guidelines for offsetting, not only for futures and options but for interest derivatives as well.[5]

CONCLUSION

As discussed above the current regulatory regime in India lacks in clarity with respect to the offsetting mechanisms that may be used by the fund manager to calculate the total exposure of the fund for the calculation of the Leverage Ratio. Further the Leverage Circular only deals with two types of derivates i.e. futures and options such as calls and puts. Considering such ambiguities, we beleive that detailed guidelines for offsetting shall be provided by SEBI. In doing so, the recommendations of the second report by Alternative Investment Policy Advisory Committee may be considered. Such guidelines inter alia should take into account the calculation of exposure for products beyond calls / puts and futures. The guidelines should also provide the mechanism to offset derivative positions of the same underlying, and having different maturity dates.

– Shivam Ahuja & Richie Sancheti
You can direct your queries or comments to the authors

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[1] THE BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (2018): "IOSCO Report: Leverage," Consultation paper

[2] https://www.sebi.gov.in/sebi_data/attachdocs/1375094611151.pdf

[3] AIF Regulations stipulate that Category I and Category II AIFs cannot undertake leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the investable funds.

[4] https://www.sebi.gov.in/sebi_data/commondocs/cir18mf_h.html

[5] Pg. 144, Chapter VI Category III Alternative Investment Funds, Second report by Alternative Investment Advisory Committee. Accessible at - https://www.sebi.gov.in/sebi_data/attachdocs/1480591844782.pdf

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