MARKET INSIGHTS ISSUE #14 | DECEMBER 2023

THE AIF MARKET – AN OVERVIEW

INTRODUCTION

This Markets Insights sheds light on the Alternative Investment Fund (AIF) market. The review of the Alternative Investment Fund Managers Directive (AIFMD), which was finalised this year, offers an interesting opportunity to analyse how this market has developed since the directive's entry into application in 2013. We compare the evolution of this market with that of UCITS in recent years and dive into country-level figures. The last section highlights the important regulatory changes that will be implemented in the context of the AIMFD review.

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THE AIFMD AND AIFS

The AIFMD was first adopted in 2011 and implemented by most Member States by July 2013. It established a regulatory framework covering the activities of the AIF sector, including all investment funds that are regulated in accordance with specific national requirements and fall outside the scope of the UCITS Directive (UCITSD).

The AIFMD was devised as part of the policy response to the 2008 global financial crisis that exposed weaknesses and vulnerabilities in many areas of the financial system, including the investment activities of certain private fund structures.

Some of the key features of the AIFMD, as well as relevant differences with the UCITSD are:

- **Scope**: Contrary to the UCITSD, the focus of the AIFMD is on fund management companies, rather than on their products, i.e. funds. This is due to the far greater diversity of the AIF sector compared to the UCITS one, and consequently reflects the need to avoid creating a common set of product-specific rules for each AIF category.

- **Authorisation and regulation**: The AIFMD requires Alternative Investment Fund Managers (AIFMs) operating within the European Economic Area (EEA)[i] to obtain authorisation from their home country regulator and adhere to the directive's regulatory requirements, including those stemming from the European Securities and Markets Authority (ESMA). Unlike the UCITSD, AIFMD does not include specific authorisation or regulation requirements at the level of the individual funds themselves, only at the level of the fund manager.

- **Reporting, disclosure and investor protection**: AIFMs are required to provide regular reports to regulators, including information on risk management, investment strategies, and any potential systemic risks posed by the funds they manage. The AIFMD establishes rules for marketing AIFs to mostly professional investors within the EU, ensuring a proportionate level of investor protection, through asset segregation requirements and adequate disclosures, among others. On the contrary, the UCITSD does not include provisions on harmonised, regular, supervisory reporting at the EU level. UCITS are only required to send their prospectus and any amendments thereto, as well as annual and half-yearly reports, to competent authorities.

- **Asset allocation and investment restrictions**: Compared to UCITS, AIFs have far more flexibility in terms of asset allocation and diversification rules. Whereas UCITS must follow certain limitations on exposure to specific assets and risk concentrations, AIFs can make greater use of leverage within flexible boundaries and can be exposed to a broader range of asset types, such as private equity, commodities, mortgage-backed securities (MBS), infrastructure, etc.

- **Passporting**: Just like UCITS, once authorised in one EU member state, an AIFM can "passport" its services to other EU member states without requiring further authorisations, making it possible to also market AIFs across the EU, mainly to professional investors.

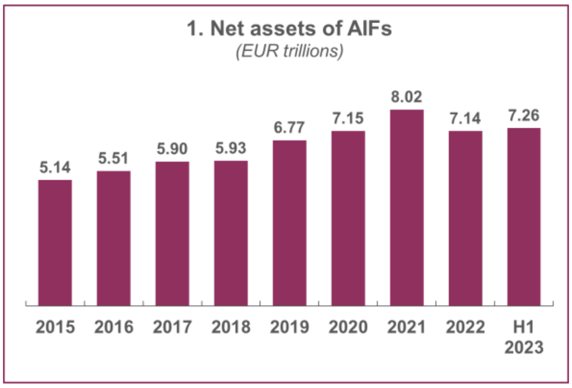
The AIFMD defines an AIF as "*any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it following a defined investment policy for the benefit of those investors and which does not require authorisation according to the UCITS Directive*."[ii]

This definition captures a broad range of financial products that could be regarded as "funds", including all non-UCITS investment funds. Both open-ended and closed-ended funds, and listed and unlisted funds, can be AIFs according to the AIFMD.

It is possible to market AIFs to retail investors, although marketing to retail clients is left to the discretion of individual European countries. AIFs are however primarily targeted toward professional and institutional investors. According to ESMA[iii], about 14% of AIF net assets are currently owned by retail investors EU-wide.

RECENT TRENDS AND COMPARISON WITH UCITS [iv]

AIFs have grown considerably since 2015.[v] Net assets of AIFs rose from EUR 5.14 trillion at end 2015 to EUR 8 trillion at end 2021, only to decline to EUR 7.14 trillion in 2022. By the end of the first half of 2023, net assets of AIFs amounted to EUR 7.26 trillion. Total net asset growth since end 2015 amounted to 41%.



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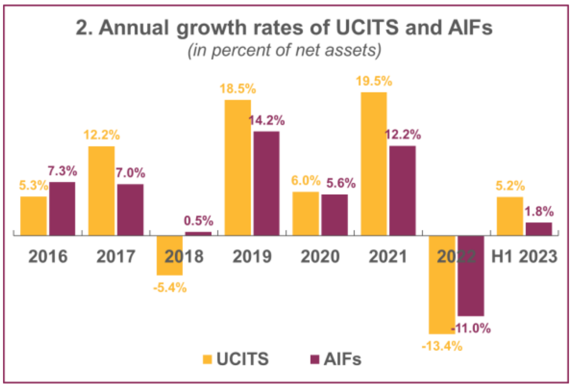


Source: EFAMA

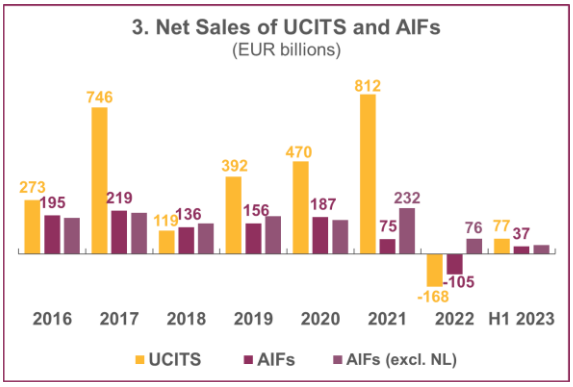
Comparing net asset growth across AIFs and UCITS since 2015 shows that growth rates of AIFs fluctuate less than those of UCITS. In periods of strong stock market growth such as in 2017, 2019 and 2021, the growth of AIFs was clearly more muted than that of UCITS. On the other hand, when stock markets decline, such as in 2018 or 2022, the decreases in net asset valuation of UCITS are larger than those of AIFs.

The more muted fluctuations in AIF net asset growth can be mainly attributed to the fact that AIFs allocate a smaller portion of their assets to listed stocks compared to UCITS. Since stocks can undergo more significant valuation variations than other assets like bonds, cash, or real estate, AIFs experience lower fluctuations in net asset growth.

AIFs also generally experience steadier net sales compared to UCITS. In the 2016-2020 period, net sales of AIFs fluctuated between a high of EUR 219 billion (2017) and a low of EUR 136 billion (2018). Over the same period, UCITS registered a peak of EUR 746 billion (2017) and a low of EUR 119 billion (2018). AIF investors tend to hold their investments for the long term, resulting in fewer significant redemptions during periods of market stress. This is mainly because the primary buyers of AIFs, namely insurers and pension funds, invest regular amounts as they have a steady stream of income. Additionally, some institutional investors exhibit counter-cyclical investment behaviour, utilizing stock market downturns to increase their AIF purchases. Finally, many AIFs are closed-ended, meaning that during a period of market stress, even those investors who would have otherwise redeemed their funds are unable to do as easily as with UCITS funds.

However, in 2021, net sales of AIFs only amounted to EUR 75 billion, compared to the absolute record-high net sales of UCITS (EUR 812 billion). In 2022, net AIF flows turned negative (EUR 105 billion), similar to the UCITS flows that year. The relatively muted net inflows in 2021 and outflows in 2022 were primarily due to substantial net outflows from AIFs in the Netherlands. This was because several large Dutch pension funds decided to manage their assets in segregated mandates rather than in AIFs, a result of the new IFR/IFD prudential rules. Disregarding net sales of AIFs in the Netherlands, net sales of AIFs would have reached EUR 232 billion in 2021 and EUR 76 billion in 2022. During the first half of 2023, net sales of AIFs (EUR 37 billion) were again surpassed by UCITS sales (EUR 77 billion).

Looking at the yearly net sales of UCITS and AIFs in percent of their net assets (see chart 4) gives an idea of the relative size of the respective flows. Also from this perspective, net sales of UCITS tended to be higher than AIFs, especially during periods when financial markets performed well such as in 2017 and 2021. During years when markets were very volatile or suffered from a downturn such as 2016 and 2018, relative net sales of AIFs outpaced those of UCITS.



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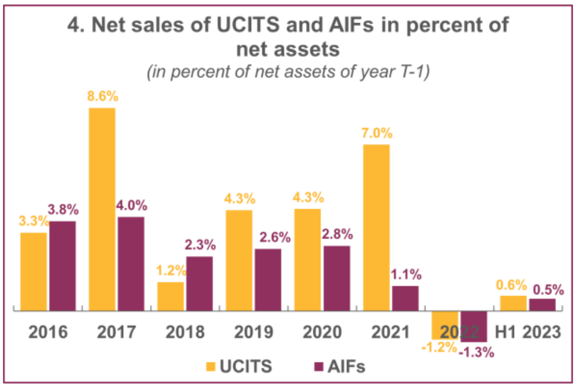
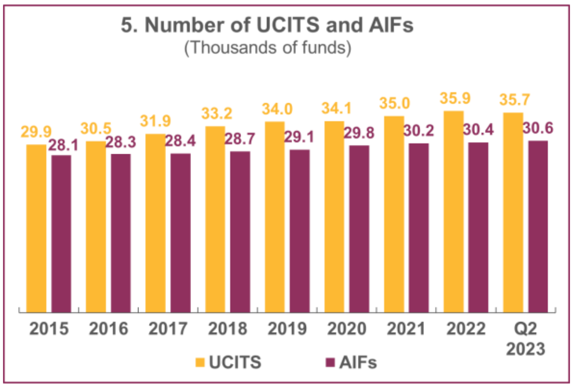


Source: EFAMA

At the end of the first half of 2023, there were just over 30,600 AIFs in Europe and just under 35,700 UCITS. Since the end of 2015 the number of UCITS increased by 19%. The number of AIFs grew at a slower pace, increasing by about 9% since 2015.

Despite a growth in the number of funds, the average size of both UCITS and AIFs increased steadily over the past years, as net sales and market appreciation outpaced the creation of new funds. Since 2015, the average fund size of a UCITS rose from EUR 275 million to EUR 353 million at the end of June 2023, an increase of about 28%. The average size of AIFs grew even more briskly, from EUR 183 million in 2015 to EUR 237 million, a growth rate of 29.5%.



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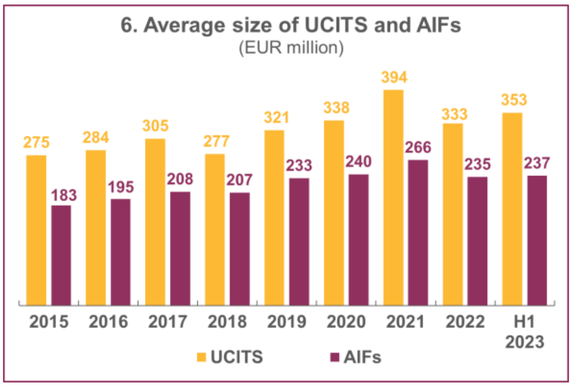
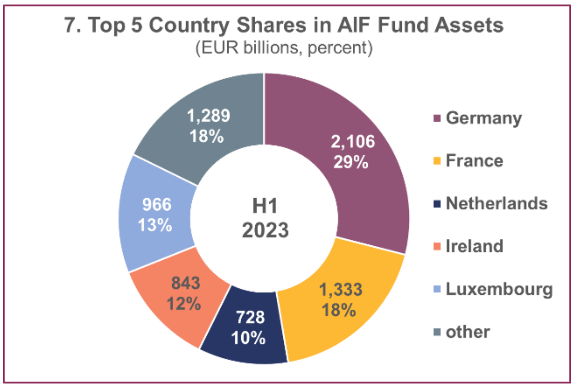


Source: EFAMA

AIFS BY COUNTRY OF DOMICILIATION

Looking at the country of domiciliation of the AIFs, the five largest domiciles accounted for 82.2% of net assets at end H1 2023, compared to a top 5 market share of about 80% in the UCITS market. Germany was the largest AIF domicile with a 29% market share, followed by France (18.4%), Luxembourg (13.3%), Ireland (11.6%) and the Netherlands (10%).

Since end 2015, the AIF market has become gradually more concentrated, with the market share of the top 5 domiciles shifting from less than 80% to more than 82% at the end of H1 2023. The market shares of Germany, Ireland, Luxembourg and France increased, whereas the Netherlands declined for the reason mentioned previously.



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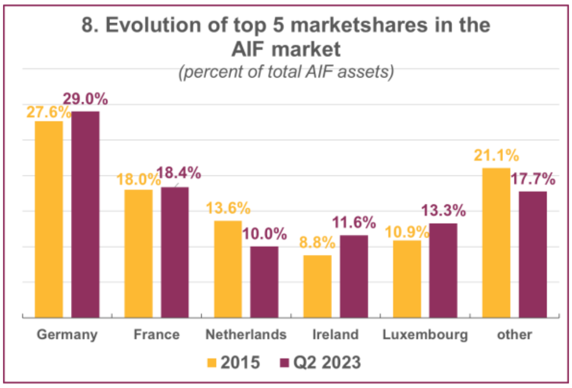


Source: EFAMA

AIF net assets and domestic AIF market shares are, to a large extent, driven by nationally regulated (non-UCITS) funds that existed before the introduction of the AIFMD. These differ significantly across European countries and depend often on how domestic pension, insurance and general financial ecosystems are organised. The table on the next page gives an overview of the country-level figures.

Zooming in on some of the domiciles with the larger AIF market shares highlights these national differences:

- **Germany**, the largest AIF market, has a domestic AIF market share of 82%. It has a longstanding tradition of so-called 'Spezialfonds'. These are funds specifically set up for institutional investors, mainly insurers and pension funds but also other institutional investors such as non-profits, foundations or holding companies. These funds often invest in different asset classes and, as such, they are often classified as multi-asset AIFs. Also in **Austria** (54% AIF market share), the majority of the AIF market consists of 'Spezialfonds'.

- In **France** (60% AIF market share), insurance companies are the main investors into AIFs. French insurers for example make use of them in the management of workplace pension schemes.

	Net assets *(EUR Million)*		Market shares	
	UCITS	AIFs	UCITS	AIFs
Austria	95,302	111,102	46%	54%
Belgium	192,181	2,187	99%	1%
Bulgaria	1,162	138	89%	11%
Croatia	2,028	690	75%	25%
Cyprus	481	7,876	6%	94%
Czech Republic	21,969	2,574	90%	10%
Denmark	163,774	102,369	62%	38%
Finland	123,005	18,560	87%	13%
France	886,927	1,333,269	40%	60%
Germany	469,774	2,105,596	18%	82%
Greece	10,765	5,391	67%	33%
Hungary	1,320	29,233	4%	96%
Ireland	2,975,573	843,409	78%	22%
Italy	239,938	122,326	66%	34%
Liechtenstein	34,595	40,796	46%	54%
Luxembourg	4,232,005	965,741	81%	19%
Malta	2,818	16,457	15%	85%
Netherlands	79,126	727,529	10%	90%
Norway	148,101	10,543	93%	7%
Poland	24,510	41,341	37%	63%
Portugal	17,306	13,258	57%	43%
Romania	3,138	5,221	38%	62%
Slovakia	6,262	2,989	68%	32%
Slovenia	4,411	529	89%	11%
Spain	310,090	37,188	89%	11%
Sweden	506,062	25,907	95%	5%
Switzerland	644,219	181,787	78%	22%
Turkey	36,638	15,519	70%	30%
United Kingdom	1,345,639	494,599	73%	27%

- The **Netherlands** (90% AIF market share) has a very well-developed and large second-pillar pension system. Dutch pension funds often use an AIF wrapper to manage their investment portfolios. Unlike insurers hampered by Solvency II rules, pension funds often invest heavily in listed stocks categorised as equity AIFs. The Dutch market share declined in 2021 and 2022 because several Dutch pension funds ceased managing their assets within AIF structures, switching to segregated mandates due to the introduction of IFR/IFD prudential rules. **Denmark** (38% AIF market share) also has a large pension fund market, with Danish pension funds making use of AIF wrappers.

- **Luxembourg and Ireland** are the two main cross-border fund hubs in Europe. These countries are mainly UCITS hubs though, as their respective AIF market shares only amount to 19% and 22%. Institutional investors in Luxembourgish and Irish-domiciled AIFs are most likely pension funds, insurers and other institutional investors based in other European countries.

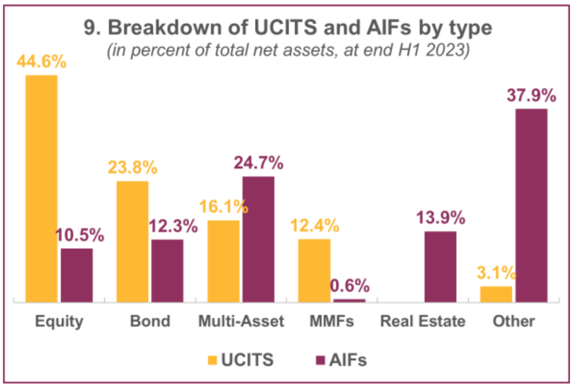
- **Cyprus, Malta** and **Liechtenstein** can be also classified as cross-border fund centres, albeit much smaller ones in terms of net assets. In Cyprus, the domestic AIF market share amounts to 94%, compared to 85% in Malta and 54% in Liechtenstein.

- The bulk of funds domiciled in **Hungary** are AIFs (95% AIF market share), a legacy of pre-AIFMD national regulation. The majority of these Hungarian AIFs are not targeted at institutional investors but rather at retail investors. In addition, **Poland** and **Romania** have relatively high domestic AIF market shares (62.5%).

BREAKDOWN BY FUND TYPE

AIFs can be broken down according to their overall investment strategy. At the end of Q2 2023, 'other' AIFs were the predominant type (37.9%). Other AIFs encompass a wide range of fund types, including private equity funds and hedge funds, as well as securitisation funds, debt/loan funds and commodities funds. What these funds have in common is that they mostly invest in alternative and often less-liquid assets. Multi-asset AIFs accounted for 24.7% of the total AIF market, they were followed by bond AIFs (12.3%) and equity AIFs (10.5%), real estate funds (13.9%) and negligible amounts of money market funds (0.6%). Compared to UCITS, AIFs have a notably lower market share of equity, bond and MMFs and markedly higher shares of other, real estate and multi-asset funds in the total net assets.

Over the past three and a half years, the share of equity AIFs has dropped from 13.9% to 10.5%, essentially because of the stock market downturn in 2022. The share of bond AIFs also declined, as interest rate increases had a negative impact on bond prices. The share of multi-asset funds stayed roughly stable. Real estate funds, and especially other funds, saw their market share increase, as they experienced solid net inflows and the assets these funds mainly invest in (real estate and alternative assets) were significantly less impacted by the 2022 decline in capital markets.



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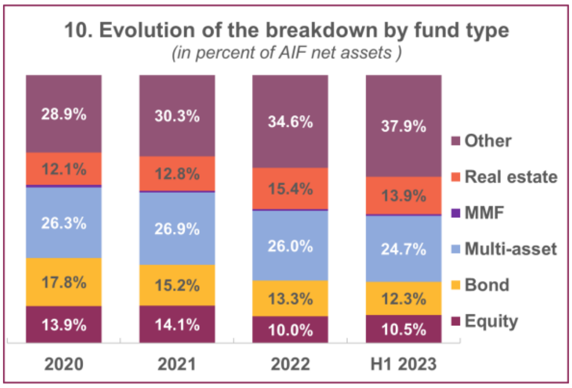
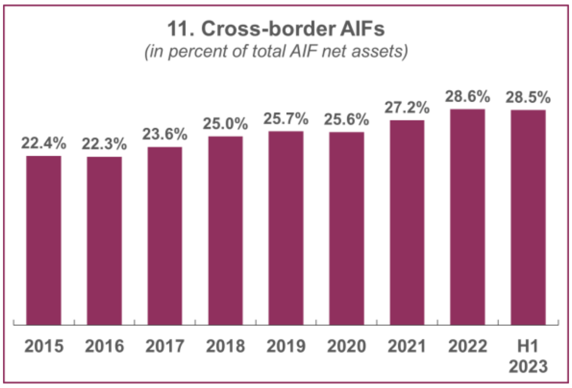


Source: EFAMA

CROSS-BORDER AIFS

AIFs that are not under a National Private Placement Regime (NPPR)[vi], can have a passport and be sold cross-border within the EEA to professional investors. Cross-border AIFs[vii] have been gradually growing in importance: between 2015 and the end of H1 2023, their market share increased from 22.4% of the total AIF market to 28.5%. This is an indication that the passprting regime is generally functioning well and that asset managers are increasingly making use of it.

Compared to the UCITS market, however, the AIF market is still very much focused on home-domiciled funds. While 69% of the total UCITS market could be considered cross-border at the end of H1 2023, less than 30% of total AIFs were sold cross-border.



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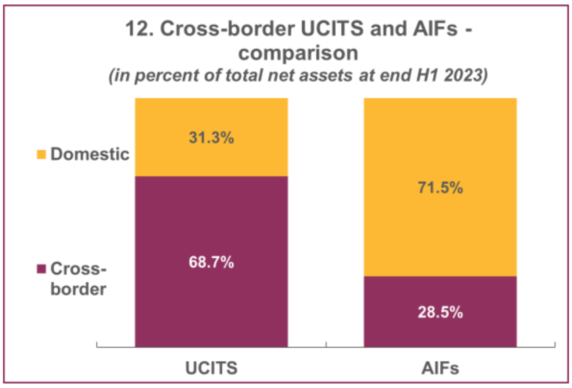

Source: EFAMA

REGULATORY ISSUES: THE AIFMD REVIEW

Since its introduction, the AIFMD regime has proven to be a successful framework for creating an internal market for AIFs, becoming a significant pillar of the Capital Markets Union (CMU). As assessed by the European Commission in the run-up to the recent AIFMD review, the framework has generally met its objectives, offering a good degree of investor protection, financial stability, and market integrity. Therefore, the aim of the review was to address a limited number of areas where further improvements could be introduced. This was broadly achieved during trilogues that were concluded at the beginning of November 2023.

The main areas in scope of the review included:

Rules on delegation

The delegation framework under the AIFMD remains largely unchanged. This is despite views expressed early in the review on the need to further clarify the maximum extent of delegation possible and a necessity for the introduction of a list of functions, to be performed internally by the AIFM. Such additional obligations would have unnecessarily hindered the use of delegation, which is nowadays an important tool for diversifying asset allocation and achieving the risk/reward profiles desired by investors, combined with operational and cost efficiencies. Instead, it is clarified that an AIFM must notify the national competent authority (NCA) about the delegation of any of the functions listed in Annex I[viii], or services referred to in art. 6(4) of AIFMD. Such delegation should naturally not affect the AIFM's liability for potential damages/losses investors may suffer as a result of an improper delegation arrangement. Additionally, new elements of delegation-specific reporting are introduced, both upon authorisation and periodically, including also quantitative data. These changes also apply to UCITS management companies.

Depositaries

The relevant provisions dedicated to depositary institutions in charge of asset safekeeping and monitoring have been slightly broadened. In this regard, a compromise has been found between the lack of a sufficiently competitive supply of depositary services, present in some Member States, and the need to properly safeguard the interest of investors. According to the new rules, a depositary can be appointed in a jurisdiction other than that of an individual fund's domicile under particular circumstances and following a case-by-case assessment by the NCA. This solution is preferable, we believe, to a full-fledged depositary passport.

Liquidity management tools

The review includes important changes to the liquidity management of AIFs, as it introduces new rules on liquidity management tools (LMTs), with a wide list thereof to be included by the Member States in their national legislation. For open-ended funds (OEFs), an AIFM shall select at least two LMTs from: redemption gates, extension of notice periods, redemption fees, swing/dual pricing, anti-dilution levies and redemptions in kind, as well as implement policies for their activation/deactivation. For MMFs, only one LMT is necessary.
The suspension of redemptions/subscriptions and side pockets can be also used in the interest of the OEF's investors. Rules on notification to the NCA about the activation/deactivation of LMTs are included, as well as on information on liquidity management that must be presented to investors. The new regime widely recognises the discretion of the manager to choose appropriate LMTs and when to activate/deactivate them, which is of fundamental importance to an asset manager's "agency" business model. Moreover, the power of the NCA to require the activation/deactivation of suspensions is limited to exceptional circumstances and demands prior consultation with the AIFM. These provisions will also apply to UCITS funds.

Loan origination and loan originating funds

Even though AIFMD is not a product-specific regulation, new provisions to govern loan origination by AIFs were included, with the aim of creating an efficient internal market for such funds. This new regime introduces rules for the activity of loan origination, which includes the granting of a loan directly or indirectly, and more specifically for loan originating funds (LOFs), whose investment strategy is mainly to originate loans, or whose notional value of originated loans represents at least 50% of their NAV. Specific policies, procedures and processes, as well as rules on risk diversification and limits, or information presented to investors, are included in the framework for the activity of loan origination. They are supplemented by exemptions for shareholder loans and the right of a Member State to prohibit loans being granted to consumers. What may be impactful for the further evolution of such AIFs is the obligation to retain 5% of the notional value of each loan (with some derogations) for a specified period of time. For LOFs, new provisions further specify that they must be closed-ended, with open-ended structures allowed only under certain conditions. LOFs would also have to adhere to leverage limits of 175% for OEFs and 300% for closed-ended funds, with those being expressed as the ratio between the exposure calculated according to the commitment method and the AIF's NAV. Two elements specific to borrowing arrangements are also included.

Other elements

In the course of negotiations, references to "undue costs" were added to the framework and in this regard, ESMA will lead work to help develop a common understanding of "undue costs". This approach is not consistent with the AIF's design, which mainly suits professional investors, and the fact that the AIFMD framework addresses managers rather than products themselves. Other elements of a similar nature include a requirement for the name of the fund to be accurate, fair, clear and also not misleading, with a mandate being given to ESMA to provide further guidelines in this regard.

CONCLUSION

The solid growth of the AIF market since 2015 proves that, overall, the AIFMD is functioning well. AIFs clearly have a place, next to UCITS, in providing returns to investors and financing to the economy. The growing importance of cross-border AIFs in particular is encouraging as it is an indication that the deepening of a single European capital market is progressing.

In EFAMA's view, the AIFMD review has remained targeted and should continue to further foster the development of the AIF market. The preservation of the delegation regime and the introduction of a wide range of LMTs are very positive elements. However, the impact of the framework on AIFs active in the area of loan origination is less clear for now, due to the requirements on risk retention and leverage.

Looking to the future, it is important to get the AIFMD implementation just right, as we are convinced that AIFs could play a growing role in the financing of the transition of the European economy to a more sustainable future. The long-term investment horizon of many institutional AIF investors, and the type of assets in which AIFs can invest, make them ideally suited for such a role.

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ENDNOTES

1. *The EEA covers all 27 Member States of the European Union plus Iceland, Liechtenstein, and Norway.*
2. *See Article 4 (1) of the Alternative Investment Fund Managers Directive 2011.*
3. *EU Alternative Investment Funds, ESMA Annual Statistical Report, March 2022.*
4. *This analysis is based on statistics collected by EFAMA from its 28 member associations and Poland. It is worth noting that the European Central Bank (ECB) and the European Securities and Markets Authority (ESMA) also publish data on the AIF market, although covering different countries (the 20 euro area countries in the ECB data and the 30 EEA members in the ESMA data).*
5. *Data is only included from 2015 onwards as data on the complete European AIF market was not yet available in 2013 and 2014.*
6. *EU Member States can allow non-EU asset managers to market AIFs at national level under an NPPR, however,r such funds cannot be passported to other countries.*
7. *Cross-border AIFs are approximated here as all AIFs domiciled in the two main cross-border domiciles - Luxembourg and Ireland - as well as a few smaller cross-border domiciles (Cyprus, Malta, and Liechtenstein). The majority of the AIFs domiciled there are sold to non-domestic investors.*
8. *This includes a list of investment management functions that an AIFM shall perform when managing AIFs and other functions that an AIFM may additionally perform.*

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Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

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