Response Form to the Consultation Paper

Guidelines on Article 25 of Directive 2011/61/EU

27 March 2020 ESMA34-32-535

Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **01/09/2020.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_PFG_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_PFG_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PFG_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on Position limits and position management in commodities derivatives").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper

This document will be of interest to asset managers managing alternative investment funds and their trade associations.

General information about respondent

Name of the company / organisation	The Investment Association
Activity	Investment Services
Are you representing an association?	☒
Country/Region	UK

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_PFG_1>

The Investment Association (IA) represents over 250 UK-based investment management firms who collectively manage assets totalling EUR 8.7 trillion, of which EUR 2 trillion is on behalf of continental European clients. The UK investment management industry is a key part of both the UK and EU's financial ecosystems, helping millions of individuals save for the long-term and enabling them to enjoy a more prosperous retirement. The UK investment management industry is the largest in Europe and the second-largest globally.

Leverage in investment funds has been an area of interest for international policy makers since the global financial crisis in the context of discussions on financial stabilty, and this subject has been raised again by some commentators in the wake of the COVID-19 crisis. Overall, there is limited evidence that leverage in investment funds contributed materially to systemic risks during the COVID-19 crisis. For example, some commentators have cited the need for leveraged AIFs to sell assets to meet increased calls as an example of the pro-cyclical risks posed by leveraged AIFs. However, we note that while some CCPs increased their margin calls significantly during the crisis, others did not increase their margin calls, suggesting the liquidations by AIFs having to meet increased margin calls may have, at least in part, been due to potential failures by CCPs to set their margin calls at a level that avoids pro-cyclicality, rather than the employment of leverage by those AIFs.

Various studies, including those by the FSB, the Commission and ESMA, have indicated the overall levels of leverage across investment funds are low, with high levels of leverage concentrated in only a small number of alternative investment funds. Any measures to assess and mitigate risks arising from leverage must therefore be proportionate and targeted at the relatively small population of investment funds employing high levels of leverage, without placing unnecessary burdens on the vast majority of investment funds that do not employ leverage on a substantial basis.

In December 2019, IOSCO published its final report on Recommendations for a Framework Assessing Leverage in Investment Funds. Adoption of this framework will provide for greater consistency on measuring leverage at an international level. Importantly, the two step process adopted by IOSCO and the measures proposed at Step 1 provide for a proportionate approach, using simple measures to screen out those funds that do not employ high levels of leverage while allowing those investment funds more likely to pose a risk to the financial system to be identified for further analysis.

The IA therefore welcomes the proposal by ESMA to adopt in its Guidelines on Article 25 of AIFMD the two step process recommended by IOSCO. We are, however, concerned that the scope proposed by ESMA for further analysis of AIFs is broader than that envisaged in the IOSCO recommendations – in particular by capturing AIFs that do not employ leverage on a substantial basis.

Our response to the consultation questions proposes the following key points:

- The frequency at which risk assessments are carried out by NCAs should be quarterly, aligned with the frequency of AIFMD Annex IV reporting.

- The analysis should only include AIFs that are substantially leveraged.

- Different thresholds are not required for different types of AIFs.

- Only leverage indicators should be used in screening at the initial stages. Other indicators may be useful at later stages of analysis, but only for AIFs already identified as more likely to pose risks due to their use of substantial leverage.

- Leverage limits should only be applied by NCAs in exceptional circumstances, to AIFs specifically identified in the assessment process, and after engagement with the AIFM concerned.

<ESMA_COMMENT_PFG_1>

Questions

Q1 : What are your views on the frequency at which the risk assessments should be performed by NCAs?

<ESMA_QUESTION_PFG_1>
We agree with the proposal in the consultation that the risk assessments should be performed quarterly by NCAs. The frequency at which risk assessments are carried out should align with the reporting frequency of AIFMD Annex IV reports provided by AIFMs. AIFMs managing AIFs with AUM of €1bn must report on a quarterly basis – AIFs that would be expected to be within the scope of the leverage assessments would fall in this category. Assessment of the quarterly reporting data provided by these AIFMs should be sufficiently frequent to provide any indication of a build up of leverage risks.
<ESMA_QUESTION_PFG_1>

Q2 : 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?

<ESMA_QUESTION_PFG_2>
We would only expect AIFs employing leverage on a substantial basis, as defined in the AIFMD Level 2 Regulations, to be within the sample of AIFs to be included under Step 1. We do not see there is any value on including AIFs not employing leverage on a substantial basis in the assessment. The objective of the assessment is to identify leverage risks arising from AIFs that may pose a risk to the wider financial system, and to determine if it is necessary to apply leverage limits to those AIFs. Even if AIFs that do not employ leverage on a substantial basis have other characteristics that pose risks to financial stability, leverage limits are unlikely to impact those AIFs or mitigate the risks posed by those AIFs.

We therefore suggest that the approach proposed by ESMA be amended to align more closely with the approach suggested for Step 1 by IOSCO in its Final Report Leverage Measures. This requires regulators to identify "those funds that are more likely to pose risks to the financial system" through their use of leverage. It is our view that only AIFs that employ leverage on a substantial basis may come into this category, and even then not all AIFs that employ leverage on a substantial basis are necessarily likely to pose risks to the financial system.

It is important that the ESMA approach aligns with the recommendations set out by IOSCO, as these recommendations are being implemented internationally across a number of jurisdictions. The consistent application of these recommendations will be important when IOSCO collates information, aggregates and reports on these. To support this consistency, we therefore recommend ESMA considers only those AIFs that employ leverage on a substantial basis at Step 1.
<ESMA_QUESTION_PFG_2>

Q3 : 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.

<ESMA_QUESTION_PFG_3>
We do not on the whole see the need to set different thresholds for different types of AIFs. It is not always straightforward to identify fund types – the large number of AIFs reported as "other" indicates this, and even within the same fund type, there can be significant variations between AIFs. Also, it is not immediately apparent to us how thresholds in different fund types would be set – this could be an arbitrary process. As stated in our response to question 2, the analysis at step 1 should only include those AIFs that employ substantial leverage.

We do, however, see merit in clarifying the calculation of leverage in the case of Private Equity funds and Infrastructure funds which utilise capital draw downs and revolving credit facilities. Although these revolving credit facilities are typically used to bridge funding gaps on investments while awaiting the payment from investor commitments, we understand these facilities are sometimes not treated as temporary borrowing, even though they are covered by capital commitments made by investors. We recommend revolving credit facilities used by Private Equity and Infrastructure Funds to bridge capital commitments are excluded when calculating the leverage thresholds for these funds.
<ESMA_QUESTION_PFG_3>

Q4 : Would you identify other relevant transmission channels?

<ESMA_QUESTION_PFG_4>
We have not identifed any other relevant transmission channels.
[IA members – please advise if there are other transmission channels you consider relevant.]
<ESMA_QUESTION_PFG_4>

Q5 : 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?

<ESMA_QUESTION_PFG_5>
Other types of (non-leverage) indicators should not be used in the initial screening process to identify AIFs more likely to pose leverage risks. Assessing these factors early in the process could bring into scope AIFs that do not employ leverage on a substantial basis, and therefore in practice will not pose significant risks to the financial system through their use of leverage. At the initial stages of assessment, only leverage measures should be considered, in particular the gross and commitment measures calculated by AIFs in accordance with articles 7 and 8 of the AIFMD Level 2 Regulation (Commission Delegated Regulation (EU) 231/2013). Other types of indicators may be helpful at later stages in determining whether the

leverage employed by those AIFs identified earlier in the process are more likely to pose a risk to the financial system, but these should only be considered after the leverage measures have been considered.
<ESMA_QUESTION_PFG_5>

Q6 : 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?

<ESMA_QUESTION_PFG_6>
If external data sources are available for particular AIFs, then we agree that it is reasonable for NCAs to use these, where the data is reliable, appropriate, and meaningful and used with care. In such cases, we would expect the NCAs to source this date themselves. For certain types of specialist AIFs, external data is unlikely to be available.

We do not have any additional suggestions to those noted in the Annex.
<ESMA_QUESTION_PFG_6>

Q7 : Which other restrictions would you consider as appropriate?

<ESMA_QUESTION_PFG_7>
We do not consider any further restrictions to be appropriate.
<ESMA_QUESTION_PFG_7>

Q8 : 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?

<ESMA_QUESTION_PFG_8>
Given AIFs are typically only marketed to professional investors, we consider that leverage limits should only be applied in exceptional circumstances, where the leverage of those specific AIFs are deemed to pose significant risks to the broader financial system. We would expect those AIFs to which leverage limits are being applied to have been specifically identified in the screening process. The decision to impose leverage limits should be taken by local NCAs responsible for regulating the AIFMs managing the AIFs in question. We would also expect the NCA to engage with the AIFMs concerned, discussing qualitative as well as quantitative factors in their employment of leverage, before deciding whether imposing leverage limits is required.

The analysis by NCAs should also include an assessment of client expectations of leverage to avoid any procyclical effects resulting from redemptions due to a forced deviation (through the setting of leverage limits) from the agreed investment strategy and risk budgets. Some funds, such as Liabilitiy Driven Investment (LDI) Funds, use significant amounts of long term hedging which can lead to high leverage readings. In practice, this derivatives exposure is used to manage long term risks, which is critical for pension schemes in particular. Placing a leverage limit on such funds would result in clients being less able to manage their risks, resulting in these clients needing to sell assets to reduce their risk exposures. This further illustrates the importance of NCAs engaging with the AIFMs before setting leverage limits to avoid any unintended consequences from these.

We are cautious on the proposal to apply limits to groups of AIFs, and in particular how those groups of AIFs will be identified. While there may be cases where it is appropriate to apply a limit to a group of AIFs, there are a number of factors that would need to be taken into account when determining if it is appropriate to group AIFs, and in practice identifying those factors is likely to be very challenging. We would not expect AIFs that have not been identified as posing material risks due to their use of leverage to be included in such groups.

Given the difficulty of identifying groups of AIFs for which a limit is applies, we recommend that each AIF is considered on its own merits. This will ensure that leverage limits are only applied to those AIFs that pose material leverage risks.
<ESMA_QUESTION_PFG_8>

Q9 : How would you assess the efficiency of leverage limits in mitigating excessive leverage?

<ESMA_QUESTION_PFG_9>
There is no clear definition of what constitutes “excessive leverage” in either the AIFMD or the IOSCO Recommendations. The determination of the level of leverage that is sustainable will depend on a number of factors related to the AIF, both internal and external. This level is likely to vary depending on market conditions and where the AIF is its lifecycle – a fund experiencing significant investment inflows is likely to be able to sustain far higher levels of leverage than one experiencing significant investment outflows Such a determination is therefore best made by local NCAs, although we recognise that NCAs will have regard to developments and market failures in other countries.

An extensive application of leverage limits, while limiting some potential risk, may also limit the investment returns available to investors in the AIF. It is understandable that NCAs will want to prevent market failures due to excessive risk taking. However, NCAs must also be mindful of the impact on competitiveness of European AIFs if stricter limits are applied than is necessary to protect markets – the professional investors who typically use AIFs are relatively well placed to access funds in other fund domiciles, and if due to the limits imposed on European AIFs they are unable to access the potential returns they are seeking, they may elect to invest in third-country AIFs that are not subject to those leverage limits.
<ESMA_QUESTION_PFG_9>