A Look At The Latest EU Alternative Investment Regulation

By **Juliette Mills and Alix Prentice** (March 27, 2024)

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On March 15, the Council of the European Union published the updated text[1] amending the Alternative Investment Fund Managers Directive, or AIFMD 2.0, which governs European managers of hedge funds, private equity funds, private debt funds, real estate funds and other alternative investment funds.[2]

The changes that are the focus of this article were adopted to improve European capital markets and strengthen investor protection in the EU in part by tightening requirements for the liquidity management of loan-originating alternative investment funds.

We are going to look at loan-originating alternative investment funds against a backdrop of growing regulatory focus on nonbanking financial institutions, or NBFIs, and how loan-originating alternative investment funds fit in to the universe of NBFIs.

NBFIs play a key role in the global financial system by supporting economic growth through the provision of nonbank financial services and credit, but they carry a commensurate risk which is the subject of intensifying regulatory intervention.

AIFMD 2.0

It is clear that the market's appetite for nonbanking finance, paired with a lighter touch regulatory approach in this sector when compared to that applied to banks, was at the forefront of the legislators' minds when drafting AIFMD 2.0.

Significant changes are being made, particularly in relation to liquidity management and leverage limits and restrictions on open-ended structures for loan-originating alternative investment funds, as well as new requirements in relation to loan origination.

These are in place with a view to ensuring that fund managers are well equipped to deal with significant outflows in times of financial turbulence, alleviate risks to financial stability and ensure an appropriate level of investor protection. Those issues all represent systemic threats that we have seen over the last 12 months, and also prior to that time.

Simply put, the structure of open-ended funds means that a liquidity crisis can be exacerbated due to mismatches between asset liquidity and redemption policies.

As a result of this, there is a need for continuous liquidity management, and this is why the commission has placed such emphasis on the role of liquidity management tools in AIFMD 2.0, and elsewhere.

Liquidity Management Tools

In order to reduce the risk of liquidity mismatches, AIFMD 2.0's starting point is that loan-originating alternative investment funds should be mandatorily closed-ended where they engage in loan origination to a significant extent, i.e., where the notional value of all loans

originated is greater than 60% of the loan-originating alternative investment funds' net asset value.

However, there are significant derogations set out in Article 16 — Liquidity Management — of AIFMD 2.0 that allow for the existence of open-ended loan-originating alternative investment funds.

Liquidity Management for Open-Ended Funds

In addition to any other prescribed liquidity management tools provided for in a loan-originating alternative investment funds' memorandum and articles of association or other constitutional documentation, open-ended loan-originating alternative investment funds must select at least two liquidity management tools.

This is except for AIFMs that manage an authorized money market fund. These AIFMs can select a liquidity management tool from amount those set out in AIFMG 2.0's new Annex V — specifically in points 2 to 7 of this addendum — and implement policies and procedures to employ these tools.

When AIFs cannot satisfy such requirements, the only option is to adopt a closed-ended structure.

Liquidity Management for Closed-Ended Funds

Closed-ended loan-originating alternative investment funds do not escape liquidity scrutiny, though the focus is less acute.

The AIFM of a closed-ended loan-originating alternative investment fund must be able to demonstrate to their national regulator that it maintains appropriate liquidity managing systems that are compatible with the loan-originating alternative investment funds' investment strategy and redemption policy.

Leverage Limits

Leverage and liquidity mismatches between assets and liabilities continue to be a key concern in NBFIs. This is particularly due to vulnerabilities they create for open-ended structures to be subject to runs, contributing to volatility in the markets and threatening the financial stability of the wider banking sector.[3]

Additionally, stress in NBFIs as a result of elevated leverage and liquidity mismatches can also lead to a spillover effect to other markets, due to the high levels of interconnectedness.[4]

This was particularly evident during the period of market turmoil at the onset of the COVID-19 pandemic, also known as the liquidity crisis, in March 2020.[5]

In December 2017, the European Systemic Risk Board explained in its recommendations paper that

> 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.[6]

Due to the risk which leverage poses in the context of NBFIs, European legislators have sought to limit investors' exposures to volatile and risky markets and avoid the contagion risk transmission introducing certain concentration limits under AIFMD 2.0.

The leverage restriction introduced by AIFMD 2.0 requires AIFMs of loan-originating alternative investment funds to ensure that the notional value of the loans originated to any single borrower by the AIF does not exceed 20% in aggregate of the AIF's capital when the borrower is:

- A financial undertaking;
- Another AIF; or
- An undertaking for collective investment in transferable securities.

Additionally, the AIFM must ensure that the AIF's leverage[7] is no more than:

- 175% where the loan-originating alternative investment fund is open-ended; or
- 300% where it is closed-ended.[8]

Tying Into Regulatory Initiatives on Shadow Banking

The shadow banking system has been broadly defined by the Financial Stability Board as "credit intermediation involving entities and activities outside the regular banking system."[9]

Loan-originating alternative investment funds fall under this definition because they act as lenders outside the traditional banking sector.

Other examples include money market funds and other funds using leverage, pension funds, insurance corporations, investment funds, finance companies, broker-dealers and structured finance vehicles.

Although this type of lending is similar to traditional bank lending, the key difference is that it is not subject to prudential regulatory frameworks and constraints applicable to regulated banks.

Prior to the global financial crisis in 2008, the NBFI system provided large amounts of credit intermediation to the banking sector, which contributed to asset price appreciation in the real estate markets.

Additionally, the funding of credit through the NBFI system significantly reduced the cost of borrowing in the run-up to the global financial crisis.

It was clear that the emergence of NBFIs and the move toward cheaper credit intermediation during boom periods had led to more severe crises and more expensive credit intermediation during periods of economic downturn.[10]

In spite of this, the NBFI sector has grown spectacularly since the global financial crisis, from $26 trillion in 2002, to $67 trillion in 2012. NBFIs represented about 50% of global

financial assets in 2023.[11]

It has been recognized across the industry that the role of shadow banking has complemented the traditional banking sector by expanding credit to support economic growth, diversifying credit sources and providing healthy competition for banks.[12]

However, the European Banking Authority noted that there are fault lines in the shadow banking system that could put the financial stability of the traditional financial system at risk.[13]

The main reason for this potential risk is because NBFI lending takes place outside the regulated banking sector, it does not have access to central banks' liquidity functions, nor any type of investor protection or resolution regime in the event of a failure.

Unlike regulated banks, shadow banks do not have the safety net of emergency central bank funding or government funding in times of stress. Additionally, the NBFI sector is so large and deeply connected with ordinary banks that their failure would trigger these fault lines and destabilize the wider system.

By way of contrast, the legislative framework for NBFIs is considerably less developed than that of traditional banking, and this limits the ability of financial authorities to address emerging risks and vulnerabilities, particularly in relation to liquidity mismatching.

This in turn means that authorities have limited tools to mitigate contagion risks, should they arise.

It is clear from the various attempts to improve legislation and guidelines regarding shadow banks in the 2015 EBA guidelines,[14] the final draft regulatory technical standards published in 2022 and now AIFMD 2.0, that European legislators and regulators recognize the instability of NBFIs and the potential dangers they pose to a resilient financial system, and the reason NBFIs and a focus on liquidity mismatches have become a central source of rulemaking in the EU.

Credit funds, including loan-originating alternative investment funds, are placed squarely within the NBFI category.

Conclusion

A resilient financial system allows real economy institutions to function efficiently, but to be resilient, a financial system should have the resources and flexibility to respond to, and not amplify, a range of different shocks and risks.

These risks, which were previously only seen from a regulated perspective have now moved to a less regulated, more opaque sector, in the form of NBFIs.

Ironically, the growth of shadow banking has largely been driven by the tightening in the regulatory requirements of banks and financial innovations, given one of the main concerns around shadow banking is the strong connection to the traditional banking system, meaning that disruptions in the shadow banking sector may quickly translate to traditional lenders.[15]

It is abundantly clear that regulators have acknowledged the economic significance of NBFIs and the concomitant risks, and that clearer more robust legislation is required.

Liquidity mismatching, and its companion maturity mismatching, have long been recognized as an issue across many industries, including funds, and the growth in the number and volumes being handled by loan-originating alternative investment funds has required regulators to catch up with measures to contain these risks.

Although it is unclear whether AIFMD 2.0 will achieve its aim of providing greater flexibility to deal with significant outflows during periods of market stress for loan-originating alternative investment funds, it is clear European regulators are not looking to eradicate this sector but are looking to control it rather more closely, and AIFMD 2.0 is only the beginning.

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[1] https://data.consilium.europa.eu/doc/document/PE-67-2023-REV-1/en/pdf.

[2] https://data.consilium.europa.eu/doc/document/PE-67-2023-INIT/en/pdf.

[3]https://www.imf.org/en/Publications/GFSR/Issues/2022/10/11/global-financial-stability-report-october-2022.

[4] https://www.imf.org/en/Publications/GFSR/Issues/2023/04/11/global-financial-stability-report-april-2023.

[5] https://www.newyorkfed.org/newsevents/speeches/2021/log210811.

[6]https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf.

[7] An AIF's leverage will be calculated according to the commitment method under the AIFMD Level 2 Delegated Regulation and expressed as the difference between the fund's exposure relative to the fund's NAV.

[8] As defined in Article 1(2) of Delegated Regulation EU 694/2014.

[9] https://www.fsb.org/2011/04/shadow-banking-scoping-the-issues.

[10] https://www.newyorkfed.org/medialibrary/media/research/epr/2013/0713adri.pdf.

[11] https://www.fca.org.uk/news/speeches/drive-data-non-bank-financial-intermediation-nbfi.

[12] https://www.fsb.org/wp-content/uploads/P050318-1.pdf#page=4.

[13] https://www.eba.europa.eu/publications-and-media/events/consultation-draft-rts-criteria-identification-shadow-banking.

[14]https://www.eba.europa.eu/sites/default/files/documents/10180/1310259/f7e7ce6b-7075-44b5-9547-5534c8c39a37/EBA-GL-2015-20%20Final%20report%20on%20GL%20on%20Shadow%20Banking%20Entities.pdf.

[15]https://www.europarl.europa.eu/RegData/etudes/STUD/2021/662925/IPOL_STU(2021)662925_EN.pdf.