

Guidelines

On Article 25 of Directive 2011/61/EU



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I. Scope

Who?

1. These guidelines apply to competent authorities.

What?

2. These guidelines apply in relation to Article 25 of the AIFMD.

When?

3. These guidelines apply from two months after the date of publication of the guidelines on ESMA's website in all EU official languages.

II. Legislative references, abbreviations and definitions

Legislative references

<i>AIFMD</i>	Directive 2011/65/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 ¹
<i>AIFMD Level 2 Regulation</i>	Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
<i>ESMA Regulation</i>	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC ²

Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
ASR	Annual Statistical Report
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
NAV	Net Asset Value

¹ OJ L 174, 1.7.2011, p. 1.

² OJ L 331, 15.12.2010, p. 84.

III. Purpose

4. These guidelines are based on Article 16(1) of the ESMA Regulation. The objectives of these guidelines are to establish consistent, efficient and effective supervisory practices within the ESFS and to ensure the common, uniform and consistent application of Article 25 of the AIFMD. In particular, they relate to the assessment of leverage-related systemic risk and aim to ensure that competent authorities adopt a consistent approach when assessing whether the condition for imposing leverage-related measures are met.

IV. Compliance and reporting obligations

Status of the guidelines

5. In accordance with Article 16(3) of the ESMA Regulation competent authorities must make every effort to comply with these guidelines.
6. Competent authorities to which these guidelines apply should comply by incorporating them into their national legal and/or supervisory frameworks as appropriate.

Reporting requirements

7. Within two months of the date of publication of the guidelines on ESMA's website in all EU official languages, competent authorities to which these guidelines apply must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.
8. In case of non-compliance, competent authorities must also notify ESMA within two months of the date of publication of the guidelines on ESMA's website in all EU official languages of their reasons for not complying with the guidelines.
9. A template for notifications is available on ESMA's website. Once the template has been filled in, it shall be transmitted to ESMA.

V. Guidelines on Article 25 of Directive 2011/61/EU

V.I. Guidelines on the assessment of leverage-related systemic risk

10. 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.
11. Competent authorities should perform the risk assessment on a quarterly basis.
12. The risk assessment should follow a two-steps approach:
 - a) Step 1: Level, source and different usages of leverage (Table 1)
 - b) Step 2: Leverage-related systemic risk (Table 2)
13. Under Step 1, competent authorities should identify AIFs that are more likely to pose risks to the financial system. The following AIFs are more likely to pose risks to the financial system:
 - 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 500mn³ 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.
14. For the purpose of point c) of paragraph 13, 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.
15. Under Step 2, competent authorities 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

³ This threshold corresponds to a semi-annual or quarterly reporting frequency, as indicated by Article 110(3) letters a) and c) of Commission Regulation 231/2013, for authorised AIFMs based on the managers’ characteristics and AIFs managed. Full diagrams on the reporting frequencies available in the ESMA guidelines on reporting obligations.

16. Competent authorities 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, competent authorities 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, competent authorities should refer to the (non-exhaustive) list of data sources included in Annex I.
17. 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. Competent authorities should inform other EU competent authorities 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.
18. Competent authorities 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.II.

Table 1

Leverage-related systemic risk	Indicator	Description	Scope	Data source ⁴
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 ⁵	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 (AuM)	Regulatory 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

⁴ Figures refer to the corresponding field in the AIFMD reporting.

⁵ This measure excludes IRDs from the computation of leverage, following the approach used in the ASR 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).

Table 2

Leverage-related systemic risk	Indicator	Description		Scope	Data source ⁶
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, 124 Size of the underlying market based on external data (see Annex II)
		Value of turnover in each asset class over the reporting months compared to the turnover of the asset class		Group of AIFs	AIFMD: 126 Turnover of the underlying market based on external data (see Annex II)
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	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
	Share of less liquid assets	Illiquid assets include physical assets, unlisted equity, non-investment grade corporate and convertible bonds, and loans, in percentage 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 competent authorities 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

⁶ Figures refer to the corresponding field in the AIFMD reporting.

Leverage-related systemic risk	Indicator	Description	Scope	Data source ⁶
		Potential liquidity demands (by source)	Single AIF	AIFMD: 297-301
Risk of direct spill-overs 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 (see annex II)
		Potential liquidity demands resulting from market shock ⁷ (see above)	Single AIF	Single AIF
	Linkages to financial institutions via investor base	Financial institution exposed to a risk of loss ⁸	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

V.II. Guidelines on leverage limits

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

⁷ Liquidity demands stemming from derivatives especially represent a counterparty risk for the counterpart.

⁸ Bank exposure to shadow banking entities is nevertheless limited by EBA's guidelines. EBA is of the view that only AIFs with limited leverage could be considered to fall outside the definition of 'shadow banking entities'.

- a) 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 performed in accordance with paragraph 12;
 - b) risks posed by common exposures. Where competent authorities determine that a group of AIFs of the same type and similar risk profiles may collectively pose leverage-related systemic risks, they should apply leverage limits in a similar or identical manner to all AIFs in that group of AIFs.
20. Competent authorities should carefully implement leverage limits, both in terms of timing and phasing in and out:
- a) where competent authorities impose 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;
 - b) when competent authorities impose temporary leverage limits to limit the build-up of risk, including any procyclical 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 procyclical;
 - c) competent authorities should implement leverage limits progressively ("the phased-in period") to avoid procyclicality, especially if imposing limits in a procyclical way could trigger the risk they intend to mitigate; and
 - d) competent authorities should take into account the possibility to apply cyclical limits to dampen the build-up and materialisation of risks in the upswing and downswing phases of the financial cycle.
21. When setting the appropriate level of leverage limits, competent authorities should take into account their effectiveness in addressing the risk of market impact, fire sales, spillovers to financial counterparties, and disruptions of credit intermediation to ensure that the sector remains able to provide valuable services to the economy. Competent authorities should take the following into account:
- a) when risks are directly related to the size of leverage, imposing leverage limits should aim at reducing the size of the risks;
 - b) 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, competent authorities should consider imposing other restrictions on the management of the AIFs (for example, restrictions on the investment policy, redemption policy or risk policy); and
 - c) 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, competent authorities 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, competent authorities 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.

22. Competent authorities should evaluate the efficiency of leverage limits in mitigating excessive leverage by taking into consideration the following:

- a) proportionality of the leverage limits to the systemic risk posed by the use of leverage by the AIFM;
- b) robustness of leverage limits to gaming and arbitrage, especially:
 - i) where competent authorities 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 profiles, 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
 - ii) complexity of the calibration.

VI. Annexes

Annex I: Use of external data for the purpose of the risk assessment

1. Competent authorities can compare AIFs in their market with data aggregated at EU level: ESMA publishes its statistical report on EU Alternative Investment Funds on an annual basis⁹.
2. For the assessment of leverage related systemic risks, external data may be necessary in order to measure the AIF's exposure in relation to their counterparty or the market in which they operate. This is especially the case when:
 - a) competent authorities want to assess the market share of an AIF or a group of AIFs, in which case they would need the information regarding the AIF's exposure and the size of the underlying market;
 - b) competent authorities want to measure counterparty risk, in which case they would need information on the counterparty.
3. The data sources indicated in Table 3 are without prejudice to any further data sources that ESMA may include in the future to improve exhaustivity, especially in terms of instruments and geographical areas.

Instruments Traded and Individual Exposures	Underlying market	Source
a) Securities		
Listed equities	listed shares	ECB: Selected euro area statistics and national breakdowns - Securities issues
Corporate bonds not issued by financial institutions	euro-denominated debt securities issued by Non-financial corporation	ECB: Selected euro area statistics and national breakdowns - Securities issues
Corporate bonds issued by financial institutions	euro-denominated debt securities issued by Non-MFI financial institutions	ECB: Selected euro area statistics and national breakdowns - Securities issues
Sovereign bonds	euro-denominated debt securities issued by central government	ECB: Selected euro area statistics and national breakdowns - Securities issues
Structured/secured products	financial vehicle corporations	ECB - Statistics – Financial corporations - Financial vehicle corporations -
b) Derivatives		
Equity derivatives	equity derivatives	ESMA: ASR on EU Derivatives markets
CDS	credit derivatives	ESMA: ASR on EU Derivatives markets

⁹ The latest iteration (at the time of issuing these guidelines) of the ESMA Annual Statistical Report, EU Alternative Investment Funds, ESMA, 2020, is available here: https://www.esma.europa.eu/sites/default/files/library/esma50-165-1006_asr-aif_2020.pdf

Foreign exchange	currency derivatives	ESMA: ASR on EU Derivatives markets
Interest rate derivatives	interest rate derivatives	ESMA: ASR on EU Derivatives markets
Commodity derivatives	commodities derivatives	ESMA: ASR on EU Derivatives markets
d) Collective Investment Undertakings		
Money Market Funds and Cash management CIU	balance sheets of euro area money market fund	ECB - Statistics - Money, credit and banking - Credit institutions and money market funds
ETF	balance sheets of euro area investment funds	ECB - Statistics - Financial corporations - Investment funds balance sheets
Other CIU	balance sheets of euro area investment funds	ECB - Statistics - Financial corporations - Investment funds balance sheets
Top counterparty exposure	Counterparty data	Source
Banks	bank balance sheet	EBA EU-wide transparency exercise
Insurance	insurance balance sheet	EIOPA insurance statistics

Annex II: Case studies (for illustrative purpose)

Leverage-related systemic risk

Indicator*

			FoF		HF		Real		PE		Other	
			AIF 1	90th percentile	AIF 2	90th percentile	AIF 3	90th percentile	AIF 4	90th percentile	AIF 5	90th percentile
Step 1	Leverage measures	Adjusted gross leverage	8x	1x	15x	11x	4x	2x	3x	1x	4x	2x
		Commitment leverage	6x	1x	36x	8x	4x	2x	4x	1x	4x	1x
Step 2	Market impact	Net exposure (EUR mn)	AIF 1	90th percentile	AIF2	90th percentile	AIF 3	90th percentile	AIF 4	3rd quartile	AIF 5	3rd quartile
			2,300	353	50,000	2,528	1,500	295	170	81	230	185
	Risk from fire sales	Liquidity profile*	AIF 1	Median	AIF 2	Median	AIF 3	Median	AIF 4	Median	AIF 5	Median
			12%	0%	0%	13%	0%	0%	47%	0%	46%	0%
		Share of less liquid assets	AIF 1	Median	AIF 2	3rd quartile	AIF 3	90th percentile	AIF 4	90th percentile	AIF 5	90th percentile
			4%	3%	27%	25%	368%	400%	221%	113%	350%	119%
	Risk of direct spill overs to financial institutions	Long value of investments in listed equities and corporate bonds issued by financial institutions and sum of long exposures in structured and securitised products.	AIF 1	Median	AIF 2	90th percentile	AIF 3	Median	AIF4	90th percentile	AIF 5	Median
			2%	7%	41%	33%	0%	0%	0%	0%	0%	14%

Coding: green=average or low risk for an AIF of this type, orange=high risk for an AIF of this type (in relative terms), red=high risk for an AIF (in absolute terms).

*Higher values indicate higher risks except for the liquidity profile indicator.

1. AIFs should be assessed according to the absolute value of the indicators and the relative value, compared to AIFs of the same type and other AIFs. The above examples (AIF 1-5) are based on real cases. All AIFs are substantially leveraged (commitment leverage >x3) and should therefore be subject to the risk assessment.
2. A high absolute value of an indicator is indicated in red in the table. A high relative value compared to AIFs of the same type is indicated in orange. Green indicate a low or medium value. For each indicator, the table also indicates a comparison with the relevant descriptive statistic for AIFs of the same category (e.g. a comparison with the median, the 3rd quartile or the 90th percentile).
3. AIF 1 is highly leveraged both in absolute terms and in comparison with AIFs of the same type (the funds of funds). Its main risk is related to its potential market impact, due to its high net exposure (EUR 2.3bn). Risks of fire sales and direct spill overs to financial institutions appear to be more limited and in line with other AIFs in the same category. Therefore, the competent authority should consider imposing leverage limits on this AIF, in case it expects this AIF to have a potential market impact, taking into account the depth of the market it is active in (i.e. its capability to move market prices when selling assets).
4. AIF 2 is very highly leveraged both in absolute terms and in comparison with AIFs of the same type. Its main risk is related to its potential market impact, due to its very high net exposure (EUR 50bn). It also holds a relatively high share of less liquid assets (27% of NAV), has a less liquid profile than AIFs of the same category (0% compared to 13%) and it is exposed to financial institutions (41% of NAV). Therefore, the competent authority should consider imposing leverage limits on this AIF, especially to reduce its potential market impact.
5. AIF 3 is more leveraged than AIFs of the same type and has a relatively high net exposure (EUR 1.5bn). Like most of its peers, the AIF is invested in illiquid assets (real estate). This combination may lead to fire sales in case of a significant redemption episode. However, the liquidity profile of the AIF does not show liquidity mismatches. Therefore, the competent authority should consider imposing leverage limits based on a deeper analysis of the appropriateness of the redemption policy of the AIF.
6. AIF 4 is more leveraged than AIFs of the same type with a relatively high net exposure compared to peers but limited in absolute terms (EUR 170mn). Like most of its peers, the AIF is invested in illiquid assets (private equity). This combination may lead to fire sales in case of a significant redemption episode. However, the liquidity profile of the AIF does not show liquidity mismatches. Therefore, the competent authority should consider imposing leverage limits based on a deeper analysis of the appropriateness of the redemption policy of the AIF.
7. AIF 5 belongs to the “other category”. It is more leveraged than other AIFs of the same type with a relatively high net exposure compared to peers but limited in absolute terms (EUR 230mn). The AIF is heavily invested in less liquid assets (private equity) but does not show liquidity mismatches. Given the type of this AIF (“other”), the competent authority should consider imposing leverage limits based on a deeper analysis of the business model of this AIF, and especially the appropriateness of its redemption policy