Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6)

February 2018

ESRB
European Systemic Risk Board
European System of Financial Supervision

Contents

The General Board of the European Systemic Risk Board,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board[1], and in particular Article 3(2)(b), (d) and (f) and Articles 16 to 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board[2], and in particular Articles 18 to 20 thereof,

Whereas:

1. The investment fund sector has grown strongly over the past decade, both in the Union and globally, and consequently investment funds now account for a greater overall component of securities markets. The role of investment funds in financial intermediation is expected to increase further in an environment of low interest rates and balance sheet constraints in the banking sector, coupled with changes resulting from the development of the Capital Markets Union. Regulatory authorities have welcomed this development as the diversification of financing sources may help to enhance the efficiency as well as the resilience of the financial system as a whole.

2. However, there are concerns that increased financial intermediation by investment funds may result in the amplification of any future financial crisis. Mismatches between the liquidity of open-ended investment funds' assets and their redemption profiles may result in fire sales in order to meet redemption requests in times of market stress. Such fire sales could adversely affect other financial market participants that own the same or closely correlated assets. Furthermore, leverage can amplify the impact of negative market movements as it creates exposure in excess of the assets of an investment fund. In addition to such channels of indirect contagion, an investment fund can spread risk through interconnectedness, e.g. interconnections with its investors, which is a direct channel through which shocks can be transmitted to other financial institutions.

3. Investment funds are also susceptible to changes in market dynamics and structure. For instance, in a low interest rate environment, the search for yield may encourage a greater proportion of investment in less liquid assets. There is a risk that macro-level shocks, such as a reversal in risk premia, could lead to widespread redemption requests by investment fund

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[1] OJ L 331, 15.12.2010, p. 1.

[2] OJ C 58, 24.2.2011, p. 4.

investors. This may be particularly pronounced in investment funds which hold a large proportion of highly leveraged and less liquid assets in their portfolios or investment funds.

4. In addition, unless this risk is appropriately managed, some investors may make use of a 'first mover advantage,' i.e. investors who redeem prior to, or in the early stages of, a stressed market situation do not bear the full impact of such a stressed market situation, leaving the remaining investors to assume the burden.

5. The current legislative framework in the Union includes measures designed to reduce the amplifying effects of the investment fund sector in a financial crisis and to strengthen the resilience of investment funds. The legislative framework comprises Directive 2009/65/EC of the European Parliament and of the Council[3], and Directive 2011/61/EU of the European Parliament and of the Council[4].

6. Directives 2009/65/EC and 2011/61/EU both contain liquidity management requirements. Alternative investment funds (AIFs) are required to have redemption policies that are consistent with the liquidity profile of their investment strategy and to conduct regular stress tests under both normal and exceptional liquidity conditions. Undertakings for collective investment in transferable securities (UCITS) are subject to detailed eligibility rules that govern the types of assets in which they are allowed to invest and must conduct stress tests where appropriate.

7. To address leverage related systemic risks, Directives 2009/65/EC and 2011/61/EU currently provide a legal basis for limiting the build-up of leverage in investment funds. Article 51(3) of Directive 2009/65/EC specifies an investment limit on the exposures of UCITS to derivative instruments and Article 83(2)(a) of the same Directive specifies a 10 % temporary borrowing cap. Article 25(3) of Directive 2011/61/EU allows national competent authorities (NCAs) to impose leverage limits or other restrictions on the management of AIFs. In addition, Article 25(7) of Directive 2011/61/EU provides a role for the European Securities and Markets Authority (ESMA) in determining that the leverage employed by an alternative investment fund manager (AIFM), or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system and ESMA may issue advice to NCAs specifying the remedial measures to be taken, including limits on the level of leverage.

8. The application of consistently high standards in respect of fund managers' capacity to manage risks across the Union is warranted to ensure that regulation will mitigate systemic risk. There is evidence that the current regulatory framework provides for effective risk management by investment funds at the microprudential level. However, their efficacy from a macroprudential perspective is largely untested. The purpose of this Recommendation is to

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3 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

4 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 (OJ L 174, 1.7.2011, p.1).

address systemic risks related to liquidity mismatches and the use of leverage in investment funds. This will enhance the macroprudential framework in the Union as it applies to the asset management sector.

9. Recommendation A is designed to address the risks that may arise when fund managers do not have adequate liquidity management tools in place such as redemption fees, redemption gates, or the ability to temporarily suspend redemptions. In the absence of such tools, redemption pressures during times of declining asset prices could cause system-wide liquidity stress and exacerbate asset price falls, which could lead to risks to financial stability. The availability of a diverse set of liquidity management tools in all Member States would increase the capacity of fund managers to deal with redemption pressures when market liquidity becomes stressed. In addition, Recommendation A calls for further clarification of the suspension of redemptions by NCAs.

10. Recommendation B is designed to mitigate and prevent excessive liquidity mismatches in open-ended AIFs. Some open-ended AIFs hold a large proportion of their investments in inherently less liquid assets. This includes investment funds that invest in real estate, unlisted securities, loans and other alternative assets. There is a need for such investment funds to demonstrate their capacity to NCAs during both the approval process, and/or after approval, to maintain their investment strategy under stressed market conditions.

11. Recommendation C is designed to promote coherent liquidity stress testing practices at the investment fund level. Stress tests are tools that help the fund manager identify potential weaknesses of an investment strategy and assist in preparing an investment fund for a crisis. If used correctly, as a risk management and decision-making tool, a stress test should reduce liquidity risk at the investment fund level and contribute to lowering liquidity risk at the financial system level. Guidance on fund managers' liquidity stress testing practices is expected to reduce liquidity risk, at both investment fund and system level, and strengthens the ability of entities to manage liquidity in the best interests of investors, including the avoidance of surprises and resulting emergency reactions during unexpectedly high redemption periods.

12. Recommendation D is designed to establish a harmonised UCITS reporting framework across the Union. Although many jurisdictions within the Union have reporting obligations for UCITS, reporting practices differ widely in terms of the reporting frequency, the UCITS covered, and the data reported. The lack of a harmonised reporting framework prevents monitoring and a comprehensive assessment of the potential contribution of UCITS to risks to financial stability. A harmonised UCITS reporting framework will also reduce existing reporting inefficiencies for both NCAs and industry.

13. Recommendation E is designed to facilitate the implementation of Article 25 of Directive 2011/61/EU, which provides for a macroprudential tool to limit leverage in AIFs. There is a need to clarify the use of this tool by developing a common approach to ensure that NCAs are able to use the tool in a harmonised manner. Therefore, guidance on a framework to assess leverage risks and on the design, calibration and implementation of leverage limits should be developed.

14. This Recommendation advocates a proportionate framework for managing the systemic risks that may arise in, or be propagated by, the investment funds sector, while maintaining the key

redemption features that attract investors to open-ended investment funds and facilitate collective investment.

15. This Recommendation takes into account ongoing international and European initiatives on macroprudential policies to mitigate risks from liquidity mismatches and leverage in investment funds and, in particular, the work of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO). On 12 January 2017, the FSB published recommendations to address structural vulnerabilities from asset management activities arising from liquidity mismatches and the use of leverage in investment funds[5]. To supplement the FSB's work, IOSCO has been tasked with implementing the FSB's recommendations. This process is currently ongoing.

16. In order to implement the macroprudential elements of the current regulatory framework for investment funds and to ensure that NCAs act consistently, this Recommendation is addressed partially to ESMA, with regard to its facilitation and coordination role.

17. In order to tackle other risks posed by investment funds, it is recommended that the European Commission should propose additional legislative measures. It is recognised that the Commission has already placed legislative reviews in this area on its agenda. These will provide an opportunity to address the macroprudential issues referred to in the recommendations.

18. Recommendations of the European Systemic Risk Board (ESRB) are published after the General Board has informed the Council of its intention to do so and provided the Council with an opportunity to react,

Has adopted this Recommendation:

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[5] Financial Stability Board, 'Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities', January 2017.

Section 1
Recommendations

Recommendation A – Liquidity management tools for redemption

1. The Commission is recommended to propose that Union legislation incorporates a common Union legal framework governing the inclusion of additional liquidity management tools (a-LMTs) in the design of investment funds originating anywhere in the Union so that the decision on which a-LMTs to incorporate in the constitutional documents of or other pre-contractual information on investment funds is made individually by each entity responsible for management.

2. The Commission is recommended to propose that Union legislation includes further provisions specifying the NCAs' role when using their powers to suspend redemptions in situations where there are cross-border financial stability implications.

3. The Commission is recommended to propose that Union legislation sets out ESMA's general facilitation, advisory and coordination role in relation to the NCAs' powers to suspend redemptions in situations where there are cross-border financial stability implications, in line with Recommendation A(2).

Recommendation B – Additional provisions to reduce the likelihood of excessive liquidity mismatches

The Commission is recommended to propose that Union legislation includes measures to limit the extent to which the use of liquidity transformation in open-ended AIFs could contribute to the build-up of systemic risks or the risk of disorderly markets.

Recommendation C – Stress testing

In order to promote supervisory convergence ESMA is recommended to develop guidance on the practice to be followed by managers for the stress testing of liquidity risk for individual AIFs and UCITS.

Recommendation D – UCITS reporting

1. The Commission is recommended to propose that Union legislation requires UCITS and UCITS management companies to regularly report data, especially regarding liquidity risk and leverage, to the competent authority, and to provide such data to the relevant NCA if it is not the competent authority for UCITS reporting purposes.

2. The Commission is recommended to propose that the data mentioned in Recommendation D(1) is reported, within a reporting framework, at least on a quarterly basis by a sufficiently relevant proportion, from a financial stability perspective, of all UCITS and UCITS management companies. As a minimum, a sufficient subset of the data set should be reported annually by a representative proportion of all UCITS and UCITS management companies.

3. The Commission is recommended to propose that NCAs make the data mentioned in Recommendation D(1) available to the NCAs of other relevant Member States, ESMA and the ESRB.

Recommendation E – Guidance on Article 25 of Directive 2011/61/EU

1. ESMA is recommended to give guidance on the framework to assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system.

2. ESMA is recommended to give guidance on the design, calibration and implementation of macroprudential leverage limits.

3. ESMA is recommended to give guidance on how NCAs should notify ESMA, the ESRB and other NCAs of their intention to implement macroprudential measures under Article 25(3) of Directive 2011/61/EU.

4. ESMA is recommended to use the information received from NCAs pursuant to Article 25(3) of Directive 2011/61/EU to benchmark and share knowledge with national macroprudential authorities and the ESRB on practices on the use of leverage limits and the imposition of other restrictions on the management of AIFs.

Section 2
Implementation

2.1 Definitions

1. For the purposes of this Recommendation the following definitions apply:

   (a) 'additional liquidity management tools' (a-LMT) means tools that assist open-ended AIFs and UCITS as well as their managers to manage requests for redemption appropriately and effectively at all times and especially in stressed market conditions. These tools should include post-event measures, such as: suspensions of redemptions or deferred redemptions ('gates'/extendable notice periods), and pre-emptive measures such as allocation of trading costs to subscribing/redeeming investors ('swing pricing'/anti-dilution levies);

   (b) 'alternative investment funds' (AIFs) means collective investment undertakings as defined in Article 4(1)(a) of Directive 2011/61/EU;

   (c) 'alternative investment fund managers' (AIFMs) has the same meaning as in Article 4(1)(b), subject to the exclusions set out in Article 2(3) and the exemptions set out in Article 3, of Directive 2011/61/EU;

   (d) 'AIFMs of open-ended AIFs' means those falling within the category defined in Article 1(2) of Commission Delegated Regulation (EU) No 694/2014[6];

   (e) 'entity responsible for management' means: (i) a management company as defined in Article 2(1)(b) of Directive 2009/65/EC; (ii) a UCITS constituted as an investment company that has not designated a management company as provided for in Directive 2009/65/EC; (iii) an AIFM as specified in Article 4(1)(b) of Directive 2011/61/EU; and (iv) an internally managed AIF constituted as an investment company that has not designated an AIFM referred to in Article 5(1)(b) of Directive 2011/61/EU;

   (f) 'leverage' means any method by which an investment fund increases its exposure over and above the assets of the fund whether through the borrowing of cash or securities or leverage embedded in derivative positions or by any other means;

   (g) 'national competent authority' (NCA) means the competent authority as defined in Article 2(1)(h) of Directive 2009/65/EC or in Article 4(1)(f) of Directive 2011/61/EU as applicable;

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6 Commission Delegated Regulation (EU) No 694/2014 of 17 December 2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers (OJ L 183, 24.6.2014, p. 18).

(h) 'systemic risk' has the same meaning as in Article 2(c) of Regulation (EU) No 1092/2010;

(i) 'undertaking for collective investment in transferable securities' (UCITS) means an undertaking as defined in Article 1(2) of Directive 2009/65/EC that has been authorised in accordance with Article 5 of that Directive;

(j) 'UCITS management company' has the same meaning as in Article 2(1)(b) of Directive 2009/65/EC.

2. Annexes I and II form an integral part of this Recommendation. In the event of conflict between the main text and the Annexes, the main text prevails.

2.2 Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:

   (a) the Recommendation covers AIFs, AIFMs, UCITS and UCITS management companies;

   (b) regulatory arbitrage should be avoided;

   (c) due regard should be paid to the principle of proportionality, taking into account the objective and the content of each recommendation;

   (d) the compliance criteria set out in Annex I.

2. Addressees are requested to report to the ESRB and to the Council on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should as a minimum contain:

   (a) information on the substance and timeline of the actions undertaken, including any actions undertaken in relation to the European supervisory authorities, where applicable;

   (b) an assessment of the functioning of the actions undertaken having regard to the objectives of this Recommendation;

   (c) detailed justification of any inaction or departure from this Recommendation, including any delays.

2.3 Timeline for the follow-up

Addressees are requested to report to the ESRB and the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the following timelines:

1. Recommendation A

By 31 December 2020, the Commission is requested to deliver to the ESRB and the Council a report on the implementation of Recommendations A(1), A(2) and A(3).

2. Recommendation B

By 31 December 2020, the Commission is requested to deliver to the ESRB and the Council a report on the implementation of Recommendation B.

3. Recommendation C

By 30 June 2019, ESMA is requested to deliver to the ESRB and the Council the guidance referred to in Recommendation C.

4. Recommendation D

By 31 December 2020, the Commission is requested to deliver to the ESRB and the Council a report on the implementation of Recommendations D(1), D(2) and D(3).

5. Recommendation E

   (a) By 30 June 2019, ESMA is requested to deliver to the ESRB and the Council the guidance referred to in Recommendations E(1), E(2) and E(3);

   (b) Starting on 31 December 2019, ESMA is requested to provide the national macroprudential authorities and the ESRB, at least annually, with the information referred to in Recommendation E(4).

2.4 Monitoring and assessment

1. The ESRB Secretariat will:

   (a) assist the addressees, ensuring the coordination of reporting and the provision of relevant templates, and detailing where necessary the procedure and the timeline for the follow-up;

   (b) verify the follow-up by the addressees, provide assistance at their request, and submit follow-up reports to the General Board via the Steering Committee.

2. The General Board will assess the actions and justifications reported by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

Done at Frankfurt am Main, 7 December 2017.

Head of the ESRB Secretariat, on behalf of the General Board of the ESRB

Francesco Mazzaferro

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