# Financial Regulatory Alert

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## ESMA Consults on Guidelines to Address Leverage Risk in the Alternative Investment Fund Sector

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On 27 March 2020, the European Securities and Markets Authority (ESMA) launched a public consultation on its draft guidelines to assess leverage risks in the Alternative Investment Fund (AIF) sector. In particular, ESMA is seeking stakeholders' feedback on the proposed principles to set leverage limits under Article 25 of the Alternative Investment Fund Managers Directive (Directive 2011/61/EU) (AIFMD). The outcome of the consultation may have significant implications for alternative investment fund managers (AIFMs), particularly as national competent authorities (NCAs) may impose leverage limits on certain categories of AIFs that pose risks to financial stability. The consultation and draft guidelines form part of ESMA's response to the recommendations of the European Systematic Risk Board (ESRB) in April 2018 to address liquidity and leverage risks in investment funds and to specifically provide guidance on Article 25 of the AIFMD. The draft guidelines are intended to promote supervisory convergence in respect of how national competent authorities assess how the use of leverage[1] within the AIF sector supplements the build-up of systemic risk in the financial system and how leverage limits are designed and implemented.

The consultation remains open until the deadline of 1 September 2020, following which ESMA intends to finalise its guidelines for publication. The two main sections of the draft guidelines concern (i) the assessment of leverage-related systemic risk and (ii) the imposition, level and efficiency of any leverage limits imposed, both of which are based on two separate parts of the ESRB's recommendations to ESMA. We set out the key features of the draft guidelines below.

### Background to the Draft Guidelines

Under Article 24 of the AIFMD, AIFMs are required to report certain information to their home NCAs in respect of each EU AIF that they manage and each AIF that they market in the EU. Non-EU AIFMs that market an AIF in the EU are required to submit such reports to the NCA of the member state in which the relevant AIF is marketed. AIFMs that manage AIFs employing leverage on a "substantial basis"[2] are required to report information about the level of leverage employed by each AIF and must evidence that the leverage limits set are reasonable. Article 25 of the AIFMD, which is the focus on ESMA's consultation paper, provides that the competent authorities of the home member state are required to use the information gathered under Article 24 for

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the purposes of “identifying the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, risks of disorderly markets or risks to the long-term growth of the economy.” Further detail as to the legislative basis for the guidelines is set out at Section III of the consultation paper. Importantly, although AIFMs are able to set leverage limits at their discretion based on what they deem reasonable, NCAs have traditionally not imposed limits—the draft guidelines suggest this position may soon change.

In light of the “rapid expansion of the investment fund sector” and the “higher risk-taking” in the context of low interest rates, ESMA noted that it is of utmost importance to implement a framework for NCAs to monitor the level of leverage and deleveraging process of highly leveraged AIFs. ESMA raised concerns that deleveraging can amplify systemic risks during financial crises, particularly where funds have short redemption periods, and spill-over effects from such deleveraging can be amplified by leverage as leveraged funds are likely to liquidate a greater amount of assets; funds’ liquidity risks may also increase given the potential for leverage to amplify the impact of negative market movements during stressed times. Although funds not using leverage may pose a risk to financial stability, ESMA notes that such risks cannot be mitigated through the imposition of leverage limits and are thus outside the scope of the guidelines.

## Key Features of the Draft Guidelines

In Annex II to the consultation paper, ESMA sets out its proposed draft guidelines. The proposed guidelines include (1) a set of common minimum indicators to be taken into account by NCAs in the assessment of leverage-related systemic risk, (2) instructions to calculate such indicators based on reporting data under Article 24 of the AIFMD and (3) qualitative and quantitative descriptions as to how to interpret the indicators.

### I. Assessment of Leverage-Related Systemic Risk (ESRB Recommendation E(1))

The draft guidelines set out a two-step risk assessment of the leverage-related systemic risk posed by the AIF sector that NCAs should perform quarterly following receipt of data pursuant to Article 24 of the AIFMD.

**Step 1 (Level, Source and Different Usage of Leverage):** Step 1 requires NCAs to identify:

I. AIFs employing leverage on a substantial basis;

II. AIFs employing leverage, but not on a substantial basis, that have assets under management of EUR 500 million (or more) at the reporting date; and

III. all other AIFs whose “unusually high sue of leverage” (as measured using the indicators set out at Table 1 of the draft guidelines) may pose risks to financial stability. An “unusually high use of leverage” is, broadly, use of leverage that differs significant from that of other AIFs (e.g., through a high percentile in the distribution) by comparing the AIF’s leverage value with the AIF’s historical median or average leverage value, and the median or average leverage value of other AIFs of the same type (e.g., hedge funds, private equity funds and real estate funds).

This assessment is focused on selecting the funds for which it is deemed appropriate to set a leverage limit.

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**Step 2 (Leverage-related Systemic Risk):** Step 2 requires NCAs to evaluate potential leverage-related systemic risks to financial stability of the AIFs identified at Step 1, including consideration of risks of market impact, fire sales, direct spill over to financial institutions and interruption in direct credit intermediation. In assessing these risks, NCAs are encouraged to apply the risk indicators set out at Table 2 of the guidelines, together with any other risk indicators deemed relevant. ESMA notes that the assessment under Step 2 ought to be consistent across jurisdictions and based on the common methodology and indicators set out at Table 2. A number of case studies have been included in Annex 1 to aid NCAs in arriving at a consistent risk assessment under Step 2.

NCAs are required to communicate the results of the risk assessments to ESMA at least annually and at any time a risk to financial stability is identified. Other EU NCAs must also be informed by the relevant NCA where a risk is identified relevant to the other jurisdiction. The risk assessment in Steps 1 and 2 above should be used together with a qualitative assessment where necessary to identify the AIFs for which it is most appropriate to set a leverage limit.

**II. Leverage Limits (ESRB Recommendations E(2))**

The draft guidelines provide that NCAs should impose leverage limits on AIFs posing risks to financial stability and, when deciding to impose such limits, NCAs should specifically consider:

I. the risks posed by funds according to their type (e.g., hedge funds, private equity, real estate, fund of funds or other relevant types) and risk profile (as defined by the risk assessment in Steps 1 and 2); and

II. risks posed by common exposure such that where the NCA considers a group of funds of the same type and same risk profile may collectively pose leverage-related risks, the NCA should apply leverage limits in a similar or identical manner to all funds in that group.

The guidelines note that the phasing in or out of any leverage limits must be carefully implemented and, in particular, when deciding **whether leverage limits should be imposed**, NCAs should consider the following:

- Where an NCA imposes continuous leverage limits to an AIF or group of AIFs posing threats to financial stability, the limits should be maintained for as long as the risks posed do not decrease;
- Where an NCA imposes temporary leverage limits to limit the accumulation of risk (e.g., when funds contribute to excessive credit growth or formation of excessive asset prices), the limits should be released when changes in market conditions or fund behaviour cease being procyclical;
- Leverage limits should be imposed progressively to avoid procyclicality, particularly where imposing limits in a procyclical way may trigger the very risks intended to be mitigated; and
- NCA's should take into account the possibility of applying cyclical limits to dampen the accumulation and materialization of risks in the upswing and downswing phases of the financial cycle.

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In setting the appropriate **level of any leverage limit**, NCAs should take into account its effectiveness in addressing the risks of market impact, fire sales, spill-overs to financial counterparties and disruptions of credit intermediation. For example, where risks are directly related to size, imposing leverage limits should reduce the risks, or where risks are partially related to size and imposing limits may not reduce risks because AIFs can amend their strategy to maintain an equivalent level of risk, then NCAs should consider imposing other restrictions. Furthermore, where imposing limits may result in the risks temporarily increasing, then other restrictions should be imposed 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 may include, for example, settling limits to the proportion of some assets based on their contribution to the risk profile of the AIF or its sensitivity to market risk factors.

When evaluating the **efficiency of leverage limits** in mitigating excessive leverage, NCA's assessments should consider both (i) proportionality of the leverage limit to the systemic risk posed by the AIFs use of leverage and (ii) how robust the leverage limits are in the face of gaming and arbitrage. For example, where AIFs managed by non-EU AIFMs pose leverage-related systemic risks and the NCA cannot impose leverage limits, it should seek to impose other restrictions relating to the management of the AIF, or where the NCA considers a fund may pose leverage-related risks, the same limits should be considered for different types of funds with similar risk profiles.

**III. Implications and Next Steps**

The changes proposed by ESMA's guidelines introduce welcome clarity to the methodology for calculating leverage under the AIFMD framework and provide for a consistent approach for NCAs in monitoring and supervising the level of leverage and deleveraging process in respect of AIFs. For example, AIFMs with over EUR 500 million of regulatory assets under management employment leverage of any kind (i.e., not on a substantial basis) will be identified by NCAs in Step 1 and, thus, may be subject to leverage limits and enhanced supervisory scrutiny. ESMA noted, however, that the draft guidelines are without prejudice to any further regulatory updates coming from the International Organization of Securities Commissions (IOSCO) work on leverage, AIFMD review and any further calibration of the indicators that may be deemed appropriate in the future.

ESMA has requested comments on the matters referred to in the draft guidelines and specifically on the questions raised in Annex I. All contributions must be submitted online at www.esma.europa.eu using the dedicated Response Form by 1 September 2020.

We continue to monitor regulatory developments in this area.

[1] Leverage is defined under the draft guidelines as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means."

[2] The phrase "on a substantial basis" is defined in Article 111 of Commission Delegated Regulation 231/2013 as instances where "the exposure of an AIF as calculated according to the commitment method under Article 8 of this Regulation exceeds three times its net asset value."

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