ESMA Analyses EMIR Data in Archegos case: Risks were visible

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Leverage and derivatives – the case of Archegos

ESMA has just published a risk analysis study that seeks to foster further financial stability analysis following the liquidation of derivative positions by counterparty banks in response to the default by US family office Archegos Capital Management (Archegos), which resulted in losses of more than USD 10bn.

The study highlights the risks related to high leverage and concentrated exposures in synthetic brokerage, and how increased margin requirements and regulatory reporting could help to prevent, or reduce the scale of, similar events. In some cases, the data is already available and could be used to assess risk. Initiatives are also underway at EU, US and international level in respect of increased regulatory reporting, monitoring, and margin requirements.

EMIR Data: Early Warning System

In an ex-post risk analysis of Archegos’ positions, using regulatory data collected under the European Market Infrastructure Regulation (EMIR), ESMA has shown how it is possible to track the steep increase in concentrated exposures undertaken by Archegos in February and March 2021, and the risks.

The risk analysis examines the investment policy employed by Archegos in the run-up to its collapse and, using EMIR data, analyses Archegos positions with EU counterparties. It also reviews data gaps and reflects on the regulatory lessons learned.

Background

In 2012, Tiger Asia, a hedge fund founded in 2001 with a focus on Asian issuers, reached a settlement with the US Securities and Exchange Commission (SEC) related to insider trading. In 2013, it changed its name to Archegos and became a US family office with USD 500mn in assets.

In January 2021, there were warning signs that Archegos had accumulated large leveraged exposures on equities by entering into total return swap contracts (TRS) with a few counterparty banks, making the firm highly vulnerable to adverse market developments. As family offices are typically excluded from reporting requirements applicable to private funds, by replicating similar positions across counterparties, Archegos was able to take very large positions unbeknownst to counterparties, market participants and regulators.

On 26 March 2021, Archegos was unable to meet variation margins when the price of the underlying stocks started to decline, resulting in the banks liquidating those stocks and incurring large losses. While the event occurred during a calm period in the markets and did not impact financial stability, the collapse of Archegos raises a number of issues in respect of the use of derivatives in the acquisition of leverage.
Synthetic Exposure: Lack of Disclosure

Archegos focused its investment strategy on long positions in a few stocks, usually in the technology sector, using TRSs to gain exposure. This allowed Archegos to obtain leverage representing around six times its capital.

The risk analysis gives an illustrative based on an initial margin of 20% on TRSs, whereby a client with EUR 100mn obtains exposure to EUR 500mn, resulting in a leverage of five. The client agrees to pay any decrease in value to the bank counterparty, and the bank agrees to pay any increase and purchases the underlying stock to hedge its positions.

In the US, the requirement on market participants to disclose stakes, where they own more than 5% of shares, does not apply to synthetic exposures. As a swap counterparty, Archegos did not have to disclose its stakes in companies to which it was exposed and its operations were largely invisible to regulators and market participants.

ESMA’s Analysis

ESMA used two EMIR datasets to analyse positions with EU counterparties; weekly trade state data (a snapshot of outstanding derivatives) and trade activity data (tracking lifecycle events of derivatives over time), which revealed the following:

During 2020, Archegos increased its exposures to TRSs, with notional amounts surging by approximately 180%. As most of this activity was with UK banks, Archegos’ exposures dropped mechanically in early 2021 when UK entities stopped reporting to EMIR. However, EEA30 data still revealed a circa 365% jump from mid-January to mid-March. As of 26 February 2021, Archegos’ gross exposures to EU counterparties were 2.5 times larger than end-2020 levels, and its net exposures were seven times larger than end-2020. Its portfolio of swaps was mainly concentrated in five stocks, accounting for 80% of its long exposures (and 360% of its net exposure).

Archegos was also taking short positions on broad market indices which, combined with long exposures on individual stocks in the technology sector, enabled it to be partially hedged against wide market movements (a ‘market neutral strategy’). Losses on technology stocks would be compensated by profits on short positions on market indices, in the event of a negative shock, and vice-versa in the event of a positive shock.

Changes were also revealed in the mark-to-market value of Archegos’ swaps portfolio. From early February to 23 March, the value of the swaps grew by 250%, reflecting the increase in the value of the underlying stocks and higher exposures taken by Archegos, reaching a peak on 23 March of more than ten times its end-January level. On 24 March, the value of the swaps started to collapse, falling to a negative value by 26 March. These changes were almost entirely driven by long positions on four stocks, which together accounted for more than 80% of the mark-to-market value of the portfolio. The data clearly shows that Archegos had a highly concentrated portfolio and that any negative change in the price of the underlying stocks could trigger large mark-to-market losses and substantial variation margins.

On 22 March, the price of one Archegos-related stock fell by close to 7% and kept declining throughout the week, as did other stocks to which Archegos was highly exposed. This resulted in an abrupt change in the value of Archegos’ swaps and to significant variation
margins being requested by counterparties. When Archegos defaulted, dealer counterparties were forced to liquidate their underlying long positions in the stocks, as they were no longer hedged. Given Archegos’ substantial market footprint in those stocks, large sales by dealers aggravated the decline in prices, leading to substantial losses. On 26 March the price of two stocks dropped by more than 27%, reflecting the liquidation of positions by the Archegos counterparties.

Key ESMA Observations

- **Risk Management and Concentration Risk:** Had higher initial and variation margins been posted by Archegos, counterparties could have better covered some of their losses. Concentration add-ons could also have reduced the risks (although perhaps of limited use where counterparties were unaware of the similar positions Archegos held with other banks).

- **Entity-Level Reporting for Family Offices:** Archegos was a US family office that implemented hedge fund-like strategies without being subject to the entity-level regulatory and reporting requirements applicable to hedge funds, as is the case for other large non-bank institutions (e.g., endowments and sovereign wealth funds). The lack of transparency and data meant regulators were unable to identify high leverage and concentrated exposure risks related to Archegos. (In the EU, family offices are subject to transaction-level reporting under EMIR for derivatives, and under the Securities Financing Transactions Regulation for securities lending, repo, buy-sell back or margin lending transactions.)

- **Minimum margin requirements on total return swaps:** Since September 2021, counterparties to OTC derivatives trades (such as TRSs), which are not centrally cleared and with gross notional exposure above USD 50 bn, are subject to initial margin requirements and a phase-in period. The requirements will also apply to entities with gross notional exposure above USD 8bn from September 2022.

- **Derivatives Reporting:** The lack of reporting, in the US, of TRSs on a single equity impacted any regulatory assessment of risks. By contrast, under EMIR, all derivatives trades must be reported to trade repositories. On 8 November 2021, reporting requirements for security-based swaps in the US entered into force. The SEC also issued a proposal to require market participants to publicly disclose large positions on security-based swaps exceeding prescribed thresholds.

- **Synthetic Prime Brokerage:** Under Basel III capital rules, traditional prime brokerage financing by banks incurs leverage and funding charges. By contrast, synthetic prime brokerage allows banks to reduce capital and liquidity costs by hedging and netting derivatives exposures against their trading book, which could be one of the drivers of the growth of synthetic prime brokerage.

Recent Developments

**SEC proposal:** in the event of extraordinary losses, large redemptions or significant margin events, large hedge fund advisers should report specific information to the SEC within one business day.
Financial Stability Board (FSB) and International Organisation of Securities Commissions (IOSCO) aims: improve risk monitoring using trade repository data and analysing leverage use by non-banks.

EU: under Article 25 AIFMD guidelines, regulators must regularly assess the extent to which the use of leverage by alternative investment funds could contribute to the build-up of systemic risk, based on AIFMD data. Data from trade repositories may in some cases also be used.

What Next?

The risk analysis demonstrates how EMIR data can be used by regulators to monitor risks related to derivatives and leverage, however, the key message is that further work is needed. Market participants should expect increased regulatory reporting requirements and monitoring.

ESMA will continue its analysis of reporting information, including under AIFMD, the Securities Financing Transactions Regulation, EMIR and the Money Market Fund Regulation, and has also suggested a framework whereby different regulatory reporting could be analysed together.

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