ICMA
International Capital Market Association

The AIFMD review and initial lessons from the COVID-19 crisis

By **Arthur Carabia** and **Irene Rey**

Introduction

The European Commission (EC) published on 22 October 2020 its long-awaited consultation on a proposed review of the Alternative Investment Fund Managers Directive (AIFMD).

Introduced in 2013, AIFMD is one of the two pillars of the EU fund regulatory framework. It has established a common set of rules for all funds which are not UCITS (ie retail funds investing in liquid assets). These include rules regarding authorisation, capital requirements, conduct of business standards, remuneration, valuation of assets, delegation, depositories, transparency and marketing (eg EU passport).

ICMA's Asset Management and Investors Council (AMIC) is carefully reviewing all options considered by the EC, as any key amendment could impact fund managers across continents given the global nature of the industry and the international use of EU labels. While the EU label for AIFs is not yet very popular in Asia (only a handful of them are managed from Asia and sold there), fund managers in Asia should also keep an eye on this development, as it may have significant implications for UCITS funds (particularly popular in Singapore, Hong Kong and Taiwan) and the existing delegation model, which is the cornerstone of the asset management industry.

This article is largely built on AMIC comments on ESMA's letter recommending the amendment of AIFMD which will inspire AMIC's response to the actual EC consultation. Anticipating the EC consultation, ESMA issued on 19 August 2020 a letter including recommendations for changes in 19 areas, including harmonising the AIFMD and UCITS regimes; delegation and substance; liquidity reporting and management tools; leverage; the AIFMD reporting regime and data use; and the harmonisation of supervision of cross-border entities.

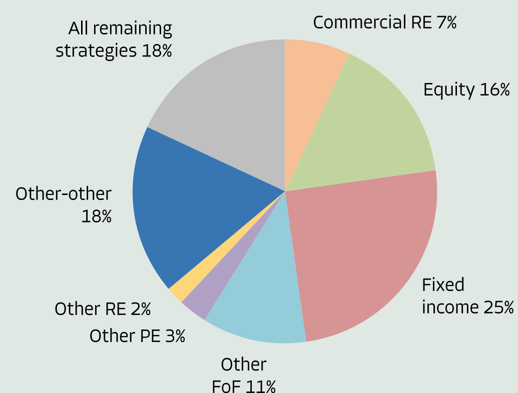
Most of the points raised by ESMA have been taken on board in one form or another by the EC consultation which contains 102 questions split across several priorities, including financial stability (leverage/liquidity reporting), international relations (delegation and National Private Placement Regime), sustainability and ESG investing, investor protection (passport, depository regime, transparency and conflicts of interest, valuation rules).

Whether the options considered will be kept by the EC in its legal proposal to be issued in Q3 2021 remains to be seen. AMIC will certainly continue to argue in favour of legislative stability or moderate changes based on recent findings of the recent COVID-19 crisis.

AIFs at a glance

With €6.6 trillion in AUM, alternative investment funds (AIFs) accounted in 2020 for almost 40% of the EU fund industry. They are mainly sold to professional investors (84%) and cover a wide range of types of funds – including hedge funds, real estate, private equity, funds of funds, and infrastructure funds, among others :

AIF strategy by NAV
Five dominant investment strategies



Note: Investment strategy of AIFs managed and/or marketed by authorised EU AIFMs and sub-threshold managers registered only in national jurisdictions, end of 2018, in % of NAV. FoF=Fund of funds, PE= Private equity funds, RE=Real estate. Data for 25 EEA countries. Sources: AIFMD database, National Competent Authorities, ESMA.

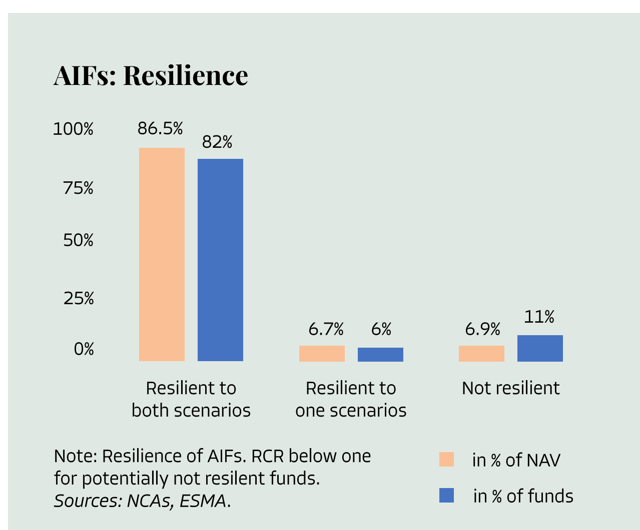
Financial stability: fund liquidity and leverage reporting

Fund liquidity

The EC is considering whether to enhance liquidity reporting obligations for AIFs. But these are already extensive and include detailed information on portfolio liquidity profiles, frequency of investor redemption or investor liquidity profiles (see page 8 of the AMIC paper).

We also note that, in the context of the COVID-19 market downturn in March/April 2020, NCAs across the EU, in coordination with ESMA, asked fund managers to continuously notify any significant redemption (>10% daily, > 30% weekly) in order to closely monitor fund liquidity issues across UCITS and AIFs. This shows that fund liquidity reporting can be swiftly upgraded at any moment by ESMA in coordination with NCAs and that changes at Level 1 are not necessary. It must also be noted that, with ESMA's Liquidity Stress Testing (LST) guidelines which have applied to both UCITS and AIFs since September 2020, NCAs may at their discretion control the ability of the fund to meet redemption requests in normal and stressed conditions.

Building on the data collected during this period, ESMA has issued a report on liquidity risk in investment funds focusing on 541 corporate debt funds (€2.07 trillion NAV) and 92 real estate assets (€294 billion NAV) between 17 February and 31 March 2020. Despite the extreme level of stress experienced during the period studied, ESMA found that, out of the 174 AIFs studied (with €1.3 trillion of AUM), none used substantial leverage nor had to suspend redemption. ESMA and NCAs also ran two stress simulations (weekly redemption equivalent to 22-27% of NAV) on these AIFs investing in corporate bonds in June 2020 and 82% of them passed both tests (see graph below). It must be noted that this is an extreme scenario (corporate bond AIFs registered net inflows in February-March 2020). This does not take into account the potential use of Liquidity Management Tools (LMTs), which are useful to absorb redemption shocks (eg gates, swing pricing, anti-dilution levies).



When it comes to the availability of LMTs, we welcome the fact that the recent crisis has contributed to accelerating the adoption of LMT tools in EU jurisdictions where they were not yet available (eg Germany). Now that LMT tools are available in most Member States and in the main AIFs' domicile centres (France, Germany, Luxembourg, Ireland, the Netherlands: 80% of EU AIFs and more than 90% of total AUM of EU AIFs), the need to amend the Level 1 on that basis (as suggested by ESMA) is not critical any more. The obligation to notify the use of LMTs considered by the EC is already included within LST guidelines, which require fund managers to report to supervisors risks and actions taken to address liquidity issues.

Overall, recent enhancements at EU and national levels, and the live stress test which our members experienced, confirm that the recent framework is fit for purpose from a liquidity perspective and does not need to be amended.

Leverage

The EC is considering whether leverage calculation methods need to be adapted. We note that AIFMD already requires AIFs to report to NCAs both gross leverage and net leverage and is in line with IOSCO recommendations. However, we agree with ESMA that some funds may look significantly leveraged under the gross methodology due to the use of derivatives (eg a liability-driven investment fund). We are therefore sympathetic to adjusting, under the gross leverage methodology, the notional amount of interest rate derivatives via Level 2 or 3 measures. We note, however, that ESMA was already able to take this into account, as it estimated in its 2020 statistical report that on average AIFs have an adjusted leverage (ie excluding interest rate derivatives) that was not substantially used (ie only 1.63 times the NAV).

Harmonisation of UCITS and AIFMD

The EC is contemplating the idea of having a single rulebook for investment funds, with the aim of harmonising the UCITS Directive and the AIFMD even though they have different objectives. (UCITS funds target retail investors and invest in liquid securities, whereas AIFs are mainly sold to professional investors, and therefore can invest in less liquid securities and use significant leverage).

AMIC is opposed to a general approach seeking to harmonise UCITS and AIFM Directives. UCITS and AIFs were intentionally created as distinct labels/vehicles, but we note that the EC is at this stage focusing on a limited amount of (albeit important) topics: liquidity reporting requirements, leverage calculation methodologies, delegation rules.

When it comes to liquidity requirements, we note that, for many years, some major domicile centres have already asked UCITS to comply with AIF reporting requirements (eg portfolio liquidity profiles) and that ESMA's action to bridge these different approaches via its 2020 convergence exercise between NCAs has already prompted asset managers to respond to granular questionnaires sent by EU NCAs in coordination with ESMA. As

NCAs are already empowered to request this information as they work together with ESMA on this, we question whether a change in the Level 1 text is really necessary.

Regarding leverage calculation, we believe it would be disproportionate for UCITS to become subject to similar requirements as AIFs. This is because the UCITS Directive includes specific and strict limits on leverage. UCITS may borrow up to a limit of 10% of their net assets, and only on a temporary basis, for example for liquidity management purposes. Therefore, in UCITS, leverage cannot be created through borrowing. Furthermore, exposures related to derivatives and SFTs cannot exceed the total net value of the portfolio.

When it comes to delegation rules, existing UCITS are already clear. ESMA also issued far-reaching Legal Opinions covering delegation in 2017, which apply to both UCITS and AIFMD. They are more granular than AIFMD provisions on delegation, and have prompted a number of changes in key fund jurisdictions (see below).

"Re-writing AIFMD would be a distraction at a time when we should devote energy to the economic recovery, sustainability and CMU."

International relations (delegation and NPPR) or the need to avoid fragmentation

Delegation

The delegation allowed under the UCITS Directive and AIFMD enables asset managers to set up a fund in the EU and carry out portfolio management or risk management activities from other jurisdictions. However, the EC is exploring possible options to change the current rules in order to prevent the creation of letter-box entities in the EU and ensure appropriate risk management by specifying quantitative criteria and a list of core or critical functions that should always be performed internally.

Here, we believe that the risks of loopholes, regulatory arbitrage and lack of substance are already being properly tackled by existing rules and the emphasis should instead be on the enforcement of these rules.

Existing UCITS and AIFMD provisions on delegation are already crystal clear in this respect: "The management company shall not delegate its functions to the extent that it becomes a letter-box entity". In addition, in 2017, the European Securities and Markets Authority (ESMA) already issued far-reaching Legal Opinions covering delegation, which apply to both UCITS and AIFMD.

For instance, management companies are now required to have at least two senior managers, and additional scrutiny is applied to management companies with less than three full-time employees for the investment function and/or monitoring of delegates.

With respect to delegation of portfolio management functions to non-EU entities, compliance with EU rules is achieved because (i) the EU delegating entity remains responsible for the operation of the fund and all activities related thereto and (ii) the entity receiving the delegation is required to comply with the appropriate EU legislation by NCAs (eg paragraphs 491 and 492 CSSF 18/698).

ICMA sees this delegation model as trustworthy because it is underpinned by MOUs giving EU national supervisors the right to ensure proper monitoring of delegated activities. ESMA has recently reaffirmed this by adopting an MOU with the UK Financial Conduct Authority (FCA) on behalf of EU NCAs in the context of Brexit.

Curbing delegation beyond what is currently authorised would not be in the interest of EU investors, since it would leave them with narrower diversification and investment options. This would also put asset managers with a European footprint at a disadvantage vis-à-vis overseas competitors, because of increased costs and the inability to leverage internal and external expertise globally.

NPPR

The EC is also considering, on the basis of a level playing field, whether it needs to review the National Private Placement Regimes (NPPR), the main route used by non-EU AIFs to reach EU investors, as it could create an uneven playing field between EU and non-EU AIFMs. Non-EU AIFs distributed in Europe accounted for €1.7 trillion of AUM via the NPPR at the end of 2018, with American domiciled AIFs contributing largely to the tally. EU based and non-EU based AMIC members are both keen to preserve NPPR.

Sustainability and ESG investing

In this section, the EC is considering whether to make the quantitative assessment of sustainability risks (ie potential impact on portfolio return) mandatory, going beyond what is required under the newly adopted SFDR. As forward-looking assessement of sustainability risks is still in its infancy and complex from a methodological perspective, and given that audited and reliable data provided by issuers on financial materiality are still lacking, we would argue that, until the NFRD review is completed, the assessment of sustainability risks from a risk management perspective should be required at least on a qualitative basis and not always on a quantitative basis. The EC is also considering whether the consideration of sustainability factors (ie the fund's ESG footprint) should become mandatory in the investment decision process. As many asset managers already apply firm-wide exclusions or ESG integration, we

believe this should still be left at the discretion of asset managers and their clients.

Conclusion

AMIC appreciates the need to review on a regular basis the legislative frameworks to make sure that they are fit for purpose. But in the case of AIFMD and the UCITS Directive this has been an ongoing process and finetuning of these texts via Level 2, 3 and 4 measures has not stopped since the Level 1 was adopted and is currently continuing.

This consistent reviewing has contributed to the development of a robust framework for investment funds, which inspires other regulators around the globe and has proved to be fit for purpose during the unprecedented market downturn we experienced in March/April 2020.

In the context of the sudden shift to remote work and massive stress felt across all asset classes, AIFs and UCITS have shown that they are operationally resilient and have sound fund liquidity management processes in place. In addition, EU funds were not the source of any occurrence of systemic risk.

Re-writing AIFMD and UCITS is not only unnecessary, it would also be a major distraction for policy makers, supervisors and asset managers at a time when collective energy should be devoted to the post-COVID 19 recovery, the Sustainable Finance Action Plan and Capital Markets Union.

We therefore call on the EC to focus on vehicles which, with changes, could foster growth in

European capital markets (eg the ELTIF ongoing review consultation) rather than those which have been successful in ensuring EU's competitiveness and attractiveness. We strongly believe that most of the concerns raised in ESMA's letter can be dealt with by ESMA and NCAs making use of their existing and recently reinforced powers (ie Guidelines, Q&As, Common Supervisory Action) or via targeted Level 2 measures.

Contacts: Arthur Carabia and Irene Rey
arthur.carabia@icmagroup.org
irene.rey@icmagroup.org