Position Paper on ESMA Consultation on Draft regulatory technical standards on open-ended loan-originating AIFs under the AIFMD

5 March 2025

Introduction

We share ESMA's aim to support liquidity in open-ended loan originating funds, though we emphasise the importance of applying the relevant LMTs, rather than all listed in the proposal. Furthermore, considering the semi-open-ended nature of real estate funds, we suggest flexibility in adjusting both the target proportion and actual amount of liquid assets, considering the overall portfolio composition.

Definition of "capital of the AIF"

We believe the definition of the capital provided in the AIFMD II is appropriate for closed end funds, which have capital commitments from investors that are called as funding needs arise. However, the definition does not reflect how typically investment into open end funds is structured, and where the capital is determined based on the NAV of the fund rather than on capital contributions and uncalled capital.

The unintended challenges in applying the definition to open-end funds pertain to both AIFMD II and ELTIF 2.0 Regulation, which applies a very similar wording of the definition of the capital. Furthermore, we note that other parts of the definition also raise questions on interpretation for both open- and closed-end funds.

Other interpretation points

Under Art. 15, an AIF cannot grant loans to its AIFM/staff/related entities, etc. A literal reading of the prohibition could result in uncertainty regarding loans made, for example, to GPs which are taken as an advance on future share of returns in the fund. These payments should not be caught by the restriction on lending to related entities, and in any case, these payments to the GP do not carry the risks associated with external lending, which the regulation aims to address.

Other literal readings of the definition of "loan-originating AIF" could have unintended consequences concerning internal funding arrangements within group structures where debt funding provided by the AIF to an AHC or other subsidiary within the group could mean that the AIF is considered to be a "loan-originating AIF," bringing it within the scope of the regulations on OE LOFs. Although we understand that this situation is also not intended to be enough to make the AIF a "loan originating fund", the lack of clarity on the point could cause uncertainty in the fund market.

<u>Responses to consultation questions</u>

We agree that the correct approach to demonstrate that the liquidity management system of the OE LO AIFs is sound is the one outlined by the Directive: presence of any elements other than the redemption policy, the availability of liquid assets, the performance of liquidity stress tests and ongoing monitoring. However, we believe that the AIFM should make the relevant demonstration to the competent authorities of its home Member State. The authorities will then use their discretion to determine whether those measures are adequate.

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Redemption policy

We believe the factors in Article 2 of the draft RTS encompass key considerations for establishing a redemption policy. However, we recommend that AIFMs only need to consider relevant factors from the list, rather than all, and should have the discretion to choose which factors to apply when determining the policy.

Furthermore, AIFMs should have the flexibility to determine the appropriateness of their redemption policies taking account of all relevant circumstances.

We note that redemption policies for institutional funds are designed and agreed with investors in fund documentation when an AIF is established, and normally are not amended during its life. Therefore, the factors listed in Article 2 will need to be considered prospectively at that stage based on reasonable expectations.

Other factors that AIFMs should consider are the actual frequency of redemption opportunities allowed in the fund documentation. In the real estate world, most loan originating funds for institutional investors are closed end, while most others are “semi-open ended” and only offer redemption opportunities both infrequently and subject to a variety of LMTs, although legally falling within the definition of “open-end funds” under AIFMD.

Moreover, we point out that institutional investors do not typically invest in open end real estate funds for liquidity. Redemptions are not frequent in loan originating real estate and infrastructure funds for institutional investors, and in some cases, redemption intervals may be very long, reflecting the long tenor of the underlying assets.

Thus, we note that with real estate and infrastructure assets both more and less frequent redemptions are compatible with the AIF’s investment strategy and more appropriate for investors. In some cases, shorter redemptions frequencies may be appropriate for strategies with longer dated assets whereby the cashflows arising from the assets are considered to provide sufficient liquidity to permit such redemptions (noting that this will not always be the case).

It may be possible that AIFMs that intend to manage OE LO AIFs determine a target proportion of liquid assets to be able to meet redemption requests. We suggest that there needs to be flexibility for both any target proportion (if required) and the actual amount of liquid assets held to change as a result of actual events and taking into account the results of ongoing monitoring and stress tests. The appropriate proportion of liquid assets should also be considered in light of the actual overall portfolio composition.

It is also important to stress the difference between redemptions that must be met by a sale of the underlying assets and redemptions that can be met through other means. It is only net redemptions that represent a liquidity risk and there is no liquidity mismatch if there is no need to sell anything. This is important in considering deferrals and other mechanisms as liquidity management tools. In such cases, we suggest that it is possible that no/a low proportion of liquid assets would be appropriate, and we suggest that there is merit in the RTS clarifying this.

To this end, we note that there is no requirement for OE LO AIFs to hold a proportion of liquid assets in the updated AIFMD level 1 rules. We welcome the flexibility proposed within the RTS, which will permit OE LO AIFs and their managers to determine the most appropriate percentage of liquid assets for their strategy.

Appropriate amount of liquid assets

AIFMs should consider only the relevant factors listed in Article 3 when establishing the appropriate amount of liquid assets, while acknowledging that the list should not be exhaustive. They should also be allowed to consider any additional factors they find relevant.

In this sense, we further suggest that the AIF's investment policy should also be considered as a factor when determining the appropriate proportion of liquid assets.

We agree that cash flow generated by the loans granted by OE LO AIFs should be considered as liquid assets, but it should be an AIFM determination on a case-by-case basis in line with the investment policy and redemption policy of the AIF in question.

Furthermore, 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.

We also recommend that the reference to "without significantly diluting their value" be amended to make it clear that this applies to any dilution in value resulting solely from the need for a fire sale to meet the redemption, and should not prevent assets from being treated as liquid by reason that the market generally for those assets is depressed at the relevant time, or looks like it may move adversely during the redemption notice/settlement period.

At the same time, we do not believe there should be a regulatory minimum amount of liquid assets to be held by an OE LO AIFs.

We generally agree with the draft provisions on liquidity stress testing set out in Article 4, noting that the appropriate frequency of stress testing should be for the AIFM to determine as appropriate to the nature of the AIF having regard to the AIF's overall liquidity profile as set out in the implementing regulation.

In conclusion, we do not consider that the RTS needs to mandate any additional parameters AIFMs managing OE LO AIFs must take into account when performing liquidity stress tests. However, other parameters that can be monitored to ensure that the AIF has a sufficient level of liquid assets to meet redemption requests are the frequency of redemption opportunities, the maturity of loans originated, the opportunity for investors to redeem via a secondary market sale of its shares or units to another investor and inflows of subscriptions would be a good start.