Markets and Securities Services

ESMA'S FINAL GUIDANCE TO ADDRESS LEVERAGE RISK IN THE AIF SECTOR

On 17 December 2020 the European Securities and Markets Authority (ESMA) published its final guidance to address leverage risks in the Alternative Investment Fund (AIF) sector[1]. ESMA's guidelines set out common criteria in order to promote convergence in the way National Competent Authorities (NCAs) assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system and also design, calibrate and implement leverage limits.

The guidelines follow the 2 steps-approach introduced by IOSCO and translate this approach into the European framework. Furthermore, the guidelines provide NCAs with a set of indicators to be considered when performing their risk assessment and a set of principles that NCAs should take into account when calibrating and imposing leverage limits.

Background

In April 2018, the European Systemic Risk Board (ESRB) published a set of recommendations to address liquidity and leverage risk in investment funds (the ESRB **recommendations**).

The ESRB 'Recommendation E' requests ESMA to provide guidance on Article 25 of the AIFMD and recommends that ESMA:

Give guidance on the framework to assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial sector

"ESRB Recommendation E(1): Assessment of leverage related systemic risk"

Give guidance on the design, calibration and implementation of macroprudential leverage limits

"ESRB Recommendation E(2): Macroprudential leverage limits"

On 27 March 2020, ESMA published a Consultation Paper (CP) on the proposed draft Guidelines. The consultation closed on 1 September 2020.

This Final Report provides an overview of the feedback received through the responses to the CP and explains how ESMA took this feedback into account. It also contains the final Guidelines on Article 25 of Directive 2011/61/EU.

Purpose behind the consultation paper

AIFs can employ both financial leverage, which includes securities financing transactions and borrowing, and synthetic leverage, through the use of derivatives.

Unlike financial leverage, synthetic leverage cannot be observed from balance sheets, as derivatives are accounted for at market value. The information on both types of leverage figures is included in the mandatory AIFMD reporting for leveraged funds.

Financial or potential spill-over effects, resulting from the fund deleveraging, may include:

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

Those effects can be further amplified by leverage as, given the same value of out-flows, leveraged funds are likely to liquidate a greater amount of assets.

The risk of fire sales is further amplified by the possibility of short-term redeemable claims (especially where the possibility of daily redemptions is offered by highly leveraged funds) and exacerbated by investors' concentration.

Leverage can also amplify the impact of negative market movements especially during stressed times, due to the need for obtaining more liquidity to cover margin calls and higher haircuts on leveraged positions, increasing a fund's liquidity risk.

Aim of the guidelines

The use of a consistent methodology to compute leverage across Member States is of fundamental importance for regulators to be able to collect data to identify potential sources of risk to financial stability. For the purpose of calculating leverage limits, NCAs should consider the leverage measures set out in the AIFMD framework.

Leverage limits should be based on the leverage measures set out in AIFMD: the gross method as set out in Article 7 of the Delegated Regulation 231/2013 and the commitment method as set out in Article 8 of the same text.

The guidelines are without prejudice to any further regulatory updates coming from IOSCO's work on leverage, the AIFMD review and any further calibration of the indicators that may be deemed appropriate in the future.

Assessment of leverage-related systemic risk

ESRB Recommendation E (1)

In order to ensure that a consistent approach is taken by NCAs in the assessment of leverage-related systemic risk, the proposed guidelines include:

- A common minimum set of indicators to be taken into account by NCAs during their assessment.
- The instructions to calculate such indicators based on the reporting data under Article 24 of the AIFMD.
- Qualitative and, where appropriate, quantitative descriptions of the interpretation of the indicators.

NCAs should assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system. The assessment of the leverage-related systemic risk posed by the AIF sector ("the risk assessment") should take into account a range of quantitative and qualitative information.

NCAs should perform the risk assessment on a quarterly basis. NCAs should base their risk assessment on AIFMD data received according to the reporting frequency set out in Article 110 of AIFMD Level 2 Regulation. Competent authorities should communicate the results of their risk assessment to ESMA at least on an annual basis and anytime they identify a risk relevant for financial stability.

Leverage limits

ESRB Recommendation E (2)

The guidelines are aimed at operationalising the leverage limits set out under Section V.2[2] and calibrate them in order to ensure their effectiveness and their efficiency.

The design of a macro prudential framework regarding leverage limits include:

- A description of the leverage limits, as imposed by the indicators of Section V.1[3].
- A set of principles that NCAs should take into account when calibrating leverage limits.
- A set of principles that NCAs should take into account when considering the imposition of leverage limits.

The calibration of leverage limits should be based on an assessment on whether the application of leverage limits would effectively limit the contribution of the leveraged fund(s) to the build-up of systemic risk. This includes a mapping of the various channels through which negative spill-overs to financial markets and/or financial market participants can materialise, such as fire sales, credit intermediation etc.

NCAs should pay particular attention on how leverage can contribute to pro-cyclicality, especially in times of economic cycle-downturn or increase in market volatility. This is the case when funds' asset sales are triggered by specific market indicators (e.g.: increase of volatility of X%; increase of margin calls of X% caused by collateral price drop).

When setting the appropriate level of leverage limits, NCAs should take into account their effectiveness in addressing the risk of market impact, fire sales, spill-overs to financial counterparties, and disruptions of credit intermediation. In order to do so, NCAs should assess the likely impact of these measures on the risks when such risks are:

- Directly related to size, and imposing leverage limits should reduce the risks accordingly;
- Partially related to size, but imposing limits may not reduce risks in the same proportion because AIFs can adjust their strategy to maintain the same level of risk, NCAs should consider imposing other restrictions on the management of the AIFs; or
- When imposing limits may, at least temporarily, result in an increase of the risks, for example because a manager may sell less risky assets to meet the new requirements, NCAs should impose other restrictions (e.g. on the investment policy, redemption policy, risk policy) on the management of the AIF, at least until the end of the phased-in period.

Examples of restrictions on the management of the AIF could include setting limits to the proportion of some assets based on their contribution to the risk profile of the fund, its sensitivity to market risk factors, its exposure to counterparty risk or their liquidity under stressed market conditions.

In order to address liquidity mismatches, managers could also implement redemption policies and reduce the frequency of redemptions offered by an investment fund or impose notice periods for investors wishing to redeem from an investment fund.

Next Steps

The Guidelines will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the Guidelines.

The Guidelines will apply from the end of this two-month period.

Guidelines on Article 25 of AIFMD

Guidelines on the assessment of leverage-related systemic risk

When assessing the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system in accordance with Article 25 of the AIFMD ("the risk assessment"), competent authorities should take into account a range of quantitative and qualitative information.

NCAs should perform the risk assessment on a quarterly basis.

The risk assessment should follow a two-steps approach:

Step 1: Level, source and different usages of leverage (Table 1)

Step 2: Leverage-related systemic risk (Table 2)

Under Step 1, NCAs should identify AIFs that are more likely to pose risks to the financial system. These include:

a. AIFs employing leverage on a substantial basis, based on Article 111(1) of AIFMD Level 2 Regulation;

b. AIFs employing leverage not on a substantial basis, based on Article 111(1) of AIFMD Level 2 Regulation, and whose regulatory assets under management are greater than EUR 500mn at the reporting date; and

c. AIFs employing leverage other than those referred to in points a) and b) whose unusually high use of leverage, as measured through the indicators of Table 1, may pose risks to financial stability.

For the purpose of point c) above, an "unusually high use of leverage" is a use of leverage that differs significantly (e.g. a high percentile in the distribution) from that of other AIFs by comparing the AIF's leverage value with a) the median or average value of leverage of AIFs of the same type (for example: hedge funds, private equity, real estate, fund of funds and other AIFs) and b) the AIF's historical median or average leverage value.

Under Step 2, NCAs should evaluate potential leverage-related systemic risks to financial stability of the AIFs identified under Step 1 and include in their assessment at least the following risks:

a. Risk of market impact;

b. Risk of fire sales;

c. Risk of direct spill over to financial institutions; and

d. Risk of interruption in direct credit intermediation.

NCAs should base their risk assessment on AIFMD data received according to the reporting frequency set out in Article 110 of AIFMD Level 2 Regulation. In addition to AIFMD data, NCAs should use the best available data for some of the indicators in Table 2, including national supervisory data and/or third-party data when appropriate. To limit the risk of inconsistencies, NCAs should refer to the (non-exhaustive) list of data sources included in Annex I.

NCAs should communicate the result of the risk assessments to ESMA at least on an annual basis and anytime they identify a risk relevant for financial stability. NCAs should inform other EU NCAs where the operations or arrangements made by the AIFM in other EU jurisdictions may pose risks relevant to financial stability and integrity of the financial system.

NCAs should use their risk assessment, in combination with a qualitative assessment where necessary, to select the AIFs for which it is appropriate to set a leverage limit, according to the Guidelines in section V.2.

Further detail and examples can be found in the form of tables 1 and 2 of the source document (see footnote 1):

Table 1
Leverage Measures
Assets under Management

Table 2
Market Impact
Risk from fire sales
Risk of direct spill-overs to financial institutions
Risk of interruption in direct credit intermediation

Guidelines on leverage limits

When deciding to impose leverage limits to an AIFM managing AIFs posing risks to financial stability, NCAs should consider (as illustrated by the case studies in Annex II):

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

NCA should carefully implement leverage limits, both in terms of timing and phasing in and out:

- Where an NCA imposes continuous leverage limits to an AIF or a group of AIFs posing a threat to financial stability, the limits should be maintained for as long as the risks posed by the AIF or the group of AIFs do not decrease;
- When an NCA imposes temporary leverage limits to limit the build-up of risk, including any pro-cyclical behaviour from an AIF or a group of AIFs, such as when the AIF contributes to excessive credit growth or the formation of excessive asset prices, the limits should be released when the change in market conditions or AIF's behaviour stops being pro-cyclical;
- NCAs should implement leverage limits progressively ("the phased-in period") to avoid pro-cyclicality, especially if imposing limits in a pro-cyclical way could trigger the risk they intend to mitigate; and
- NCAs should take into account the possibility of applying cyclical limits in order to dampen the build-up and materialisation of risks in the upswing and downswing phases of the financial cycle.

When setting the appropriate level of leverage limits, NCAs should take into account their effectiveness in addressing the risk of market impact, fire sales, spill-overs to financial counterparties, and disruptions of credit intermediation. NCAs should take into account:

- When risks are directly related to the size of leverage, imposing leverage limits should aim at reducing the size of the risks;
- When risks are partially related to size, but imposing limits may not reduce risks in the same proportion because AIFs can adjust their strategy to maintain the same level of risk, NCAs should consider imposing other restrictions on the management of the AIFs (for example, restrictions on the investment policy, redemption policy or risk policy); and
- When imposing limits may temporarily result in an increase of the risks, for example through a sale by an AIFM of lower risk assets to meet the new requirements, NCAs should impose other restrictions on the management of the AIF, at least until the end of the phased-in period.

For example the restrictions could include setting limits on the proportion of certain assets based on their contribution to the risk profile of the AIF, their sensitivity to market risk factors, their exposure to counterparty risk or their liquidity under stressed market conditions. In order to address liquidity mismatches, NCAs may also require the AIFM to implement redemption policies and reduce the frequency of redemptions offered by an AIF or impose notice periods for those redemptions.

NCA's should evaluate the efficiency of leverage limits in mitigating excessive leverage by taking into consideration the following:

- Proportionality of the leverage limits to the systemic risk posed by the use of leverage by the AIFM;
- Robustness of leverage limits to gaming and arbitrage, especially:
  - Where NCAs determine that an AIF may pose leverage-related systemic risks, the same limits should be considered for different types of AIFs but with a similar risk profile, as defined by the risk assessment.

    This is especially to avoid the situation where an AIFM would declare a different type of AIF to avoid leverage limits; and
  - Complexity of calibration.

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[1] See https://www.esma.europa.eu/sites/default/files/library/esma34-32-552_final_report_guidelines_on_article_25_aifmd.pdf.

[2] V2 = Guidelines on leverage limits.

[3] V1 = Guidelines on the assessment of leverage-related systemic risks.

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