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| Response Form to the Consultation Paper  |
| Guidelines on Article 25 of Directive 2011/61/EU  |

**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](http://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](http://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](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/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**

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| --- | --- |
| Name of the company / organisation | Invesco |
| Activity | Investment Services |
| Are you representing an association? |[ ]
| Country/Region | International |

**Introduction**

***Please make your introductory comments below, if any***

<ESMA\_COMMENT\_PFG\_1>

Invesco welcomes the opportunity to comment on ESMA’s proposed guidelines Article 25. Invesco recognises that effective risk management is critical not only to investor protection but also to ensure sound and resilient financial markets. One of the primary objectives of AIFMD is the monitoring of macro-prudential risks of AIFs by enhancing transparency (including use of leverage, monitoring of systemic risks, sharing of data at EU level) and ensuring better practices of risk and liquidity management. Leverage has rightly been identified as a risk factor, given that excessive leverage can exacerbate market movements and procyclicality.

Under AIFMD, firms are required to set internal leverage limits that are appropriate to the strategy pursued by the fund and ensuring adequate oversight and governance is put in place as part of effective risk management. Enhanced reporting is required where leverage is used on a substantive basis. We believe that this framework is working well, as borne out by both the KPMG study on the AIFMD. The reported conclude that “most NCAs that responded to the survey did not express any concerns about the leverage levels they observe in AIFs in their jurisdictions. This evidence indicates that the AIFMD requirements on reporting leverage ratios to NCAs and disclosing them to investors is having the intended effect – i.e. the provisions are effective.

Both the KPMG report and ESMA’s annual statistical report shows that leverage levels across AIFs remain low, with a significant concentration of exposures held within a small number of funds (primarily hedge funds) We, therefore, believe that these guidelines should be targeted to those funds that make significant use of leverage rather than seeking to scope in a wide range of funds that are unlikely to represent a significant risk to financial stability. Furthermore, when assessing whether the use of leverage might represent a risk to financial stability, the focus should not be solely on absolute notional exposure numbers but needs qualitatative judgement so as to to be place the numbers in the context of the firm’s risk management policies and procedures, as ensuring high quality risk management at the firm level should be seen as the first line of defence, with regulators stepping in to set leverage limits only in exceptional circumstances. In particular, any consideration of leverage needs to take into account the fact that synthetic leverage does not always amplify risk and procyclicality but is often used to decrease risk through hedging, as well to as part of efficient portfolio management techniques, which benefit investors and the broader market.

As noted in ESMA’ statistical report, the AIF market is international, with significant non-EU presence and therefore international consistency is important. We welcome the proposal to follow a two-step approach to ensure consistency with IOSCO process. In keeping with the need to ensure proportionality, the role of first step should be to screen out funds that are unlikely to pose any significant risk, with a more in-depth evaluation at step 2. It is important that the scope of funds screening in at step 1 is manageable and proportionate.

We also welcome recognition that assessing the extent to which a fund may pose systemic risk will require judgement by regulators. We fully support preserving discretion for NCAs at step 2 to ensure that any measures taken recognise the breadth of strategies and the multitudinous reasons for funds to have exposure to synthetic leverage, which may may be undertaken with the aim of reduce risk rather than increasing it, as well as to take into account the market dynamics in which the fund is operating and the risks and controls in place that might act as risk mitigants.

That said, we believe that the imposition of leverage limits should remain the last resort given the potential for unintended consequences and rather the focus of this exercise should be to improve market surveillance and, where risks are identified, improving on governance and controls around leverage by the fund manager as a first step. High notional exposure in and of itself doesn’t necessarily equate to additional risks for financial stability so long as such risks are appropriately managed, including having in place the necessary governance and controls, including stress testing, to manage sudden spikes in volatility or redemptions.

<ESMA\_COMMENT\_PFG\_1>

**Questions**

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

<ESMA\_QUESTION\_PFG\_1>

The frequency of the risk assessment should not lead to a disproportionate increase in the reporting burden on firms and therefore needs to take into consideration the reporting frequency set out in Article 110 of Commission Regulation 231/2013. Under the Regulation, reporting can be quarterly, semi-annual or annual depending on the size of the AIFM, on the size of the AIFs managed by the AIFM and on the use of leverage. For the purposes of establishing the frequency of the risk assessment, it may make sense to differentiate between step 1 and step 2 and will also, to some degree depend on the final scope of funds considered under step 1.

Under AIFMD, smaller funds that do not employ significant leverage will only be required to report on an annual basis under AIFMD. Therefore, should the final scope of step 1 include funds not employing leverage on a substantial basis but that exhibit “unusually high leverage compared to peers”, some of those funds may only be reporting on an annual basis and therefore a step 1 assessment would only be possible annualy. However, if step 1 were limited to funds employing leverage on a substantial basis (as we believe it should) then quarterly assessments would indeed be logical.

<ESMA\_QUESTION\_PFG\_1>

1. : 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 like to underscore that Article 25(2) is primarily focused on the use of leverage. Therefore, any extension beyond substantially leveraged funds would need to be justified. In particular, given that the purpose of these guidelines is to assist NCAs in order to determining when the use of Article 25(3) to impose a limit to the level of leverage, it would appear counterintuitive to include in Step 1 funds that are not employing leverage on a substantial basis.

In particular, we do not agree that funds using limited leverage should be included merely on the basis of size. We believe that this exercise should be risk-based and there is little evidence that size, in and of itself, is a risk factor. However, we agree that size and significant leverage ***in combination*** should be considered since a larger leveraged fund could have a larger market impact, which should be considered under Step 2, since the riskiness derived from the size of the fund will be a function of the market in which the fund invests and therefore a fixed threshold could lead to false positives and false negatives.

<ESMA\_QUESTION\_PFG\_2>

1. : 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>

As set out in our response to question 2 above, we believe that the criteria and thresholds should be solely focused on leverage. We would, therefore, challenge the idea that any fund employing little leverage should be scoped in simply due to its size. This would lead to a significant number of funds potentially being scoped in despite using very little leverage and posing little risk to the financial system.

In relation to the third category of AIFs employing “unusually high leverage”, as per our comments above, we are unclear what the value of this approach would be of going beyond the existing definition of funds deploying leverage on a substantial basis.

Were such a threshold to be included in step 1, we believe that the definition would need to be more tightly defined. Under the AIFMD, the categories of AIFs is very broadly defined and, as highlighted in the ESMA statistical reports on AIFMD, over 60% of AIFs are categorised as “other”. Even within the defined categories of hedge funds, fund-of-funds, real estate funds and private equity, there will be a significant heterogeneity of investment strategies grouped under the same heading. For example, the risk profile and use of leverage of a distressed debt fund will differ significantly from a long/short fund, even if both would be classified at hedge funds.

Therefore, a much more precise and granular classification system based on the underlying strategies would be necessary in order to identify funds employing “unusually high leverage” compared with their peers. For AIFs falling under “other”, it may be necessary to develop a more detailed classification of strategies but note that this issue may be addressed as part of the broader AIFMD Level 1 review. To ensure consistency across NCAs, the guidelines should specify the percentile to be used as the threshold for the inclusion in step 2.

<ESMA\_QUESTION\_PFG\_3>

1. : Would you identify other relevant transmission channels?

<ESMA\_QUESTION\_PFG\_4>

No, we believe the four risks identified are sufficient.

<ESMA\_QUESTION\_PFG\_4>

1. : 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>

While we are broadly in agreement with the indicators set out in Table 2, we would underscore the need to ensure that the methodologies for computing these indicators in specified in more detail to ensure that regulators are comparing apples with apples. Small differences in the assumptions underpinning the calculations can have significant impacts on the final numbers. For example, some firms net offsetting FX risks while others do not, resulting in leverage numbers several hundred percent higher than would otherwise be the case. Many of the metrics proposed are also rather simplistic and would benefit from being refined. Therefore, we believe that the indicators would need to be developed further across the board to ensure that they were meaningful and comparable.

* Net exposure: this would need to be defined by asset class in order to be able to match with the market footprint, rather than at the fund level.
* Investor concentration: while investor concentration is likely to be of greater significant for funds addressed to institutional investors, the understanding redemption risk is more nuanced than simply identifying the largest 5 beneficial owners of the fund, particularly in a retail context where the fund may have a very dispersed ownership structure.The IOSCO final report recommends taking into account also the investor base, investor profile and redemption patterns.
* Share of less liquid assets: there is no single definition of less liquid assets, and in many cases the lines can be blurred. For example, some very large high yield issues can be quite liquid while smaller investment grade issues may be less liquid. Therefore, assessing the share of less liquid assets based on such broad asset segments may deliver rather superficial results.
* Liquidity: Table 2 primarily deals with liquidity demands (from collateral and other) but fails to consider the availability of borrowing or cash financing to bridge any short-term liquidity shortfalls. The IOSCO final report recommends considering the value of borrowing and cash financing available, as well as the percentage of cleared/uncleared transactions and the value of posted or revived collateral or margin, including the extent to which such collateral has been re-hypothecated. Furthermore, such indicators will be less relevant for less liquid fund or close ended funds. Therefore, these indicators will need to be applied in a proportionate way depending on the strategy/fund type.
* Linkages to financial institutions: in terms of linkages through investments, we have doubts as to how significant these exposures would be and the likelihood that it could create material spillovers to the financial institution. Likewise, linkages via the investment base would already be captured under the investor profile and may already be addressed through large exposure rules at the level of the bank. We believe that the main exposures to financial institutions are likely to be adequately captured by counterparty risk.
* Risk to direct credit intermediation: again, simply measuring exposure to bonds and loans may be oversimplifying the way that capital markets influence the availability of credit but also broader financing for non-financial corporates.

<ESMA\_QUESTION\_PFG\_5>

1. : 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>

Assessing financial stability risks requires a system-wide view. We, therefore, believe that it would make sense to complement AIFMD data with data sets that cover the broader financial system. For example, assessments of derivatives exposures could leverage EMIR data. However, any external data used should be regulatory data to ensure that it is of sufficient quality, consistency and completeness.

<ESMA\_QUESTION\_PFG\_6>

1. : Which other restrictions would you consider as appropriate?

<ESMA\_QUESTION\_PFG\_7>

The toolbox of restrictions will likely depend on the source of risk and the transmission channel through which any risk is likely to materialise. For example, an NCA may raise concern about an AIF’s ability to meet margin calls in relation to its derivatives positions where the fund’s underlying assets are largely illiquid. In such a circumstance, an NCA may wish to consider imposing requirements in relation to liquidity rather than a leverage limit.

We would urge NCAs to engage in a dialogue with the fund manager in order to ensure that the fund has in place the appropriate controls, which is likely to be a more meaningful approach to controlling risks than imposing hard constraints on the fund, which are likely to have unintended consequences.

<ESMA\_QUESTION\_PFG\_7>

1. : 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>

We agree with ESMA’s analysis that the implementation of leverage limits needs to be carefully thought through, in particular given the risk of unintended consequences and risk of exacerbating procyclicality. We believe that the imposing of leverage limits should be seen as a last resort by regulators, with the focus rather on enforcing governance and controls by the fund managers to ensure that financial stability risks are effectively monitored and controlled by the fund. NCAs should be encouraged to enter into a dialogue with fund managers that exhibit risks linked to the use of leverage to ensure that their risk controls and processes are appropriate to the risks involved and leverage limits should only be deployed where this is not the case.

In our view, the application of leverage limits under Article 25(3) should be very targeted on a single fund basis. Given the potential for unintended consequences, we believe that applying leverage limits across segments of funds could do more harm than good and lead to perverse outcomes for the market. However, there may be limited circumstances where a group of AIFs are part of the same fund family managed by the same portfolio manager and following the same investment process and therefore the group of AIFs are likely to exhibit similar characteristics. In such circumstances, it may be justified to apply a leverage limit across this group of AIFs.

In relation to the possible countercyclical application of leverage limits, we would caution against this as the complexity of doing so is likely to outweight the benefits. For example, a Bank of England research paper on countercyclical margining found that the application of discretionary limits would require regulators to have near perfect information about market players positions across the market in order to appropriately calibrate the buffer, which they consider highly unlikely in practice. The paper considered rules-based approaches, including a rules-based countercyclical buffer and a constant buffer. It found that the additional benefit of countercyclical margining was minimal compared to a simpler, constant margin buffer while the additional complexity was significant. We believe that impact analysis for leverage limits would lead to similar conclusions for leverage limits.

<ESMA\_QUESTION\_PFG\_8>

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

<ESMA\_QUESTION\_PFG\_9>

In our view, leverage limits are a fairly blunt instrument, which can be difficult to calibrate and could lead to unintended consequences. For example, credit funds investing in less liquid assets may use derivatives to manage redemptions while keeping the fund risk profile in line, which would imply a short-term increase in leverage. The alternative would be to sell less liquid securities, potentially during a market downturn that could exacerbate price declines and also have a negative impact on the fund’s investors. However, were that fund subject to a leverage limit, it may deprive the fund of the ability to pursue such a strategy, which could ultimately be worse for financial stability as well as investor outcomes.

Furthermore, when considering imposing of leverage limits, regulators need to be mindful of how to judge the efficacy of such measures and how to assess the counterfactual given that leverage limits may further exacerbate procyclality in the system by forcing funds to develerage as a result of fund redemptions or market volatility. Since leverage limits are based on the level of exposure as a percentage of the NAV of the fund, both redemptions and market volatility can impact the NAV, triggering deleveraging in a fund, which in and of itsef could have negative consequences for financial stability. Regulators should therefore consider the second order consequences for the markets of introducing such measures.

More broadly, there is evidence that macroprudential tools applied at the level of financial institutions are less effective at managing system-wide leverage compared with borrower-based leverage limits.

This is why we believe that a focus on governance and controls, including appropriate stress testing of funds to understand how they might respond to market volatility or redemptions, would be more effective in mitigating risks stemming from excessive leverage.

<ESMA\_QUESTION\_PFG\_9>