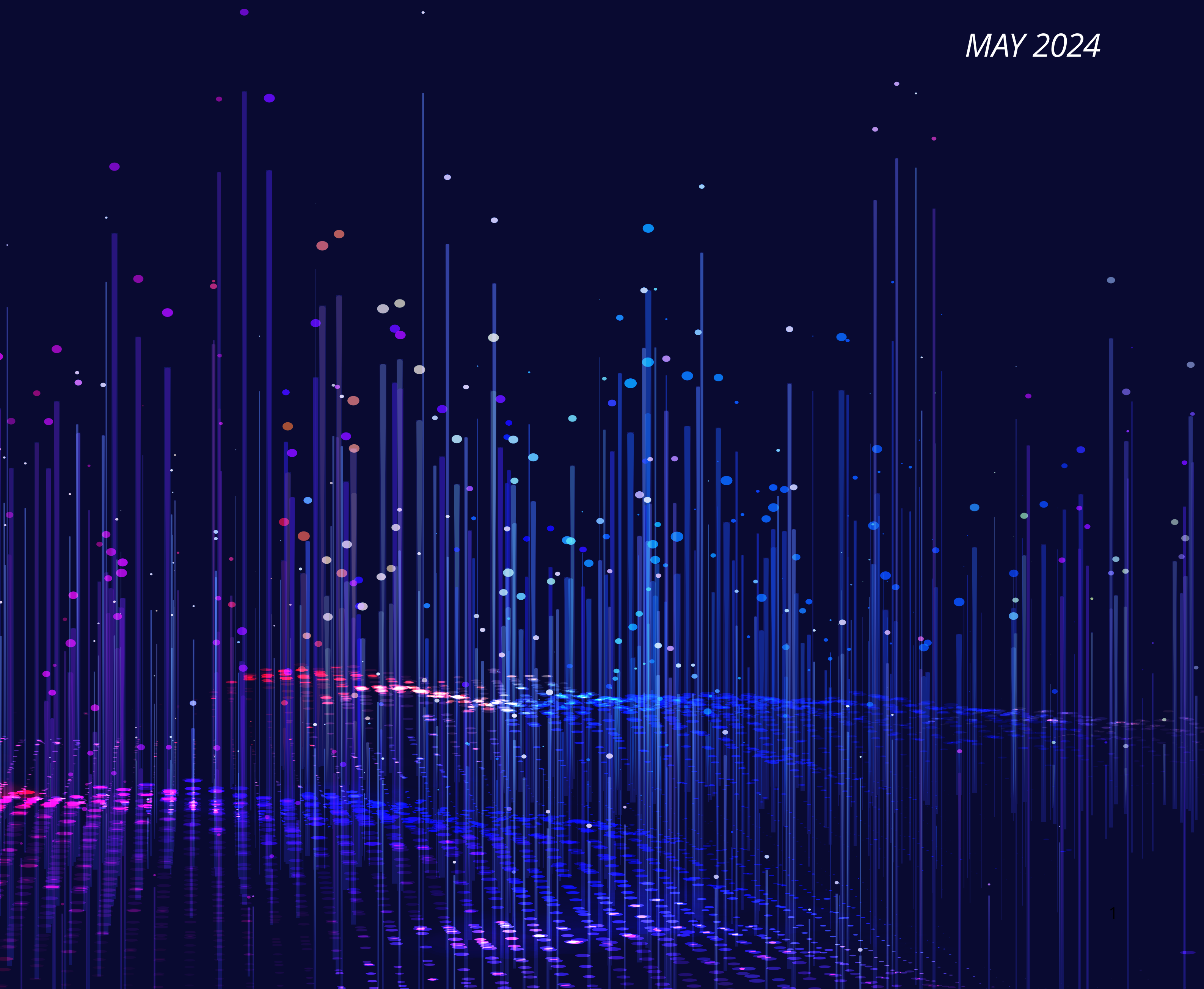
AIMA

DEEPENING CAPITAL MARKETS IN EUROPE

THE ROLE OF THE ALTERNATIVE INVESTMENT MANAGEMENT SECTOR

A Policy Vision for 2024 and Beyond

MAY 2024



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THE PURPOSE OF THIS PAPER

This paper has been prepared by the Alternative Investment Management Association (AIMA) and the Alternative Credit Council (ACC) to explain the role that the alternative investment management sector can play in supporting the EU's goal of developing a true Capital Markets Union (CMU), increasing cross-border investment throughout the EU and, importantly, channelling capital towards sustainable investments.

These ambitions are particularly important as the new European Commission and European Parliament will begin their legislative term in 2024 and unveil a new legislative agenda aimed at achieving these goals.

In this paper, we provide:

(i) An explanation of the alternative investment industry which we represent;

(ii) An overview of the contribution that the industry makes to the European economy and how this is done;

(iii) Our vision for how the EU can take concrete steps to deepen capital markets and work towards the completion of the CMU.

Our policy vision is built around 2 key themes:

(i) Funding the future of Europe,

(ii) Strengthening competitiveness of the EU investment industry.

Under these 2 themes, we set out 8 specific recommendations which policymakers can incorporate to work towards the completion of the CMU. We hope that this paper will provide the starting point for discussions with policymakers. We are committed to providing further, more detailed feedback in the future.

This paper is a summarised version of the full AIMA Policy Vision Paper which is available on the AIMA website (www.aima.org) and upon request.

WHO ARE WE?

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than €3 trillion in hedge fund and private credit assets.

AIMA's members and the broader alternative investment industry perform an important social role by managing investments for pension funds, insurance companies, university endowments, charitable foundations, and other socially important investors.

AIMA's head office is located in London. We also have offices in Brussels, Washington DC, China as well as National Groups in Canada, Cayman Islands, Hong Kong, Singapore, Japan and Australia. AIMA's members comprise the leaders in the alternative investment management industry. They include hedge fund managers, alternative credit managers, fund-of-funds managers, prime brokers, administrators, lawyers and auditors.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage approximately €500 billion of private credit assets globally.

WHAT ARE HEDGE FUNDS?

A hedge fund is an investment vehicle that manages money on behalf of institutional investors by pursuing investment strategies with all or some of the following characteristics:

(i) They may use derivatives (financial contracts whose value is linked to a related item such as oil, mortgages or currencies);

(ii) They may seek to magnify returns through borrowings;

(iii) They may use some form of short selling to hedge the risk of a market fall or crash;

(iv) They charge a fixed fee to manage the fund as well as a performance fee if returns exceed a predetermined benchmark;

(v) Fund investors are typically permitted to withdraw capital periodically, e.g. quarterly or semi-annually;

(vi) Usually, the managers who set up the fund are significant investors in the hedge funds themselves. This is described as “alignment of interests” or having “skin in the game”.

Today, there are roughly 8,000 hedge fund managers across the world managing around 25,000 hedge funds worth approximately €4 trillion. The industry employs close to 400,000 people worldwide.

WHAT ROLE DO HEDGE FUNDS PLAY IN CAPITAL MARKETS?

Capital markets are crucial in the financing of the economy. The alternative investment industry plays an ever-increasing role in the entire chain of investing and financial intermediation, contributing to market depth, sophistication, transparency and thus the ability of capital markets to support growth.

Much hedge fund activity may seem complex and confusing. It can be important to remind ourselves of some of the real-world examples of the benefits to the economy that hedge funds provide:

- Without interest rate derivatives trading by hedge funds, banks and other lenders would find it more risky or expensive to offer fixed-rate mortgages to their customers.
- Without commodity derivatives trading by hedge funds, airlines would find it more difficult to plan ahead and control the costs related to their fuel consumption.
- Without credit derivatives trading by hedge funds, banks would have to liquidate wholesale portfolios of Small and Medium-sized Enterprises (SMEs) loans and restrict finance to an already cash-starved sector.

By providing liquidity and taking on risks that others may avoid, hedge funds help to drive the engine of financial services, ensuring that capital reaches companies and borrowers.

WHO ARE THE INVESTORS IN HEDGE FUNDS?

There are a wide variety of investors in hedge funds, including pension funds, insurance companies, foundations, charities, sovereign wealth funds, fund-of-funds as well as high-net worth individuals (see Figure 1 below). Roughly two-thirds of all capital in hedge funds is allocated by institutional investors.

Most investors apportion a share of their overall portfolio to one or more alternative investment funds. This share typically ranges from about 5-10% of the total portfolio for public sector pensions to 30% or more for endowment funds.

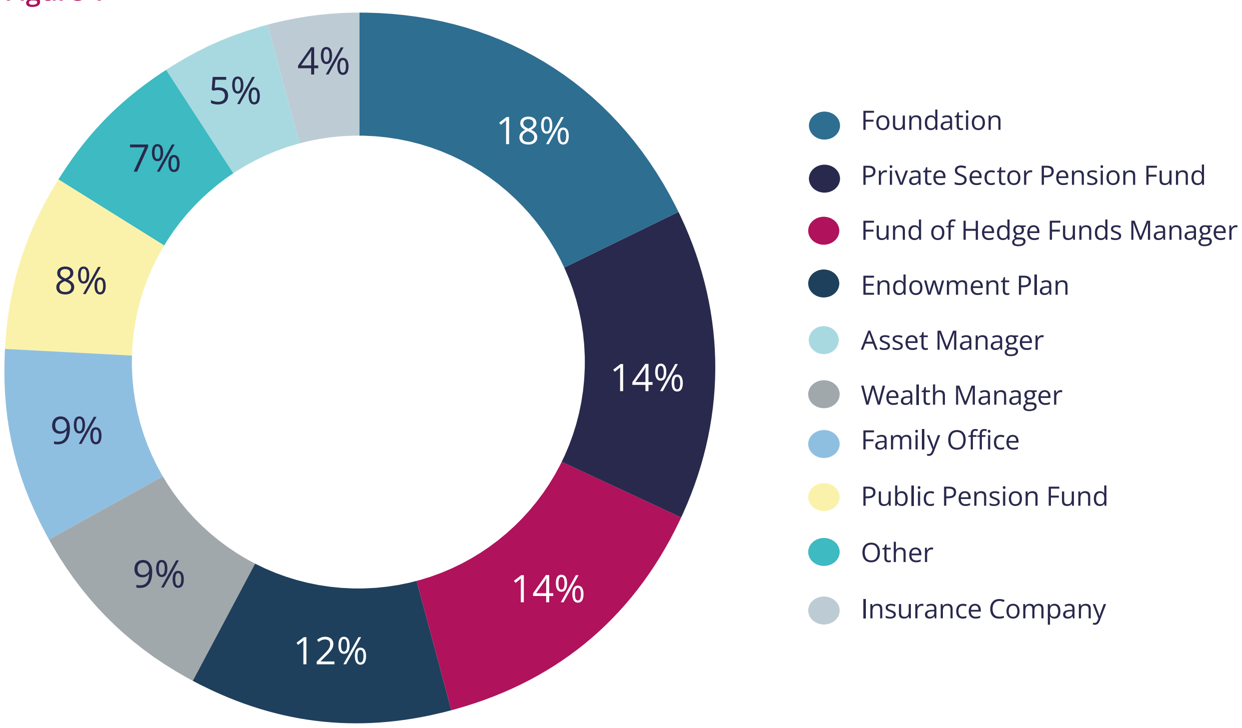
In the last 20 years or so, we have witnessed an increasing proportion of capital invested into hedge funds from pension funds (both private and public) on behalf of schoolteachers, doctors, nurses, private sector workers and university students.

This brings the alternative sector front and centre in the debate around the democratisation of finance.

Investors put their money in hedge funds as they are typically looking for:

- Competitive risk-adjusted returns, i.e. a way of measuring the value of the return (gain) in terms of the degree of risk taken.
- Downside protection: alternative investment funds are designed to provide greater protection against the large declines that the main asset classes including stocks, commodities and bonds sometimes experience.
- Flexibility and diversification: hedge funds usually have a broader investment strategy and can be counter-cyclical in nature, i.e. they produce a return even during difficult macro-economic environments.

Figure 1



WHAT IS PRIVATE CREDIT?

Private credit is an umbrella term used to describe the provision of credit to businesses by lenders other than banks. Most commonly, these lenders are regulated asset management firms pooling investor money into funds that are then used to finance respective businesses. The term private credit is often used interchangeably with phrases such as ‘private debt’, ‘direct lending’, ‘alternative lending’ and ‘non-bank lending’.

Private credit is an established but growing sector within the alternative investment market. It can be differentiated from other types of lending activity and investment strategies in various ways, including:

- **Bilateral relationships**: private credit lenders will often have a direct rather than an intermediated relationship with the businesses they are lending to.
- **Buy and hold**: the loans originated by private credit lenders are generally held to maturity by the original lender rather than traded.
- **A flexible approach**: core features of a credit agreement such as repayment terms or covenants will typically be structured to match the unique needs of the borrower.

Some of the more common private credit strategies include:

- **Corporate lending –** lending to performing operating businesses secured by business equity/cashflows.
- **Real estate –** lending to real estate projects/developers.
- **Infrastructure –** lending to infrastructure projects.
- **Asset based –** lending to business secured by assets (e.g. airplanes) rather than business-generated cashflows as in direct lending.
- **Trade finance –** lending to support trade in goods.
- **Structured credit** - lending with tranching of credit risk.
- **Speciality finance** - lending to support e.g. consumer credit or peer-to-peer platforms.
- **Venture debt** - to early-stage companies.

As with hedge funds, private credit is predominantly an institutional asset class with the most of the capital allocated to private credit strategies coming from pension funds, insurers or sovereign wealth funds. Family offices, high net worth individuals and private banks also invest in private credit but make up a smaller proportion of the overall investor base. We hope that the recently revised European Long-term Investment Fund (ELTIF) Regulation will provide a robust channel by which to support increased retail participation in private markets.

In November 2023, ACC published the 9th edition of its Financing the Economy report.[1] The Report showed that private credit managers lent an estimated $330bn globally in 2022. This lending was a vital source of finance and liquidity for SMEs and mid-market businesses as other credit markets retrenched.

1 https://www.aima.org/compass/insights/private-credit/financing-the-economy-2023.html

SUMMARY OF POLICY RECOMMENDATIONS

Theme 1: Funding the Future of Europe

Recommendation 1: Revive EU Securitisation landscape:

A reformed securitisation framework will help to reduce the EU's over-reliance on bank funding, one of the central pillars of the CMU project. The benefits of a more effective securitisation framework will be felt primarily by consumers, SMEs and mid-market companies in the form of better access to finance. Securitisation also has a huge potential to increase the capacity of the private sector to fund the sustainability transition whether it is through infrastructure, real estate or energy finance. Overall, the asset management sector needs to be put at the centre of the securitisation process both on the supply (creation and management of securitizations) as well as the demand side (investment in securitisation products).

Particular focus should therefore be given to clarifying the scope of the Securitisation Regulation, permitting fund managers to act as sponsors of securitisation and the proportionality of investor due-diligence and disclosure requirements. Reform of the Securitisation Regulation should be accompanied by concurrent reforms to the prudential treatment of securitisation for banks and insurance companies to ensure securitisation is able to play a full role in the financing of the EU economy.

Recommendation 2: Lower the Barriers for Loan Origination Fund Activity:

The recently concluded review of the Alternative Investment Fund Managers Directive (AIFMD) introduced a cross-border lending passport for loan origination funds (LOFs). This reform has the potential to significantly boost the amount of capital available to meet the finance and liquidity needs of EU businesses, permitting them to invest, grow and support job creation. The implementation of the new rules for LOFs must ensure that single market rights for cross-border lending by funds are not hampered by national restrictions or other regulatory barriers which diminish the progress that has been made. The AIFMD rules also need to be implemented in such a way as not to undermine the effectiveness of the newly introduced ELTIF framework.

Recommendation 3: Maintain Professional v Retail Investor Distinction:

Having robust wholesale and professional capital markets is key to financing the economy. Ensuring that retail investor regulation is not extended to those markets is key in lowering cost of intermediation. The proposed Retail Investment Strategy (RIS), by focusing on costs as a panacea for encouraging investment, will not contribute to the development of the CMU. Although recent amendments adopted by the European Parliament are welcome, we call on policymakers to take a fresh, broader look at the debate by examining all relevant issues aimed at encouraging retail participation in capital markets, not just cost.

Theme 2: Strengthening Competitiveness of the EU Investment Industry

Recommendation 4: Streamline, Harmonise and Centralise Regulatory Reporting:

The EU asset management industry is heavily burdened, unlike any other in comparison, by the proliferation of different reporting requirements. These requirements are made more complex by the fact that, often such reporting must be channelled to individual EU Member States rather than solely to countries where asset managers are authorised or to the European Securities & Markets Authority (ESMA). Information that is reported should be streamlined and collated between different regulators to improve efficiency. Under AIFMD, the European Commission will be responsible for adopting Implementing Technical Standards (ITS) including a template for reporting on systemic risk. We believe that the European Commission should ensure alignment with global reporting standards and avoid requiring disclosure of portfolio-level data. We also put forward suggested changes to the European Market Infrastructure Regulation (EMIR), the Short Selling Regulation (SSR) and the Markets in Financial Instruments Regulation (MiFIR) regimes that are often duplicative and overlapping.

Recommendation 5: Focus on Improving Market Liquidity and Resilience:

EU public markets are suffering from inadequate liquidity, undermining the most basic function of capital markets – efficient price formation. With an ever-increasing focus on building new layers of macro-prudential regulatory intervention in the asset management sector – layers that are not present and are not likely to be present in any other major financial centre – the EU risks stunting the growth of its most promising and innovative parts of the industry. Any interventions to improve financial stability should be undertaken with a lens of improving the diversity and liquidity of markets and should focus on market-wide resilience rather than individual institutions, or types of institutions.

Recommendation 6: Enhance EU Supervisory Architecture:

Greater harmonisation of practices and supervisory convergence is needed. In particular, the role of ESMA with regard to 3rd country elements should be enhanced and equivalence should be assessed at a technical level rather than at a political level.

Recommendation 7: Strengthen Good Practices in Legislative Process:

The practice of carrying out appropriate impact assessments prior to the adoption of a new rule – whether in the initial proposal or added at a later stage by the European Parliament or Council of the EU – should be regarded as indispensable. Proposed new laws should always be underpinned by strong evidence of market failure on the one hand or tangible benefits on the other hand.

Recommendation 8: Maintain Tax Neutrality for Investment Funds:

The principle of tax neutrality is generally recognised in EU law but we are conscious that there may be situations where the principle is put in doubt in the future, for example in discussions on the proposed Unshell Directive. The EU Pillar Two Directive outlines that appropriate treatment for funds should also include entities owned by the fund such as special purpose vehicles. Going forward, we believe the European Commission should adopt this principle across the board.

FIND OUT MORE

Thank you for taking the time to read our Policy Vision Paper.

To find out more about our industry and priorities, please visit www.aima.org or email info@aima.org.

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