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ESRB considerations regarding the AIFMD

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Dear Sean,

With this letter I am providing the information which your staff requested on the shortcomings of the current AIFMD framework. I understand that the European Commission plans to report to the EU co-legislators on the application and scope of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) in early 2020.

As you know, the non-bank financial sector accounts for more than half of the EU financial sector's total assets.¹ EU Investment funds, which include alternative investment funds (AIFs) and Undertakings for the Collective Investment in Transferable Securities (UCITS), are a key part of the non-bank financial sector. In terms of net asset value the EU AIF market accounts for around €5.8 trillion, making up approximately 40% of the EU fund industry.² The sector is expected to grow further with the progression of the Capital Markets Union.

While the investment fund sector can provide a valuable alternative to bank finance and facilitate efficient capital allocation in the EU, increased financial intermediation by investment funds can also create vulnerabilities that can lead to risks to financial stability. These vulnerabilities particularly relate to liquidity risks, high levels of leverage in some types of funds and procyclical risk-taking. Under stressed conditions,

¹ ESRB (2019b), EU Non-bank Financial Intermediation Risk Monitor 2019, No 4/July 2019 [[link](#)]

² ESMA (2020), ESMA Annual Statistical Report – EU Alternative Investment Funds, January [[link](#)]

this may result in funds amplifying shocks as interconnectedness with other parts of the financial system can lead to direct and indirect contagion, with potential adverse implications for the financing of the real economy. Reflecting this, national competent authorities (NCAs) and authorities with a financial stability mandate need to be able to monitor and manage the extent to which the investment fund sector could contribute to systemic risk.³

The AIFMD provides the ESRB with important data to help analyse systemic risks.⁴ Nevertheless, there are some areas in which the reporting framework could be improved and the review of the AIFMD provides an opportunity to consider these in more detail.

In this letter, which has been approved by the ESRB's General Board, I would like to share the ESRB's experiences with the scope and application of the AIFMD. In particular, I would like to share considerations regarding (i) the suitability of the reporting framework and access to data for monitoring systemic risk, (ii) the need to operationalise existing macroprudential policy instruments, and (iii) the ongoing development of the macroprudential policy framework "beyond banking" in general and for investment funds in particular.

I hope that these considerations prove useful to the Commission going forward.

Yours sincerely,



Francesco Mazzaferrro
Head of ESRB Secretariat

Encl.

Experiences with the scope and application of the AIFMD

Copy to: Ralf Jacob, Klaus Wiedner

³ ESRB (2016), Macroprudential policy beyond banking: an ESRB strategy paper [[link](#)]

⁴ ESMA Annual Statistical Report, EU Alternative Investment Funds, 2019 [[link](#)]

Experiences with the scope and application of the AIFMD

The following three sections outline the ESRB's considerations regarding (i) the suitability of the AIFMD reporting framework and access to data for monitoring systemic risk, (ii) the need to operationalise existing macroprudential policy instruments, and (iii) the ongoing development of the macroprudential policy framework "beyond banking" and for investment funds in particular.

(i) The suitability of the reporting framework and access to data for monitoring systemic risk

The AIFMD provides NCAs with valuable and unique information to assess potential vulnerabilities stemming from the alternative investment fund sector. Based on the AIFMD reporting framework, the ESRB has suggested a risk monitoring framework for NCAs to help operationalise macroprudential tools including leverage limits.⁵ Some areas for improvement in AIFMD reporting have been identified, and could be addressed to further enhance NCAs' abilities to monitor vulnerabilities in investment funds:

- **Availability of fund identifiers:** Around half of funds reporting under AIFMD do not report or possess a Legal Entity Identifier (LEI). The availability of unique identifiers is crucial for the analysis of interconnectedness, the understanding of complex group structures or when linking AIFMD data with other data sources. For example, when trying to combine data collected through AIFMD and EMIR to explore exposures of investment funds on derivatives markets, analysis conducted by the ESRB shows that approximately 25% of funds which report trading derivatives under AIFMD do not report LEIs. The importance of LEI reporting was also highlighted by ESMA in its response to the previous consultation on the fitness check on supervisory reporting.⁶
- **Fund classification:** Around 60% of investment funds' net asset value is classified as "Other", which includes the two large fund categories of equity funds and fixed income funds. At the same time 6% of investment funds' net asset value is classified as "Hedge Funds" which is further subdivided into seventeen specific investment strategies. Systemic risk analysis would benefit from a revised approach to fund classification that better reflects the type of funds registered as AIFs and where the "Other" category is reduced in size.

⁵ Recommendation ESRB/2017/7 of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds [[link](#)]

⁶ ESMA's response to the public consultation on the fitness check on supervisory reporting, page 7, 2018 [[link](#)]

- **Information on funds' interconnectedness**
 - Information on assets and liabilities: Fund managers report portfolio holdings on an aggregate level, which is helpful for assessing general trends and vulnerabilities. More granular data, such as the top five instruments or counterparties of a fund, further complement the aggregate statistics and help to assess portfolio concentration. However, since most funds have highly diversified portfolios, the top five exposures on average cover less than 25% of funds' net asset values. This coverage decreases to 18% for larger funds that have portfolios with net asset values in excess of €1 billion. A more complete portfolio breakdown using international identifiers (e.g. ISIN, LEI) would significantly enhance systemic risk analysis.
 - Geographical focus: The AIFMD provides information on funds' investment exposure to larger regions (e.g. Europe, Asia Pacific). The absence of a more granular geographical breakdown of exposures (e.g. at country level) by asset classes, investors, counterparties, and sponsorship arrangements means that NCAs are not able to fully assess potential contagion risks. Without a more detailed geographic breakdown it can also be difficult for NCAs to identify the relevant stakeholders, including other NCAs, when policy action is being considered.
- **Information on leverage**
 - Computation of leverage: The AIFMD provides two leverage measures to assess the build-up of vulnerabilities in the financial system and to guide NCAs' use of macroprudential leverage limits. However, NCAs cannot readily reconstruct a fund manager's computation of leverage based on the current reporting. This makes comparisons across funds and data quality assessments challenging.
 - Metrics on the risks of leverage: Current measures of leverage may not provide an accurate reflection of the associated risks, for instance if funds use derivatives.^{7, 8} Without the development of additional metrics on the risks of leverage, it can be difficult to identify key areas of vulnerability resulting from the use of leverage. In particular, additional metrics should capture the potential losses and the potential liquidity demands stemming from leverage.
- **Information on liquidity risk**
 - Special redemption arrangements: AIFMD reporting shows that less than 3% of funds used liquidity management tools such as redemption gates in 2018. The reporting does not show

⁷ ESRB (2019a), ESRB public comment on IOSCO Report: Leverage [[link](#)]

⁸ IOSCO (2019), Recommendations for a Framework Assessing Leverage in Investment Funds, December [[link](#)]

- which tools are available to fund managers and under which conditions. Such information would allow NCAs to better understand possible contagion risk in crisis scenarios.
- Measure of liquidity: The AIFMD provides NCAs with fund managers' subjective views on the liquidity of their investments and investors' ability to redeem funds. A harmonised, more objective, perspective is currently not available. For instance, there is no common understanding of how asset managers determine the liquidity profile of portfolios and assign a corresponding liquidation period.
 - **Reporting frequency:** The existing reporting framework aims to be flexible across different fund types by requiring AIFMs to report either quarterly, semi-annually or annually. From a financial stability perspective, the low and differentiated frequency of reporting as well as the long lag for data provision can hinder the timely monitoring of risks. At the same time, better alignment of reporting frameworks in line with the European Commission's recent "fitness check"⁹ should help to align data reporting requirements, improve data quality and allow for a more comprehensive systemic risk analysis.
 - **Access to data:** The current framework provides NCAs with information to assess the build-up of potential systemic vulnerabilities stemming from the alternative investment fund sector. In some cases, authorities with a financial stability mandate may not have access to all relevant data, which can hamper the ability of these authorities to carry out their financial stability mandates. Henceforth, all relevant ESRB member institutions with responsibilities in the area of financial stability should be able to access relevant datasets.

(ii) The need to operationalise existing macroprudential policy instruments

The ESRB issued a recommendation to ESMA to help operationalise the use of leverage limits for AIFs.¹⁰ The AIFMD provides NCAs with the power to impose leverage limits or other restrictions to limit the extent to which the use of leverage in funds contributes to the build-up of systemic risk or disorderly markets (Article 25). NCAs also have the possibility to suspend redemptions in the public interest (Article 46(2)). The ESRB has identified the operationalisation of these instruments as a priority, and ongoing work by ESMA to develop a European framework in line with the ESRB's recommendations will help NCAs to operationalise the macroprudential leverage limit in a harmonised and coordinated way.

⁹ European Commission (2019), Fitness Check of EU Supervisory Reporting Requirements, November [[link](#)]

¹⁰ Recommendation ESRB/2017/7 of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds [[link](#)]

Similarly, NCAs would benefit from an operational framework for suspension of redemption in the public interest. The AIMFD currently does not provide a definition of what is meant by “public interest”, and whether this includes financial stability. As a result, NCAs may not consider this instrument as a macroprudential tool, separate from suspension of redemption in the interest of shareholders. Moreover, no guidance exists under AIFMD regarding the relevant risk indicators to guide NCAs’ decisions on the use of suspension of redemption in the public interest, the implementation or phasing out of this instrument, or coordination and cooperation with other NCAs.

To complement the macroprudential tools above, the ESRB recommended that a harmonised legal framework be developed to govern the availability of additional liquidity management tools to fund managers. Such a framework would improve the ability of fund managers to react to stressed liquidity situations, as this is limited by the significant variation in the current availability of these tools across jurisdictions.¹¹

The consistent application of operational frameworks for the instruments outlined above is crucial given the cross-border nature of the AIF sector. Since fund managers can easily relocate their fund business, a coordinated approach is needed to mitigate the risk of regulatory arbitrage, and to minimise the risk of cross-border spillovers. In this regard, further consideration should be given to the possible need for reciprocation.

(iii) The ongoing development of the macroprudential policy framework “beyond banking” and for investment funds in particular

The development of the European macroprudential framework for investment funds – and non-banks more generally – is still at an early stage. Ultimately, the macroprudential framework “beyond banking” should facilitate the beneficial role of non-bank financial intermediation as a valuable alternative to bank finance, while at the same time ensuring resilience by mitigating risks related to leverage, liquidity and maturity mismatches, procyclicality and contagion.

At the global level, the FSB¹² has called on IOSCO to develop recommendations to improve the liquidity risk management practices of open-ended funds.¹³ The recommendations note that there should be an

¹¹ Recommendation ESRB/2017/7 of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds, Appendix Table A1 [[link](#)]

¹² Financial Stability Board (2017), Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, January. [[link](#)]

¹³ IOSCO (2018), Recommendations for Liquidity Risk Management for Collective Investment Schemes, February [[link](#)]

appropriate alignment between portfolio assets and redemption terms, and that funds should not be managed in such a way that the investment strategy relies on additional liquidity management measures such as suspensions. FSB and IOSCO will assess if the FSB recommendations have been implemented effectively and an IOSCO peer review of the IOSCO Liquidity Recommendations will be carried out in 2020, in which several European countries will also be assessed. A follow-up to the conclusions of the IOSCO Peer Review would be of great interest at the European level, and further reflection may be required as the AIFMD currently does not provide for any ex-ante liquidity requirements, such as better aligning redemption terms with the liquidity of assets, from a macroprudential perspective.

Work at the European level in line with the FSB and IOSCO recommendations is ongoing, with the aim of developing the macroprudential framework for investment funds. If this cannot be concluded within the timeframe for the current AIFMD review, there would be a need to review the adequacy of the macroprudential framework in the AIFMD in a subsequent review process.