MEMO# 33005

December 22, 2020

ESMA Issues Guidelines for Regulating Alternative Investment Fund Leverage

[33005]

December 22, 2020 TO: ICI Members
ICI Global Members SUBJECTS: Derivatives
Financial Stability
International/Global RE: ESMA Issues Guidelines for Regulating Alternative Investment Fund Leverage

The European Securities and Markets Authority last week issued its final report setting guidelines for national competent authorities ("NCAs") to regulate the use of leverage within the alternative investment fund ("AIF") sector.[1] The final report adopts: (I) a two-step approach for NCAs to assess leverage-related systemic risk; and (II) guidelines for NCAs to impose leverage limits.

ESMA published the final report in response to European Systemic Risk Board recommendations to address liquidity and leverage risks in investment funds. In particular, the ESRB 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] The final report also follows ESMA's consultation paper on the same topic, and the final guidelines are substantially similar to those proposed in that consultation paper.[3]

The guidelines will be translated into the official EU languages and published on the ESMA website. They will take effect two months after publication. Following that date, NCAs should comply by incorporating the guidelines into their national legal and/or supervisory frameworks. If NCAs do not comply, they must notify ESMA within two months of the date of publication of their reasons for not complying.

We summarize the final guidelines briefly below.

I. Assessment of Leverage-Related Systemic Risk

The guidelines direct NCAs to 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").[4]

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

a. AIFs employing substantial leverage (three times their net asset value under the commitment method);[5]

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;[6] 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 will evaluate leverage-related systemic risk from the AIFs identified in Step 1. This step will require NCAs to assess risk based on risk indicators from certain AIFMD information, as specified in Appendix B, 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.

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

II. Guidelines for Leverage Limits

The guidelines require NCAs to use their risk assessment in combination with a qualitative assessment, where necessary, to select AIFs for which it is appropriate to set a leverage limit. When deciding to impose these leverage limits, the guidelines require that NCAs consider:

- Risks posed by AIFs 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 AIFs 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 AIFs in the group.)[9]

In addition to explaining when NCAs should impose leverage limits, ESMA sets guidelines on determining the level, length, and manner of assessing the effectiveness of the leverage limits.

Level of the Leverage Limits. When determining the level of the leverage limits, the guidelines state that NCAs should consider their effectiveness in addressing the risk of market impact, fire sales, spill-over effects to financial counterparties, and disruptions of credit intermediation. NCAs, in particular, should consider the following:

- When risks are directly related to size of leverage, imposing leverage limits should reduce the risks.
- 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 an increase to 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 NCAs 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 for as long as the risks posed do not decrease.
- 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 the AIF contributes to excessive credit growth or the formation of excessive asset prices), an NCA should retain the limits 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 should evaluate the effectiveness of the limits in mitigating excessive leverage. The evaluation should consider the:

- Proportionality of the leverage limits to the systemic risk posed by the AIF's leverage.
- Robustness of leverage limits to gaming and arbitrage. Specifically, the guidelines state that NCAs should consider:
    - Imposing the same limits for different types of AIFs with similar risk profiles when an NCA determines that an AIF may pose leverage-related systemic risks. This is especially to avoid the situation where an AIF manager would declare a different type of AIF to avoid leverage limits.
    - The complexity of the calibration.

Appendix A: Table of AIFMD Information NCAs Should Use for Step 1 of the Guidelines

Leverage-related systemic risk Indicator Description Scope Data source[11]

Leverage measures
Level, source and different usages of leverage   Gross Leverage Leverage of the AIF as calculated under the Gross Method Single AIF AIFMD: 294 Commitment Leverage Leverage of the AIF as calculated under the Commitment Method Single AIF AIFMD: 295 Adjusted Leverage[12] Gross exposures (excluding IRDs and FEX for hedging purposes) as percentage of NAV Single AIF AIFMD: 123, 124, 53 Financial Leverage Value of borrowings of cash or securities as percentage of NAV Single AIF AIFMD: 283, 286, 53 **Assets under Management** Regulatory Assets Under Management ("AuM") Value in base currency of the AuM for the AIF, using the method set out in Articles 2 and 10 of the AIFMD Level 2 Regulation Single AIF AIFMD: 48

Appendix B: Table of AIFMD Information NCAs Should Use for Step 2 of the Risk Assessment

Leverage-related systemic risk Indicator Description Scope Data source[13]
Market impact
The size of an AIF or a group of AIFs is sufficient to move the market   Net exposure NAV x leverage calculated under the commitment method Single AIF AIFMD: 53, 295 Market footprint on the underlying market Main categories of assets in which the AIF invested compared to the size of the underlying market Group of AIFs AIFMD: 123, 124Size of the underlying market based on external data Value of turnover in each asset class over the reporting months compared to the turnover of the asset class Group of AIFs AIFMD: 126Turnover of the underlying market based on external data Investor concentration Percentage of the AIF's equity that is beneficially owned by the five largest owners Single AIF AIFMD: 118 Liquidity profile Average difference across time buckets between share of AIFs' portfolios capable of being liquidated and investor ability to receive redemption payments Single AIF AIFMD: 53, 57, 178-184, 186-192 **Risk from fire sales**
The activities of an AIFM could contribute to a downward spiral in the prices of financial instruments or other assets in a manner that threatens the viability of such financial instruments or other assets   Share of less liquid assets Illiquid assets include physical assets, unlisted equity, non-investment grade corporate and convertible bonds, and loans, inpercentage of AuM Single AIF AIFMD: 33, 123 Potential liquidity demands resulting from market shock (Single AIF: in % of NAV; group of AIFs: in base Currency Risk measures Net Equity Delta Single AIF or group of AIFs AIFMD: 53, 139, 142 Net DV01 Net CS01 Additional information that NCAs could require AIFMs to report on a periodic basis pursuant to Article 24(5) of the AIFMD VaR Single AIF or group of AIFs AIFMD: 53, 139, 145, 302 Vega exposure Net FX Delta Net Commodity Delta Other potential liquidity demands Potential liquidity demands from collateral calls (on AIFs' derivatives and repo) relative to available liquid assets Single AIF AIFMD: 185, 284-289, 157-159 Potential liquidity demands (by source) Single AIF AIFMD: 297-301 **Risk of direct spillovers to financial institutions**
The exposure of an AIF or several AIFs could constitute an important source of market, liquidity or counterparty risk to a financial institution Linkages to financial institutions via investments Long value of investments in listed equities and corporate bonds issued by financial institutions Group of AIFs AIFMD: 123 (securities issued by financial institutions) Sum of long exposures in structured and securitised products Group of AIFs AIFMD: 53, 57, 123 Counterparty risk Mark-to-market net counterparty credit exposure vis a vis the AIF Single AIF 160-171 Size of the AIF counterparty based on **external data** Potential liquidity demands resulting from market shock[15] (see above) Single AIF Single AIF Linkages to financial institutions via investor base Financial institution exposed to a risk of loss[16]

Group of AIFs AIFMD: 209 **Risk of interruption in direct credit intermediation** AIFs contributing to the funding of the real economy deleverage during the downturn thus contributing to the procyclicality of the overall credit supply AIFs' investments in credit instruments of non-financial institutions Sum of long values of corporate bonds, convertible bonds not issued by financial institutions Group of AIFs AIFMD: 123 Sum of leveraged and other loans Group of AIFs AIFMD: 123

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endnotes

[1] *See* ESMA, "ESMA Publishes Final Guidance to Address Leverage Risk in the AIF Sector," 17 Dec. 2020 (press release with link to the final report: Guidelines on Article 25 of Directive 2011/61/EU ("final report")), *available at* https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-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] *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. For a summary of the consultation, *please see* ICI Memorandum No. 32434 (4 May 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32434. ICI Global filed a comment letter in response to the consultation. *See* https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-art-25-aifmd#TODO. For a summary of ICI Global's comment letter, *please see* ICI Memorandum No. 32721 (28 Aug. 2020), *available at* https://www.ici.org/my_ici/memorandum/memo32721.

[4] In response to comments, including from ICI Global, ESMA clarifies that the quarterly requirement was not intended to require AIF managers that report less frequently to report on at least a quarterly basis. Rather, the requirement was for NCAs to perform, on a quarterly basis, risk assessments based on the information reported by AIF managers on either a quarterly, half-yearly or yearly basis.

[5] *See* Commission Delegated Regulation (EU) 231/2013 ("AIFMD Level 2 Regulation") at Article 111, *available at* https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF.

[6] Contrary to several commenters, including ICI Global, ESMA did not exclude AIFs that do not use substantial leverage from the three categories. It reasons that such funds could cause financial stability risks and that Article 25 of the AIFMD does not confine leverage

limits to AIFs using leverage only on a substantial basis.

[7] In making this determination, NCAs should 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. These will be measured through the indicators in Appendix A.

[8] ESMA provides the non-exhaustive AIFMD information in Appendix B 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 the market in which they operate or to their counterparty. It provides a non-exhaustive list of certain data sources for this additional information. *See* final report at Annex I. It also provides case studies to demonstrate how to evaluate funds. *See* final report at Annex II.

[9] Contrary to several commenters, including ICI Global, ESMA determined to recommend leverage limits not only on individual AIFs but on groups of AIFs. It stresses that if NCAs have to impose leverage limits because of a threat to financial stability, it is likely that the threat would stem from several AIFs and not from a single AIF. In determining leverage limits, ESMA states its expectation that NCAs adopt limits that are tailored to the characteristics of each AIF that collectively creates a risk to financial stability.

[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).

[11] Figures refer to the corresponding field in the AIFMD reporting.

[12] This measure excludes interest-rate derivatives ("IRDs") from the computation of leverage, following the approach used in the Annual Statistical Report on EU AIFs. Indeed, the use of IRDs tends to inflate leverage measures, since IRDs are measured using notional amount (rather than adjusted by duration as done under the commitment approach).

[13] Figures refer to the corresponding field in the AIFMD reporting.

[14] Figures refer to the corresponding field in the AIFMD reporting.

[15] Liquidity demands stemming from derivatives especially represent a counterparty risk for the counterpart.

[16] Bank exposure to shadow banking entities is nevertheless limited by European Banking Authority ("EBA") guidelines. EBA is of the view that only AIFs with limited leverage could be considered to fall outside the definition of 'shadow banking entities.'