

MEMO# 32434

May 4, 2020

ESMA Issues Consultation Paper on Framework for Regulating Alternative Investment Fund Leverage; Member Call Scheduled for Thursday, May 21 at 10 am (Eastern Time)

[32434]

May 4, 2020 TO: ICI Members

ICI Global Members SUBJECTS: Derivatives

International/Global

Systemic Risk RE: ESMA Issues Consultation Paper on Framework for Regulating Alternative Investment Fund Leverage; Member Call Scheduled for Thursday, May 21 at 10 am (Eastern Time)

The European Securities and Markets Authority earlier this spring issued a consultation paper on a framework for national competent authorities (“NCAs”) to regulate the use of leverage within the alternative investment fund (“AIF”) sector.^[1] The framework proposes: (a) a two-step approach for NCAs to assess leverage-related systemic risk; and (b) guidelines to impose leverage limits.

ESMA published the consultation in response to a European Systemic Risk Board report providing recommendations to address liquidity and leverage risks in investment funds. The report recommended that, among other things, ESMA give guidance on: (1) the framework to assess the extent to which leverage in the AIF sector contributes to systemic risk in the financial system; and (2) the design, calibration, and implementation of macroprudential leverage limits.^[2]

ICI Global plans to submit a comment letter on the consultation, which comments are due on 1 September 2020. We have scheduled a member call to discuss the consultation and potential comments for **Thursday, May 21 at 10 am (Eastern Time)**. Please contact Ruth Tadesse at rtadesse@ici.org to receive dial-in information for the call. If you have any comments, please contact Ken Fang at kenneth.fang@ici.org or Shelly Antoniewicz at shelly@ici.org. We summarize the consultation briefly below.

I. Background

In addition to addressing the ESRB recommendations, ESMA states that, given the rapid expansion of the investment fund sector and the “higher risk-taking, in a context of low interest rates,” it is of “utmost importance” to implement a framework for NCAs to monitor the level of leverage^[3] and the deleveraging process of highly levered AIFs. ESMA believes that during a financial crisis, a fund’s deleveraging may create potential spill-over effects, including:

- Amplifying the price impact of adverse market movements on fund assets;
- Fire sales, which can adversely affect other market participants owning the same asset or assets that are highly correlated;^[4]
- Contagion effects to the banking system, in light of the interconnectedness with the investment fund sector; and
- Interruption in direct credit intermediation, which can amplify the credit cycle and impact the economy.

ESMA believes that leverage amplifies these risks, as leveraged funds likely will liquidate a greater amount of assets during stressed periods. Further, it states that leverage may require more liquidity to cover margin calls and higher haircuts on leveraged positions, amplifying the impact of negative market movements during stressed times and increasing fund liquidity risk.

Accordingly, ESMA stresses the importance of using a consistent methodology to compute AIF leverage to collect data and identify potential sources of risk to financial stability. It also proposes that NCAs impose leverage limits based on the leverage measures already set out for AIFs.^[5] In making its recommendations, ESMA asks for comment on nine specific questions, which are provided in Appendix A.

II. Assessment of Leverage-Related Systemic Risk

The consultation recommends that NCAs assess AIF leverage-related systemic risk quarterly using a two-step approach based on data AIFs report under the Alternative Investment Fund Managers Directive (“AIFMD”).

Under Step 1, NCAs would look at the level, source and different uses of AIF leverage. This step would require NCAs to identify three types of AIFs based on specified information reported under the AIFMD, which is summarized in Appendix B. The identified categories would be:

- a. AIFs employing substantial leverage (three times their net asset value under the commitment method);^[6]
- b. AIFs employing leverage but not on a substantial basis and whose regulatory assets under management are greater than EUR 500 million at the reporting date; and
- c. AIFs employing leverage other than those in a) or b), whose unusually high use of leverage may pose risks to financial stability. (ESMA states that “unusually high use of leverage” is leverage that differs significantly (e.g., a high percentile in the distribution) from that of other funds.)^[7]

Under Step 2, the NCAs would evaluate leverage-related systemic risk from the AIFs identified in Step 1. This step would require NCAs to assess risk based on risk indicators from certain AIFMD information, as specified in Appendix C, and other information the NCAs deem relevant.^[8] The assessed risk must include at least the following:

- Risk of market impact;
- Risk of fire sales;
- Risk of direct spill over to financial institutions; and
- Risk of interruption in direct credit intermediation.

NCA's would communicate the results of the risk assessments to ESMA at least annually and each time they identify a risk to financial stability. In addition, NCA's would inform other EU NCA's when they find risks relevant to those jurisdictions.

III. Guidelines for Leverage Limits

The consultation would require NCA's to impose leverage limits on AIFs posing risk to financial stability.^[9] ESMA proposes guidelines to operationalize and calibrate the leverage limits to ensure their effectiveness and efficiency. In this regard, when deciding to impose leverage limits on AIFs, the consultation states that NCA's should consider:

- Risks posed by funds according to their type (hedge fund, private equity, real estate, fund-of-funds, or any other relevant type) and risk profile, as set forth in the NCA's risk assessment; and
- Risks posed by common exposures. (When the NCA determines that a group of funds of the same type and similar risk profiles collectively may pose leverage-related systemic risk, the NCA should apply leverage limits in a similar or identical manner to all funds in the group.)

The calibration of leverage limits should be based on an assessment of whether the leverage limits effectively confine a fund's contribution to systemic risk. NCA's should pay particular attention to how leverage can contribute to procyclicality, especially in times of economic downturns or increases to market volatility (e.g., when fund asset sales are triggered by specific market events, such as increased volatility or increased margin calls caused by collateral price drops). In addition, ESMA proposes guidelines on the level, length and effectiveness of leverage limits.

Level of the Leverage Limits. When determining the level of the leverage limits, the consultation states that NCA's should consider the impact of the limits on addressing the risk of market impact, fire sales, spill-over effects to financial counterparties, and disruptions of credit intermediation. NCA's, in particular, should consider the following:

- When risks are directly related to size, imposing leverage limits should reduce the risks accordingly.
- When risks are partially related to size but limits may not reduce risks proportionally because AIFs could adjust their strategies to maintain the same level of risk, an NCA should consider imposing other restrictions on the management of the AIF (e.g., restrictions on the investment policy, redemption policy or risk policy).
- When imposing limits temporarily may result in the increase in risks (e.g., through an AIF manager's sale of lower risk assets to meet requirements), an NCA should impose other restrictions on the management of the AIF until the end of the phased-in period (e.g., setting limits on the proportion of assets based on their contribution to the AIF's risk profile, their sensitivity to market risk factors, their exposure to counterparty risk or their liquidity under stressed market conditions).^[10]

Length of the Leverage Limits. When determining the length of the leverage limits, the consultation states that NCA's should consider the following:

- When imposing continuous leverage limits on an AIF or group of AIFs posing a threat

to financial stability, an NCA should retain the limits until the risk decreases.

- When imposing temporary leverage limits to limit the aggregation of risk, including any procyclical behavior from an AIF or group of AIFs (e.g., when funds contribute to excessive credit growth or the formation of excessive asset prices), an NCA should retain the limit until the change in market conditions or the fund behavior stops being procyclical.
- An NCA should implement leverage limits progressively to avoid procyclicality, especially if imposing limits in a procyclical way could trigger the risk they were supposed to mitigate.
- An NCA should consider the possibility of applying cyclical limits to dampen the formation of risks in the upswing and downswing phases of the financial cycle.

Effectiveness of the Leverage Limits. NCAs would evaluate the effectiveness of the limits in mitigating excessive leverage. The evaluation would consider the:

- Proportionality of the leverage limits to the systemic risk posed by the AIF's leverage, to ensure that the sector can provide valuable services to the economy; and
- Robustness of leverage limits to gaming and arbitrage. Specifically, the consultation states that NCAs should consider:
 - Imposing the same limits for different types of funds with similar risk profiles when an NCA determines that an AIF may pose leverage-related systemic risks.
 - Imposing other restrictions related to management of the AIF when AIFs managed by non-EU managers pose leverage-related systemic risks but an NCA cannot impose leverage limits; and
 - The complexity of the calibrations.

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[Attachment](#)

endnotes

[1] See ESMA, "ESMA Consults on Guidance to Address Leverage Risk in the AIF Sector," 27 Mar. 2020 (press release with link to the consultation paper: Guidelines on Article 25 of Directive 2011/61/EU ("consultation")), *available at* <https://www.esma.europa.eu/press-news/esma-news/esma-consults-guidance-address-leverage-risk-in-aif-sector>.

[2] See ESRB, Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6) at Recommendation E (recommending that ESMA produce guidance on Article 25 of Directive 2011/61/EU), *available at* https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf.

[3] ESMA states that investment fund leverage can take the form of financial leverage (through securities financing transactions (e.g., reverse repurchase agreements, securities lending, and sale/buyback transactions) and borrowings) and synthetic leverage (e.g.,

derivatives).

[4] Investor concentrations and short-term redemptions also may amplify this risk, especially when highly leveraged funds offer daily redemptions.

[5] See Directive 2011/61/EU, *available at* <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>. ESMA states that leverage limits should be based on the gross method in Article 7 and the commitment method in Article 8 of Commission Delegated Regulation (EU) 231/2013, *available at* <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>.

[6] See Commission Delegated Regulation (EU) 231/2013, *supra* note 5, at Article 111.

[7] In making this determination, NCAs would compare the AIF's leverage value to: the median or average leverage of AIFs of the same type (hedge fund, private equity, real estate, fund-of-funds, and other AIFs); and the AIF's historical mean or average leverage value.

[8] ESMA provides the non-exhaustive AIFMD information to ensure that the Step 2 risk assessment is consistent across jurisdictions and based on a common methodology and indicators. ESMA states that, for the assessment of leverage-related systemic risk, external data also may be necessary to measure fund exposure in relation to their counterparty or the market in which they operate. It provides a non-exhaustive list of certain data sources for this additional information to reflect the best available data and to limit inconsistencies. See consultation at Annex I. It also provides case studies to demonstrate how it proposes to evaluate funds for illustrative purposes. See consultation at Annex II.

[9] ESMA believes that the decision to impose leverage limits will necessitate a qualitative assessment and expert judgment.

[10] To address liquidity mismatches, the NCA could consider imposing redemption restrictions (e.g., reducing the frequency of redemptions or notice periods for the redemptions).

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