RESPONSE TO CONSULTATION

DRAFT REGULATORY TECHNICAL STANDARDS ON OPEN-ENDED LOAN-ORIGINATING AIFS UNDER THE AIFMD

alfi
association of the luxembourg fund industry

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We thank ESMA for the opportunity to participate in this consultation.

Important considerations

According to the revised AIFMD level 1 text (Article 16(2)(a)), it is sufficient that AIFMs are able to demonstrate to the competent authorities that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. AIFMs need to have a liquidity risk management policy in place as per Article 46 of EU Regulation 231/2013. Such document already covers the different types of funds, including loan funds, as well as their liquidity profile. In Luxembourg, the CSSF can at any time make enquiries about the content of the policy, but it is not required to file such policy each time a new fund is launched. In this respect, it is important to know that AIFMs typically have redemption/liquidity policies for groups of funds of the same type (like loan funds or real estate funds). Where needed, provisions concerning individual funds are included in appendices. We would not see a need to draft separate policies for each single fund.

We understand that ESMA has in mind to clarify that loan-originating AIFs are by default closed-ended, while open-ended loan-originating AIFs are the exception. We welcome that the wording of the proposed RTS is neutral with respect to the process of demonstrating a compliant liquidity risk management system. The AIFMD as a manager regulation requires only AIFMs to be authorised. Where AIFs are not subject to an approval requirement, they are still indirectly supervised through their managers that have to report on the funds on a regular basis.

Response to consultation

Sound liquidity management (Article 1)

Q1: Are there any elements other than the redemption policy, the availability of liquid assets, the performance of liquidity stress tests and ongoing monitoring that AIFMs shall take account to demonstrate that the liquidity management system of the OE LO AIFs they manage is sound? If yes, please specify.

We do not think that there is a need for further supervision of AIFMs with respect to their liquidity management system. As per current AIFMD provisions, AIFMs already need to have processes and procedures in place considering the characteristics of all the funds they manage. As outlined by ESMA in point 6 of the consultation paper, ESMA performed an assessment of the existing AIFMD level 2 provisions on liquidity management to establish whether there were any gaps that would need to be addressed to account for the specificities of OE LO AIFs. In point 11, ESMA reaches the conclusion that there are no gaps in that sense, and hence, we believe that the current AIFMD framework is efficient enough.

Appropriate redemption policy (Article 2)

Q2: Do you agree with the list of factors set out in Article 2 of the draft RTS to be considered by AIFMs to establish an appropriate redemption policy for an OE LO AIF? If not, please justify your position.

Considering the diversity of funds and the need to remain agile in a competitive environment, we are of the view that each AIFM should consider which are the relevant factors to be considered, depending on the investment policy and characteristics of the funds managed. In that sense, well-written procedures and policies already cover the points listed by ESMA. We do not believe that a specific list of factors should be added in the RTS, as this gives the impression that this is a limitative list while relevant factors would vary depending on each type of fund, investment policy, target assets etc.

In addition, we would like to stress that AIFMs typically have redemption/liquidity policies for groups of funds of the same type (like loan funds or real estate funds). Where needed, provisions concerning individual funds are included in appendices. We would not see a need to draft separate policies for each single fund.

Finally, we would like to point out that the redemption policy of OE LO AIFs is different from the daily redemptions typical of UCITS. AIFs may have a variety of redemption terms, which would be very different from daily redemptions, while the fund would still qualify as open-ended. In addition to redemption frequency, notice periods and redemption gates are appropriate liquidity management tools.

Q3: Are there any other factors that AIFMs shall consider to demonstrate that the redemption policy of the OE LO AIFs they manage is appropriate? If yes, please provide a list of such factors and explain why they shall be included.

We do not think that there are any other factors that AIFMs should be required to consider to demonstrate that the redemption policy of the OE LO AIF they manage is appropriate. As outlined by ESMA in point 6 of the consultation paper, ESMA performed an assessment of the existing AIFMD level 2 provisions on liquidity management to establish whether there were any gaps that would need to be addressed to account for the specificities of OE LO AIFs. In point 11, ESMA reaches the conclusion that there are no gaps in that sense, and hence, we believe that the current AIFMD framework is sufficient.

Availability of liquid assets (Article 3)

Q4: Do you agree that AIFMs that intend to manage OE LO AIFs shall determine an appropriate proportion of liquid assets to be able to meet redemption requests? If not, please justify your positions?

We do not believe that a required level of liquid assets can be defined on a pre-launch/product basis, as various criteria need to be considered in order to assess the liquidity of a fund. A similar approach in respect of ELTIFs was abandoned for justifiable reasons. Even for a single AIF, the requested amounts for redemption as well as the cash-flow schedules (including credit risk) may

change significantly over time. Loan funds can generate liquidity (interest payments and principal repayments, as well as covenants and provisions that protect the lender by accelerating repayment, e.g. cash sweep clauses). Moreover, it is worth noting that the portfolio composition is not the only way to ensure liquidity in a fund (see new list of liquidity management tools under AIFMD II), and therefore referring to a defined level of liquid assets does not always make sense, and it may limit the ability of the European fund industry to remain competitive in a globalised environment. More specifically, the AIFM should have the ability to determine which portion of the AIF's portfolio may be deemed 'liquid' for the purpose of meeting redemption requests, taking due consideration of other liquidity management tools (e.g. redemption limits).

Q5: Do you agree with the list of factors that AIFMs shall consider to establish the appropriate amount of liquid assets? If not, please justify your position. Shall AIFMs consider other factors, and if yes what are these factors?

The non-exhaustive list provided defines in a flexible manner the elements one would have to account for to model liquidity. We believe that no other factors need to be added and we support in particular point 3 of Article 3, which underlines that other investments made by the OE LO AIF may also be considered as liquid, provided certain conditions are met.

As per our answer to Q4, we believe that at least these factors can be used to determine the liquidity profile of the fund in a dynamic and flexible manner, and would not form the basis of a "rule" defined on a pre-launch basis, as had been tried for ELTIFs.

Q6: Do you agree that cash flow generated by the loans granted by OE LO AIFs shall be considered as liquid assets? If not, please justify your position.

While the cash-flows generated by the loans can be used as a source of liquidity over the lifetime of the OE LO AIF, it is important to account for the fact that these cash-flows will also be re-invested. As such, the potential classification of these cash-flows as liquid assets can only be made with a pre-defined constraint on time. For example, while imminent cash-flows can be allocated to existing redemption requests, these cash-flows may not be considered as a source of liquidity when considering long-term redemption forecasts (e.g. six months or longer). As mentioned in our answer to Q4, we believe that it should remain the responsibility of the AIFM to determine which assets it considers to be 'liquid' for this purpose. We believe that it is not the intention of the AIFMD level 1 text to have a pre-defined list of liquid and non-liquid assets in the RTS.

Q7: Do you agree that AIFMs may consider other assets as liquid if they can demonstrate that these assets can be liquidated within the notice period, to meet redemption requests, without significantly diluting their value? If not, please justify your positions.

Yes, any asset which can be shown to be liquidated under the timeframe defined for a redemption request (accounting for the notice period) without significant price impact could be used for generating cash in order to meet investor redemptions. The methodologies used in the measurement of the transaction cost, including price impact, are documented as part of the AIFM's liquidity risk management framework. This is not dissimilar to semi-open-ended private equity AIFs which maintain a portfolio of liquid assets (e.g. ETFs) in order to meet short-term liquidity requirements.

However, we should avoid having rules similar to the ELTIF Regulation, which provide that redemptions can only be a percentage of a portion of the portfolio deemed to be liquid, rather than a portion of the entire portfolio.

Moreover, as mentioned in our answer to Q4, we believe that it should remain the responsibility of the AIFM to determine which assets it considers to be 'liquid' for this purpose. We believe that it is not the intention of the AIFMD level 1 text to have a pre-defined list of liquid and non-liquid assets in the RTS.

Q8: Are there any other types of assets that could be considered as liquid for the purpose of the availability of liquid assets? If yes, please give examples and explain why they could be considered as liquid for the purpose of the availability of liquid assets. Conversely, are there any other types of assets that shall not be considered as liquid? If yes, please specify.

Given that the draft RTS define liquid assets in a principle-based manner, we do not see the need to extend the definition further or even to establish a list of liquid and non-liquid assets. Managers determine liquidity in line with their policies and should continue to have the right to decide how they assess the liquidity of the overall portfolio.

Q9: In your practical experience, how do AIFMs that manage OE LO AIFs determine the level of liquid assets to be held by the fund to meet redemption requests? In particular, how do they calibrate the amount of liquid assets with respect to the maturity of the loans granted and the number of loans in the portfolio?

AIFMs have detailed liquidity management plans in place, as well as well-structured redemption policies. The AIFMs are responsible to determine which assets are considered liquid, under the general supervision of their regulator. It should be noted that the sale of assets is only one way of meeting redemption requests, and that managers may decide to use other means (e.g. borrowing, use of subscription proceeds), irrespective of the liquidity of their portfolio.

Q10: Do you believe there should be a regulatory minimum amount of liquid assets to be held by an OE LO AIFs and, if yes, please specify it? Should this minimum apply across all types of OE LO AIFs, or should it differ among OE LO AIFs and, if yes, how?

No, we do not believe a regulatory minimum is warranted as the AIFs' liquidity profiles fluctuate over time. Instead, AIFMs should ensure that the risk of liquidity shortfall is minimised through accurate comparisons of liabilities and asset liquidities, using sufficiently conservative assumptions, e.g., via liquidity stress testing, as well as taking into consideration various available liquidity management tools.

It is worth keeping in mind that AIFs (contrary to e.g. ELTIFs) are not regulated, and that liquidity is not only determined by looking at the portfolio composition. We fear that any limitations in this regard would be a competitive disadvantage compared to other non-European markets.

Liquidity Stress Testing (Article 4)

Q11: Do you agree with the draft provisions on liquidity stress testing set out in Article 4 of the draft RTS? If not, please justify your positions.

We agree with the draft provisions in the RTS and would like to highlight that ESMA did not identify any gaps in current rules.

Q12: What other parameters, if any, AIFMs managing OE LO AIFs shall take into account when performing liquidity stress tests?

In our view, the conduct of liquidity stress tests should remain at the discretion of the AIFMs, and therefore, the approach should not be further prescribed by additional parameters.

Q13: What could be the criteria that would justify a frequency of liquidity stress tests higher or lower than on a quarterly basis?

Generally, we think that the frequency of the liquidity stress-tests should be aligned with the redemption policy set for the AIF. In line with the ESMA guidelines on liquidity stress tests, the latter should be carried out at least annually.

Factors that may lead to a higher frequency stress-testing exercise could be:

- Higher dealing frequency.
- More concentrated investor base.
- Fund characteristics: Funds with more complex or volatile investment strategies may require more frequent liquidity stress tests to ensure they can handle sudden market changes.
- Market conditions: During periods of market instability or high volatility, increasing the frequency of liquidity can help in better managing liquidity risks.

The features of the loans being originated could also lead to a higher frequency stress-testing exercise, for example:

- Average probability of default of target obligor base (e.g. if the fund targets obligors with inherently low creditworthiness);
- Seniority of the target loans (e.g., if the fund originates non-senior debt).

Finally, for AIFs on the higher side of the concentration limits defined in AIFMD II, AIFMs could consider performing more frequent stress tests.

Ongoing monitoring (Article 5)

Q14: Do you agree with ESMA's proposal on ongoing monitoring set out in Article 5 of the draft RTS? If not, please justify your position.

We agree with the elements listed in Article 5, which we understand are non-exhaustive.

Q15: What are the parameters that AIFMs managing OE LO AIFs shall monitor to ensure that the AIF has a sufficient level of liquid assets to meet redemption requests?

For assets that are not loans originated by the AIF, the AIFM should monitor the cost of disposing of these assets for multiple redemption thresholds, in line with the notice period of the AIF. However, excluding transactions costs exceeding a pre-defined threshold of acceptable dilution risk set by the AIF should not be excluded, as this would reduce flexibility where AIFMs seek liquidity e.g. in distressed markets.

In addition, the AIFM could leverage on the results of stress-tests on the loan portfolio to determine a conservative term structure of liquidity generation from repayments.
The total liquidity generating capacity for the fund at a given time horizon will be defined as the sum of the liquid assets that can be sold over that horizon and the total cash generated from loan payments under conservative assumptions on the risk factors that affect these repayments (credit risk factors).

As previously mentioned in our answer to Q9, other methods such as borrowing could also be used to meet redemption requests (irrespective of the liquidity of the AIF portfolio).

Q16: How do AIFMs that manage OE LO AIFs monitor the liquidity of the loans originated by the AIFs?

AIFMs define precise policies and procedures when funds are created. Liquidity management including monitoring activities are defined in detail.

Other questions (non-related to the proposals on the draft RTS)

Q17: If you are managing an open-ended loan-originating AIFs, please indicate:

a) the size of these funds, specifying the smallest size as well as the average size;

ALFI and KPMG publish an annual private debt survey (link to the 2024 edition), which is based on data received from 13 depositaries representing 1,300+ funds (or sub-funds) investing in private debt.

According to the survey, 26% of private debt funds are open-ended. It is worth noting that credit funds in that sense cover all types of debt funds, not only loan-originating AIFs as defined by the AIFMD.

The main investor type is institutional investors (80%), followed by retail investors (6%), sovereign wealth funds (5%) and private banks (4%). Investors are mainly from EU countries (68%). Seventy-eight percent of funds have between 1 and 25 investors per fund.

45% of debt funds have AuM up to EUR100 million.31% of debt funds are mid-size funds, i.e. those with a net asset value of EUR100 million to EUR500 million. Finally, large funds ranging from EUR1 billion to EUR5 billion represent 22%.

Most funds (43%) have an expected return of between 1%–5%, followed by 44% with an expected return between 6%–10%.

b) the number of loans originated by these funds, specifying the smallest number as well as the average number of loans;

We are not in a position to provide feedback to this question.

c) the loan-origination strategy you implement (direct lending, mezzanine, distressed debt, venture debt, diversification strategy etc);

According to the ALFI-KPMG private debt survey 2024 (see our answer to Q17 point a) Luxembourg (open-ended and closed-ended) debt funds use three main debt strategies: direct lending (62%), distressed debt (8%), and mezzanine (16%).

d) the policy of the fund regarding the management of non-performing loans;

We are not in a position to provide feedback to this question.

e) the shortest, highest and average redemption frequency and, if any the notice period;

The UK Alternative Credit Council publishes every year a report called "Financing the economy". According to the 2023 edition, a large majority of respondents to the related questionnaire (48%) that offer redemptions do so at quarterly or greater intervals. The vast majority of respondents also have notice periods for open-ended funds of one month or longer. Respondents offering more frequent redemptions or shorter notice periods were typically focused on more liquid private credit strategies or assets with shorter maturity profiles.

f) among the loans you granted, please indicate (as a % of the number of loans granted, and as a % of the total amounts of the loans):

i. the share of shareholders' loans[1];

We are not in a position to provide feedback to this question.

ii. the share of non-performing loans;

We are not in a position to provide feedback to this question.

[1] Shareholders' loans are defined Article 4(1) of AIFMD *as means a loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5 % of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking.*

iii. **the share of loans whose maturity has been extended;**

We are not in a position to provide feedback to this question.

Q18: If you are managing an open-ended loan-originating AIFs, have you already sold loans to meet redemptions requests? What were the main characteristics of the secondary market you used to sell them (i.e.: types of counterparties, time required to achieve the sales process, liquidity, overall cost of transaction etc)?

We are not in a position to provide feedback to this question.

Q19: If you are managing OE LO AIFs, what are the types of loans originated, how frequently do you value them and what is their level of liquidity?

The UK Alternative Credit Council publishes every year a report called "Financing the economy". According to the 2024 edition, 90% of respondents to the related questionnaire report valuing their loans either quarterly or more frequently, and the majority of respondents report using external valuation expertise on a regular basis.

Q20: If you are managing OE LO AIFs, what are the liquidity management tools you are using to comply with the obligations set out in Article 16 (1) and (2) of the AIFMD? Are you also using liquidity management tools other than those listed in Annex V of AIFMD, and if yes, what are these tools?

The UK Alternative Credit Council publishes every year a report called "Financing the economy". According to the 2023 edition, it is common for multiple liquidity management tools to be employed within a single fund structure and managers can additionally tailor the tools to meet investor needs, e.g. adjusting the length of the lock-up period or size of the gate.

Examples of typical liquidity risk management tools employed in open-ended or hybrid funds are:

- Lock-up periods: Preventing redemptions for a pre-determined period.
- Ex-ante investor gates: Pre-determined limitation on the amount of invested capital a given investor can redeem at one time.
- Ex-ante fund level gates: Pre-determined limitation on the aggregate amount that all investors in a given fund can redeem at once.
- Prescribed redemption windows: Investors may only redeem at pre-determined intervals.
- Notice period: Investors must provide minimum notice for redemption requests.
- Slow pay provisions: Segregating an investor's share of the assets and returning it in line with maturity of the asset, e.g. run-off basis.

64% of respondents to the related questionnaire reported using a lock-up period for some of their open-ended funds, with 51% stating that they do so for all their open-ended funds. Of those respondents who do not use lock-ups, many reported being invested in trade finance or more liquid strategies where such LMT were less relevant.

59% of open-ended funds use gates. Once again, those who stated they do not use gates broadly conformed to those invested in more liquid private credit strategies.

Cost-benefit analysis (Annex III)

Q21. Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits of the option taken by ESMA as regards the RTS on open-ended loan originating AIFs? Which other types of costs or benefits would you consider in that context?

We generally agree with the analysis conducted by ESMA, but as mentioned in our introductory remarks, an authorisation or approval requirement for open-ended loan-originating AIFs would not be in the spirit of the AIFMD and would make the European fund industry less competitive compared to other non-EU markets. It should be sufficient to demonstrate to NCAs that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy, either systematically or upon request.

Q22. Is there any ESG and innovation-related aspects that ESMA should consider when drafting the RTS under the AIFMD?

We agree with ESMA's assessment that ESG-related aspects are not of direct relevance to the specific nature of the proposed RTS on open-ended loan-originating AIFs and so we consider that there is no need for the RTS to address ESG-related matters. While credit funds can and do take a variety of approaches to ESG matters, where such funds disclose under Article 8 or Article 9 of SFDR, the promoted environmental and social characteristics and/or sustainable investment objectives are typically not relevant to the liquidity proportion of an open-ended fund, as such assets would normally fall within the "#2 Other" bucket under the description relating to asset allocation in the SFDR pre-contractual disclosure templates (set out in Annexes II and III of the SFDR RTS), on the basis that the purposes of the liquidity assets is to facilitate sound liquidity management, rather than to promote ESG outcomes. We further note that the SFDR is the appropriate regulatory vehicle for ESG matters relating to funds; introducing further ESG requirements across different regulatory regimes risks causing unnecessary confusion, duplication and inconsistencies, particularly as the SFDR is currently undergoing review. We therefore consider that it would be inadvisable to introduce any new ESG-related requirements or restrictions in the RTS (or any other current legislative files).

About ALFI

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.