Client Alert

Corporate

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Open End Credit Funds – ESMA Is Looking for Answers

The ESMA Consultation Paper on draft regulatory technical standards on open-ended loan-originating AIFs (OE LO AIFs) under the AIFMD, published on the 12 December 2024, aims to set out the requirements which OE LO AIFs must comply with in order to be able to maintain an open-ended structure by demonstrating that it is able to manage liquidity risks effectively and is part of the process of reshaping the European private funds landscape for credit fund managers started by the AIFMD II.

The AIFMD introduced a general rule that loan originating AIFs should be closed-ended unless the AIF managers (AIFMs) can *demonstrate* to the competent authorities that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy of the AIF. Whilst ESMA determined that the existing provisions on liquidity management which are set out under the Commission Delegated Regulation (EU) No 231/2013 (Level 2 Regulation) do not contain any gaps, the Consultation Paper proposes to introduce specific parameters/elements that AIFMs managing OE LO AIFs will need to take into account when applying the existing liquidity management requirements.

In summary, the Consultation Paper covers the following key areas:

- *Sound liquidity management*. ESMA confirms that AIFMs should define a tailored redemption policy and an appropriate proportion of liquid assets for each OE LO AIFs they manage, in each case taking into account the list of prescribed factors.

- *Liquid assets*.
  - ESMA states that AIFMs will need to determine an appropriate proportion of liquid assets that the OE LO AIFs they manage will target in order to meet redemption requirements. Again, ESMA proposes to introduce a prescribed list of factors that AIFMs must consider when determining the appropriate proportion of liquid assets. ESMA also asks for various views from market participants, including with respect to any other types of assets that could or should not be considered as liquid or whether a regulatory minimum amount of liquid assets should be introduced.
  - ESMA does not propose to specify all the assets that can be considered ex-ante as liquid and it will be left to AIFMs to make such determinations. However, ESMA clarifies that liquid assets include expected cash flows generated by the loans granted as well as other investments so long as such investments can be converted into cash over the duration of the notice period without *significantly* changing their value (without further guidance, however, as to what changes would be considered "significant", save for an example where the value of an asset would be subject to a "big discount" affecting the overall liquidity available for meeting redemption requests).
- *Liquidity stress testing.* ESMA believes that in addition to the requirements for stress testing under Level 2 Regulation, AIFMs should conduct liquidity stress tests on at least a quarterly basis, unless a higher or lower frequency is justified by the characteristics of liquidity of the loans (separately testing the assets and the liabilities of the AIFs and using conservative scenarios with respect to various factors but also taking into account scenarios with low probability but high impact outcomes).
- *Ongoing monitoring*. ESMA proposes that AIFMs should monitor on an ongoing basis various prescribed elements of the OE LO AIF, such as the level of liquid assets, the expected cash flows, and potential future liabilities, etc. to ensure that the liquidity management system remains compatible with OE LO AIF's investment strategy and redemption policy.

Whilst ESMA does not propose to provide further detailed rules on the prescribed liquidity management tools, it does invite respondents to share their experience relating to application of such tools and to suggest any tools not yet contemplated by AIFMD II.

The Consultation Paper is calling for responses by 12 March 2025 and managers of in scope OE LO AIFs (as well as investors investing in such AIFs) are encouraged to share their experience with ESMA to ensure that all possible nuances of various strategies are taken into account in the final regulation.

For further background on AIFMD II see our update *Navigating AIFMD II: A Regulatory Odyssey*.