29 April 2024
ESMA50-43599798-9491

ADVICE OF THE EUROPEAN SECURITIES AND MARKETS AUTHORITY

of 26 April 2024

on a proposed measure by the Central Bank of Ireland under Article 25 of Directive 2011/61/EU

In accordance with Article 25(6) of Directive 2011/61/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], the **Board of Supervisors** has adopted the following advice:

I. Legal basis

According to Article 25(6) of Directive 2011/61/EU (AIFMD), the European Securities and Markets Authority (ESMA) shall issue advice on whether the conditions for taking action appear to be met, whether the measures are appropriate and on the duration of the measures.

II. Background

1. On 4 March 2024[2], in accordance with Article 25(3) of the AIFMD, the Central Bank of Ireland (CBI) notified ESMA and the European Systemic Risk Board (ESRB) of its intention to impose an investment restriction under Article 25(3) of the AIFMD[3]. The restriction would apply to AIFMs established in Ireland managing GBP-denominated AIFs pursuing a liability-driven investment strategy and defined as "*any fund whose investment strategy seeks to match the sensitivity of their assets to UK interest rate or inflation to that of their investors' pre-defined liabilities*", (hereafter 'GBP LDI fund').
2. These funds are typically set up by defined benefits pension schemes that provide guaranteed returns to future pensioners. Most European Union (EU) AIFs pursuing LDI strategies are targeted at pension funds established in the United Kingdom (UK) with their shares issued in GBP.
3. GBP LDI funds faced acute stress in September 2022, following a sharp increase in GBP yields in the UK. Against this backdrop, National Competent Authorities (NCAs) in Ireland and Luxembourg outlined supervisory expectations for AIFMs established in their jurisdiction and managing GBP LDI funds. AIFMs should be able to maintain a level of resilience for GBP LDI funds — measured by the increase in yield that a fund can withstand before its NAV turns negative — at around 300-400 basis points (bps). This initiative was supported by ESMA[4]. Since then, GBP LDI funds established in Ireland and Luxembourg have maintained this level of resilience.

[1] OJ L 174, 1.7.2011, p. 1.
[2] On the same day, the Commission de Surveillance du Secteur Financier (CSSF) also notified ESMA and the ESRB of its intention to introduce similar measures on LDI funds established in Luxembourg for which ESMA issued advice (ESMA_Advice_under_article_25_AIFMD_CSSF_measure.pdf).
[3] According to Article 25(3) of the AIFMD, the CBI was not obliged to notify any other competent authority since the measure only concerns AIFs established in Ireland.
[4] See ESMA's communication ESMA welcomes NCAs' work to maintain resilience of liability driven investment funds (europa.eu)

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4. In November 2023, the CBI and the CSSF published consultation reports[5] to implement resilience requirements that GBP LDI funds would be required to comply with via the use of Article 25 of AIFMD. Both consultations included also targeted guidance on portfolio liquidity so that GBP LDI funds are required to have sufficient holdings of assets eligible for margin or collateral calls. The resilience requirements set out in the consultation papers slightly differ from the ones GBP LDI funds had been maintaining since September 2022 after NCAs outlined their supervisory expectations. The differences relate mainly to the level of resilience (at least 300bps in the consultation report compared with a range of 300-400bps previously) and to the liquidity requirements outlined in the consultation report (but not specified in the earlier communication by NCAs).

5. The proposed measure applies from 29 April 2024. GBP LDI funds established on or after this date have to comply with the measure immediately. Existing GBP LDI funds have a three-month transitional period to comply. The measure is not limited in duration.

III. On the adverse events or developments

6. EU managers of GBP LDI funds reported 366 GBP LDI funds domiciled in the EU in 2023, representing a NAV of EUR 143bn at the end of 2023, of which EUR 118bn from GBP LDI funds managed by AIFMs domiciled in Ireland. GBP LDI funds invest in long-term assets, such as sovereign bonds. The duration of their assets is shorter than the pension schemes commitment to deliver a guaranteed return in the very long-term. Therefore, GBP LDI funds use interest rates derivatives (IRDs) such as interest rate swaps to reduce this duration mismatch. GBP LDI funds also enter into repurchase agreements (repos) using sovereign bonds as collateral, to acquire leverage. Such leverage is used to increase returns and hence reduce the gap between guaranteed returns and the return on assets they hold. In 2023, GBP LDI fund exposures consisted of sovereign exposures (EUR 204bn), repo borrowing (EUR 81bn) and interest rate derivatives (EUR 139bn).

7. In September 2022, some funds pursuing GBP LDI strategies were subject to acute liquidity stress following a sharp rise in UK sovereign yields (130 bps in a few days). The increase in yields triggered a large fall in the value of sovereign bonds used as collateral by GBP LDI funds and a surge in margin requests on IRD exposures of those funds[6]. As GBP LDI funds sold sovereign bonds amid low market liquidity, the downward price pressure created a self-reinforcing price spiral which led the Bank of England to conduct a temporary and targeted programme of purchases of long-dated UK government bonds (gilts).

8. In September 2022, GBP LDI funds domiciled in the EU held more than 10% of the total gilt outstanding. In some cases, EU GBP LDI funds have been reporting more than 1,000% leverage under the AIFMD commitment method. Due to the size of these positions, substantial asset sales by, GBP LDI funds run the risk of impacting market prices[7]. GBP LDI funds managed by AIFMs domiciled in Ireland amount to 82% of the net asset value of EU GBP LDI funds.

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[5] CSSF Macroprudential measures for GBP Liability Driven Investment Funds (cssf.lu)
CBI CP157 - Macroprudential measures for GBP Liability Driven Investment funds (centralbank.ie)
[6] For further analysis see the special feature on LDI funds in the ESRB EU Non-bank Financial Intermediation Risk Monitor 2023.
[7] For further analysis see the special feature on EU LDI funds in the ESRB EU Non-bank Financial Intermediation Risk Monitor 2023

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9. In addition, GBP LDI funds may pose a risk of **fire sales** through the use of IRDs and repos. IRDs and repos can create demand for additional liquidity as yields and interest rates increase, which may result in funds selling gilts or other assets. Repo transactions used by GBP LDI funds are almost exclusively backed by gilts posted as collateral. If the value of the gilts used as collateral declines, GBP LDI funds must supply additional eligible collateral to maintain the value of the collateral (after haircuts) in line with the repo borrowing. If the fund does not have unencumbered eligible gilts, it needs to sell assets — triggering forced sales — and buy eligible gilts with the proceeds. Alternatively, the fund can close the position and repay repo borrowing, triggering forced sales to raise cash.

10. GBP LDI funds may pose a **risk of spill over** by transmitting the liquidity pressure in debt markets where GBP LDI funds are active (particularly UK government debt markets) with implications for other financial institutions, in the UK and in the EU. Direct links to financial institutions include pension funds on the liability side and Money Market Funds (MMFs) on the asset side. During 2022's market stress, GBP LDI funds made substantial redemptions from their holdings of EU MMF shares to raise cash to meet liquidity demands: at least five EU MMFs low volatility net asset value (LVNAV) denominated in GBP experienced cumulative redemptions exceeding 10% of the net asset value in a week, in a context of NAV deviations close to the regulatory threshold (20bps)[8].

11. Considering the high level of leverage reported by some GBP LDI funds and their large market footprint on the gilt market, substantial asset sales by GBP LDI funds run the risk of impacting market prices. Moreover, in case of a significant yield shock, the potential liquidity needs stemming from the use of IRDs and repos expose them to the risk of forced sales, with potential spillovers to other entities and especially MMFs. Overall, if not mitigated, GBP LDI exposure to interest rate risks make them susceptible to amplify shocks affecting the gilt market through disorderly asset sales, with broader macro-financial implications in the UK and in the EU. Therefore, ESMA considers that the conditions for taking action are met.

IV. On the appropriateness of the measure

The measure

12. The measure consists in requiring GBP LDI funds to be able to withstand a rise in GBP yields of at least 300 bps before their NAV turns negative[9]. For this purpose, the CBI requires GBP LDI funds to develop a weighted average of the interest rate sensitivity of all their exposures and maintain a buffer of liquid assets available to meet margin or collateral calls that result from a rise in interest rates of at least 300 bps.

13. The measure introduced by the CBI falls into the category of 'other restrictions on the management of the AIF' as referred to in Article 25(3) of AIFMD rather than as a standard leverage limit. This measure limits leverage-related risks such as interest rate sensitivity and liquidity risk in relation to margin or collateral calls.

[8] Report on Trends, Risks and Vulnerabilities, No. 1 2023, ESMA.
[9] The CBI refers to this measure as a "yield buffer".

14. The measure requires funds to develop a weighted average of the **interest rate sensitivity** of all their exposures. Duration and convexity determine the impact of a change in yields on the value of exposures of a fund, and hence on the fund's NAV. Setting up a buffer of liquid assets as foreseen by the measure contributes to reducing the weighted average duration of the portfolios since liquid assets have a shorter maturity than less liquid assets.

15. The measure requires GBP LDI funds to set up a buffer of liquid assets sufficient to mitigate **liquidity risk** resulting from a 300bps shock in UK yields. GBP LDI funds must ensure that the buffer consists of assets which are eligible to meet margin or collateral calls that result from adverse market circumstances, or assets which can be transformed into such eligible assets with requisite speed under normal and stressed market conditions. The CBI will require fund managers to exercise a prudent approach to the inclusion of assets which are not cash or eligible collateral in the yield buffer, with such assets only accounting for a limited part of the total buffer.

16. Where assets included in the yield buffer are not sensitive to UK yields, the measure requires GBP LDI funds to appropriately consider and manage the risks of these assets. In addition, managers must perform regular assessments of the fund's resilience to simultaneous shocks to UK yield sensitive and non-UK yield sensitive assets. Furthermore, non-UK yield sensitive assets should form a limited part of the buffer.

17. Assets owned by GBP LDI funds' investors ('external assets') that the LDI fund is authorised to use will not form part of the yield buffer.

18. The measure addresses leverage-related risks, but it is not a direct leverage limit. However, it is expected to indirectly limit the level of **leverage** a GBP LDI fund can take, contingent on the duration of its portfolio. The size of a fund's exposures and the duration of those exposures determine the minimum size a fund's NAV needs to be to remain positive after a 300bps increase in UK yields. Therefore, for a given duration, the measure implicitly limits the leverage of the fund, expressed as a ratio of exposures to NAV. The higher the duration is, the less leverage a fund is able to employ. This is particularly relevant for GBP LDI funds, as these target a specific duration that matches the duration of their investors' liabilities.

19. To mitigate potential procyclical effects, the measure provides that on a rolling basis over the last four reporting observations (i.e. monthly average yield buffer at the end of each month), one of the reporting observations can be below 300 bps in exceptional circumstances. The purpose of the provision is to limit threshold effects where GBP LDI funds would have to sell gilts in order to comply with the buffer, thus replicating the fire sale dynamics this measure intends to avoid.

20. Furthermore, the CBI may temporarily disapply the yield buffer requirement should there be a significant, market-wide shock to financial stability. Disapplication of the yield buffer would be considered in the case of a severe market wide shock or event, where it is anticipated that it may take a substantial period for funds to return to the required levels of resilience, and that forcing them to expedite this process would further amplify the shock.

Appropriateness

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21. This measure codifies the limit set after the September 2022 stress. Since the implementation of this measure, the NAV of GBP LDI funds has declined from EUR 211bn in 2021 to EUR 143bn in 2023 (-32%). GBP LDI funds reduced their gross exposures by around EUR 274bn (-37%), mainly related to lower sovereign exposures (-144bn) and lower repo borrowing (-66bn).

22. While gross leverage measures slightly decreased, with a ratio of assets under management to NAV of 353% in 2023 compared with 382% in 2021, GBP LDI funds have increased the relative share of liquid assets holdings: cash and money market funds (MMFs) amount to 13% of the NAV (EUR 19bn) compared with 9% in 2021.

23. In terms of calibration, the proposed level of the measure (at least 300bps) exceeds the surge experienced in the 30Y Gilt market in September 2022 (190bps in 5 days) and any other interest rate movement experienced in the last ten years. Funds being able to resist a systemic shock of a magnitude sensibly higher than historical stress events would be less prone to forced asset sales. The measure is also consistent with the guidance issued by the UK Pensions Regulator in April 2023, which sets a market stress buffer of at least 250bps[10].

24. This approach is preferable to a single leverage limit, as a single leverage limit would not account for the duration of LDI funds. Indeed, two LDI funds with the same level of leverage but different duration will experience different impacts from the same shock to interest rates and this is what the yield buffer accounts for.

25. ESMA notes that the proposed level of 300 bps would limit the risk of fire sales from GBP LDI funds, and the contagion to other institutions and markets in the UK and in the EU. ESMA also notes that a single leverage limit would not account for the duration of GBP LDI funds. Considering that the materiality of this risk was evidenced in September 2022, and considering that the measures taken in response have visibly reduced the risk of a similar events, ESMA finds the limit of 300bps in UK yields appropriate to address the risks identified.

26. Regarding the composition of assets to be included in the liquidity buffer, ESMA considers important to exercise a prudent approach to the inclusion of assets which are not cash or eligible collateral in the yield buffer, with such assets only accounting for a limited part of the total buffer. This prudent approach should especially apply to MMF shares included in the yield buffer. Since MMFs are likely to be affected by the same yield shock as LDI funds, MMF shares might be less liquid in stressed market conditions. Moreover, significant redemptions of MMF shares in a distressed market would have the potential to spread liquidity stress to the MMF sector and the unsecured money markets they invest in.

Transitional period

27. GBP LDI funds established on or after 29 April 2024 must comply with the measure immediately and existing GBP LDI funds have three months from that date to comply. ESMA is of the opinion that the implementation phase of three months is proportionate, taking into account the fact that

[10] See UK Pensions Regulator, 'Using leveraged liability-driven investment', April 2023.

existing GBP LDI funds have already been required by the CBI to make significant portfolio adjustments in November 2022 following the gilt crisis.

V. On the duration of the measure

28. The measure proposed by the CBI is continuous and does not include any duration. This is consistent with ESMA's Guidelines according to which the limits should be maintained for as long as the risks posed by the AIF or the group of AIFs do not decrease. Such risks are exacerbated by the current macroeconomic environment and the uncertainty around the level of interest rates. Therefore, ESMA considers that not limiting the duration is appropriate.

VI. Conclusion

29. For the reasons above, ESMA considers that the measure introduced by the CBI is appropriate to address the concerns relating to the stability and integrity of the financial system.
30. Nonetheless, ESMA recommends that the CBI closely monitors the evolution of the LDI funds sector to assess the relevance of its measure and the necessity to recalibrate it. This close monitoring applies in particular to the use of MMF shares in the buffer, due to their potential lower liquidity in stressed market conditions and the risk that significant redemptions of MMF shares in a distressed market could spread liquidity stress to the MMF sector and the unsecured money markets they invest in.
31. Finally, ESMA also expects other competent authorities of AIFMs managing GBP LDI funds to adopt similar measures.

Done in Paris, 26 April 2024

For the Board of Supervisors

Verena Ross, ESMA Chair
[Signed]