

EFAMA's RESPONSE TO ESMA CONSULTATION PAPER ON GUIDELINES ON ARTICLE 25 OF DIRECTIVE 2011/61/EU

31 August 2020

GUIDELINES ON ARTICLE 25 OF DIRECTIVE 2011/61/EU

GENERAL POINTS

- **EFAMA welcomes a holistic approach** in establishing whether the use of leverage in AIFs poses leverage-related systemic risk and materially contributes to financial instability. We would reiterate our approach that **any regulatory policies on leverage need to be evidence based and developed with empirical evidence** showing to what extent the use of leverage in AIFs contributes to the build-up of systemic risk. **The Covid-19 pandemic is testament that no major dysfunction was reported in terms of use of leverage by AIFs.** In addition, some members experienced a significant increase in margin calls during the crisis from some (but not all) CCPs. As such, while we support the benefits of central clearing to reduce systemic risk, **we emphasise the importance of focusing on the potential procyclicality of increasing margin calls during stressed situations more than on the level of leverage in a fund.** In this respect we note the ESRB's recent comments to this effect in its report on 'Mitigating the procyclicality of margins and haircuts in derivatives markets and securities financing transactions January 2020'. Also, as highlighted in the KMPG Report as well as in the ESMA 2019 Statistical Report on EU Alternative Investment Funds, **high leverage is rare in AIFs**, with the vast majority of AIF categories making limited or no use of leverage. **Those considerations should be taken into account by ESMA in the development of the guidelines.**
- **Need for international consistency & alignment with the IOSCO Recommendations** – we welcome the two-step approach to ensure consistency with the framework provided by IOSCO. The role of Step1 should be to screen in funds that are *“more likely to pose risks to the financial systems”* (see *IOSCO Recommendation 1¹*), with a more in-depth evaluation at Step 2. ESMA is however requiring much more granular information, which may have the unintended effects of extending the scope at Step 1 beyond what is intended to be required at global level by the IOSCO Recommendation 1, and therefore **harming the competitiveness of EU-based players and funds.**
- **No need for new reporting requirements & focus on existing data** - Any new reporting requirement or increased reporting frequency to enable the proposed assessment of leverage-related systemic risk would be difficult and costly to implement. In particular, any increase in reporting frequency for infrequently priced funds will not be meaningful, in addition to being burdensome to implement. Our request to ESMA is to **use the data already provided through the existing AIFM fund reporting**, as well as the row data already provided to some national central banks under the form of individual fund gross inventories, from which NCAs can build their own internal monitoring tools.

QUESTIONS

Question 1: What are your views on the frequency at which the risk assessments should be performed by NCAs?

The frequency of the risk assessment should **not lead to a disproportionate increase in the reporting burden on firms** and therefore needs to take into consideration the reporting frequency set out in Article 110 of Commission Regulation 231/2013 (set out below). Under the Regulation, reporting can be quarterly, semi-annual or annual depending on the size of the AIFM, including information on leverage.

The more focused the scope, the more useful and feasible it is to have a more frequent reporting, **as these firms are likely to already be reporting on a quarterly basis** (Art. 110(3)b-c of Commission

¹ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf> (Page 8)

Regulation 231/2013). In any case, more frequent assessment from competent authorities should not lead to a requirement for more frequent reporting by firms.

COMMISSION DELEGATED REGULATION (EU) No 231/2013/Article 110):

“3. The information referred to in paragraphs 1 and 2 shall be reported as follows:

*(a) on a **half-yearly** basis by AIFMs managing portfolios of AIFs whose assets under management calculated in accordance with Article 2 in total exceed the threshold of either EUR 100 million or EUR 500 million laid down in points (a) and (b) respectively of Article 3(2) of Directive 2011/61/EU but do not exceed EUR 1 billion, for each of the EU AIFs they manage and for each of the AIFs they market in the Union;*

*(b) on a **quarterly** basis by AIFMs managing portfolios of AIFs whose assets under management calculated in accordance with Article 2 in total exceed EUR 1 billion, for each of the EU AIFs they manage, and for each of the AIFs they market in the Union;*

*(c) on a **quarterly** basis by AIFMs which are subject to the requirements referred to in point (a) of this paragraph, for each AIF whose assets under management, including any assets acquired through use of leverage, in total exceed EUR 500 million, in respect of that AIF;*

*(d) on an **annual** basis by AIFMs in respect of each unleveraged AIF under their management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control.*

Question 2: What are your views on the sample of funds to be included under Step 1? Do you agree in including in the risk assessment not only substantially leveraged funds but also funds not employing leverage on a substantial basis which may pose financial stability risks?

We do not agree with the proposed approach to include in the risk assessment both funds that are substantially leveraged and funds that do not employ leverage on a substantial basis. In the view of EFAMA, **this approach would render the potential scope of funds that may be captured under Step 1 as unnecessarily broad.**

Given that the purpose of these guidelines is to assist NCAs in order to determine when to use Article 25(3) to impose a limit on the level of leverage, it would appear counterintuitive to include in Step 1 funds that are not employing leverage on a substantial basis.

We believe that ESMA should aim to ensure consistency with the process recommended in the December 2019 “IOSCO Recommendations for a Framework Assessing Leverage in Investment Funds”. Those Recommendations are aimed at being applied in the same terms by all NCAs globally, and we support the ESMA proposal for a risk assessment designed as a two-step approach.

We see however a divergence in the design of Step 1 which amounts to an extension of the scope by ESMA potentially to all AIFs. In contrast, *IOSCO’s Recommendation 1 recommends* for Step 1 the identification of funds **‘more likely’** to cause risks in the financial system and not all funds that ‘may cause risks’. (Please see below). “

- *Recommendation 1 IOSCO: “The goal of Step 1 is to provide regulators with a means of efficiently identifying those funds that are **more likely** to pose risks to the financial system.”*
- **Vs.** ESMA Recommendation : “Under Step 1 (Level, source and different usages of leverage), NCAs should identify not only AIF employing leverage on a substantial basis but also non-

*substantially leveraged AIFs which **may cause risks** to financial stability and thus need to be assessed under Step 2.”*

In our view, the two different wordings highlighted above may lead to a diverging scope, where the ESMA’s proposal would lead to catch a far wider scope of funds than the one proposed at global level by IOSCO.

We consider that **only the category “letter a” in the proposed ESMA’s Guidelines at para 13 should be caught in Step 1:**

- Regarding letter b of draft Guidelines’ para 13, i.e. AIFs employing leverage but not on a substantial basis and whose regulatory assets under management are greater than EUR 500m, this category covers a vast majority of funds which are nationally-regulated UCITS-like funds with a low leverage (if any). We do not see why these funds, because they are larger, would be “*more likely to pose risks to the financial system*” from a Leverage perspective.
- Consequently, we would also ask for the deletion in the Guidelines of para 13 c and 14, as currently going beyond the IOSCO recommendations.

Our members believe that, in addition to being ineffective in terms of risk surveillance, a too broad scope in Europe compared to other regions may have negative consequences in terms of competitiveness for EU fund managers, as it will likely be costlier and heavier to implement and to report upon.

Question 3: Do you agree with the proposed threshold identified under Step 1? Would you set the same threshold for all AIFs, or would you be in favour of setting different thresholds based for different types of AIFs (e.g.: real estate, hedge funds, private equity etc) or sub-types of AIFs (please specify) based on a statistical analysis (e.g. percentile)? Should you prefer the latter option, please provide proposals and detailed arguments and justification supporting them

Please refer to our answer to Question 2. We believe that the criteria and thresholds should be **solely focused on leverage**, as provided for by Article 25 of AIFMD. We would, therefore, **challenge the idea that any fund employing leverage in a minor way should be scoped in simply due to its size**. This would lead to a significant number of funds potentially being in scope despite using very small leverage and posing little risk to the financial system from a leverage perspective.

The assessment of the level of leverage in a given fund is key and AIFMD already provides with the “substantially leveraged funds” distinction which triggers the obligation to provide NCAs with enhanced reporting.

The view from some of our members is that on top of the 3 times “substantially leveraged funds”, a condition of size of at least EUR 1bn could further narrow those funds that would need further analysis at Step 2 with regards to the possible systemic implications stemming from the leverage risk. As mentioned above, size alone is not a criterion to be used when assessing potential financial systemic risk linked to leverage risk. The present guidelines are meant to assess leverage risk, and to determine if leverage limits should be imposed. A large fund that employs little or no leverage by definition will not pose leverage risks, and therefore any systemic risks associated with its size will not be mitigated by leverage limits, hence there is no value in including funds based on size alone in this analysis.

In addition, some members have also expressed the need for further clarification of the leverage calculations for certain types of AIF, especially for funds with a capital call structure to avoid scoping in funds on the basis of this type of structure. The assessment of the characteristics of different fund structures remains key. For example, it is usual practice for a number of alternative funds to have capital

draw down structures or revolving credit facilities which contribute to reported leverage figures. These and other fund characteristics such as fund dealing cycles should be taken into account when assessing the impact of leverage in specific funds.

Apart from these clarifications, from a general point of view we see no need to set different thresholds for different AIF types.

Question 4: Would you identify other relevant transmission channels?

No, we do not identify other relevant transmission channels. In our view the identified risks (i.e. risk of market impact, risk of fire sales, risk of direct spill over to financial institutions and risk of interruption in direct credit) cover the potential spill over effects resulting from fund deleveraging in a potential financial crisis.

Question 5: What are your views on using not only leverage indicators, but also other types of indicator such as those indicated under Table 2 of the draft Guidelines? Do you agree with the list of indicators provided?

We believe the **Guidelines should focus on the leverage indicators only, in consistency with Article 25 of AIFMD.**

The metrics to be used at Step-1 should be based on gross and commitment approaches as foreseen in the EU framework. We do not see any other measures as relevant for this step.

Only a small subset of investment funds, those with a substantial leverage in conformity with Article 25 of AIFMD, will merit further analysis at Step-2 and Step-1 needs to set the right criteria to appropriately identify such funds. Even then, it is important to stress that **funds identified for a further assessment at Step-2 are not to be automatically considered as posing such risks**, as there is further assessment to take place on the basis of the investment strategy, the risk profile, the level of interconnectedness and the specific characteristics of the asset management business model. We also highlight the importance of understanding client expectations of leverage to avoid procyclical effects which might occur as a result of clients redeeming following a forced deviation from the initially agreed and disclosed risk budgets or leverage limits.

We would suggest deleting from Table 1 the indicators of Adjusted gross leverage and Financial Leverage, as there is no definition of those metrics under the AIFMD. As highlighted in our response to the IOSCO consultation, the EU AIFMD Delegated Regulation includes conversion methodologies for some derivative instruments for the calculation of the exposure of an AIF in accordance with the gross method, including delta adjustments for options, to avoid overstating the market risk of funds. We agree with these particular adjustments proposed in the AIFMD framework. However, we also see that the use of gross method alone, even with these adjustments, cannot sufficiently address the challenge of overstating the market risk of funds. **We consider, therefore, the EU framework takes the right approach by including the commitment method in combination with the gross method.**²

We do not agree that also other types of indicators such as those indicated under Table 2 should be used in Step 1. In Table 2, there are **various criteria that are not related at all to Leverage** (e.g. some criteria on Liquidity). Once again, this extensive approach appears inconsistent with the provisions of Article 25 of the AIFMD Level 1, if not the whole aim of the AIFMD Leverage provisions. **We think that only**

² EFAMA Response to the IOSCO Consultation Report on Leverage:
<https://www.efama.org/Publications/Public/Risk%20Management/19-4013.pdf>

indicators related to Leverage should be used, in conformity with Article 25 of the AIFMD Level 1 and more widely the AIFMD Level 1 provisions related to Leverage, before digging further in the other criteria related to that fund.

In addition, in Table 2, **the concept of a “group of funds” is unclear and misleading, may dangerously admit different interpretations and potentially lead to a local bias.** This should be avoided in a context whereby ESMA is trying to introduce consistent methodology across NCAs.

For this reason, we challenge the inclusion of the concept of group of funds in the Guidelines, as subject to interpretation, and we believe it would be more reasonable to follow fund Leverage over time at the level of the given fund itself. In particular, although some funds may follow a similar strategy, the impact of leverage within each fund may be very different depending on investor type, concentration, dealing frequency as well as counterparty exposure. These individual fund variables all affect the potential impact leverage will have on the actions an individual fund will need to take in a crisis situation.

Reference to the concept of "group of funds" implies taking into consideration a plurality of funds for the risk assessment (only those funds included in NCA supervisory scope). Regardless of the grouping criteria, the funds included in the risk assessment are local, and that would include a 'bias' in the assessment by NCA that is also local. This could lead to the conclusion that the same funds or group of funds may require, under the supervision of an NCA, the adoption of limits on leverage when that same group of funds, evaluated in another jurisdiction, does not require it. Such local bias is, in our view, against both the concept of a level playing field across Europe and the initial purpose of the Guidelines.

We would also suggest that if the final Guidelines keep this concept, **NCAs should coordinate to ensure a coherent interpretation across Europe based on objective criteria.** In this case, a group of funds would be identified based on objective criteria and leverage limits would still apply at the fund level for each fund in the group.

Question 6: What are your views on using not only AIFMD data but also other external data sources to perform the assessment? Which types of external data sources would you consider more useful for the purpose of performing the assessment under Step 2, other than those already identified in Annex of to the draft Guidelines?

Our members believe that **there are no external data sources** which we would consider more useful for the purpose of performing the assessment under Step 2, **other than those already identified.** Our request to ESMA is to use the data already provided through the existing AIFM fund reportings, as well as the row data already provided to some national central banks under the form of individual fund gross inventories, from which NCAs could build their own internal monitoring tools.

We would suggest steering way from adding other leverage measures in addition to the commitment and gross leverage measures already imposed by the AIFMD. The latter measures work well, and additional measures would not add any further value to the analysis.

Our view is that any new fields to the existing AIFM reporting and/or new reporting from management companies are not needed. This is the NCA's responsibility to perform the data finding exercise based on existing data points from existing fields.

Question 7: Which other restrictions would you consider as appropriate?

We do not see any other restrictions to be added, in an already overly complex approach. Any restrictions imposed need to be considered holistically to avoid any unintended consequences.

Question 8: What are your views on the application of the leverage limits? Should those be applied only on the single fund or, where appropriate, limits should also be applied on group of funds? In this case, how would you identify the group of funds?

It is primarily the responsibility of each NCA to regulate its own locally-domiciled range of AIFs.

In our view, the application of leverage limits under Article 25(3) should be very targeted, primarily on a single fund basis. We would need further clarification on the rationale and consequence of having a perimeter of a group of funds instead of targeting at the single fund level and in general we would advise against this approach. **Our view is that risks are best managed at the individual fund level, taking into account the fund's investment objective, investment profile and legal pool of assets (and liabilities).**

Therefore, for the sake of clarity, consistency and level playing-field across the EU and following our comments on Q5, we suggest avoiding the concept of "group of funds" in the risk assessments. We would also suggest that if the final Guidelines keep this concept **NCA's should coordinate to ensure a coherent interpretation across Europe based on objective criteria.**

Question 9: How would you assess the efficiency of leverage limits in mitigating excessive leverage?

If the first step of assessing the funds more likely to pose leverage risks from a systemic risk point of view is efficiently done, then it will only be efficient to impose leverage limits on identified funds in exceptional cases and circumstances.

Competent authorities have the responsibility to set locally the most appropriate leverage limits, however such limits, if required, should only be imposed only after discussion with the manager of the fund and taking into consideration all the parameters related to the given fund. It should also be recognised that at EU level the AIFMD provides greater protection for both the financial system and investors as compared to other regions with, among other measures, an objective definition for AIFs with a substantial leverage, i.e. through a quantitative calculated threshold of 300% and more.