AIFMD II's risk retention rules – How may they impact cross trades between credit funds?

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Credit funds managed by the same sponsor may engage in cross trades, whereby credit assets are transferred between different funds under the sponsor's management. This may happen for a variety of reasons. A loan may be transferred because it aligns better with a fund pursuing a different credit strategy, to achieve diversification, optimize the portfolio's risk-return profile, or because the transferor fund reaches the end of its term. In case of parallel funds, transfers may be required for rebalancing purposes.

The incoming risk retention rules

AIFMD II introduces risk retention rules (RR Rules) that will apply as from April 16, 2026. The RR Rules provide that an EU authorized alternative investment fund manager (EU AIFM) must ensure that when originated loans are transferred to third parties, the transferring alternative investment fund (AIF) retains exposure to at least 5% of the notional value of the transferred loan until the earlier of maturity or 8 years after the loan origination date. Loans that originated prior to April 15, 2024 are exempt from the RR Rules. A recital to AIFMD II clarifies that the purpose of the risk retention requirement is: "to avert moral hazard and maintain the general credit quality of loans originated by AIFs"

The RR Rules are thus designed to deter the origination and subsequent transfer of weak credit exposures. By requiring the originator to retain at least 5%, any deficiencies inherent in the loan will continue to impact the originator after the transfer. As a result, the originator will be discouraged from originating weak loans. AIFMD II also introduces a prohibition on "originate to distribute" strategies. As such strategies are rarely undertaken by AIFs and will simply be prohibited, we do not focus on these rules here.

RR Rules only apply for AIFs managed by EU AIFMs

An analysis of the RR Rules is only relevant if the transferring AIF is managed

by an EU AIFM. There are ample Luxembourg AIFs that are not managed by EU AIFMs but e.g. by US AIFMs. This can thus lead to an unlevel playing field, as AIFs managed by an EU AIFM must navigate the RR Rules, while AIFs managed by a non-EU AIFM do not.

To level the playing field, EU Member States could consider enforcing the rules as soon as a non-EU AIFM registers an AIF for marketing in a member state.

RR Rules are triggered if four cumulative conditions are met

The RR Rules are triggered if four cumulative conditions are met: (i) a loan is transferred; (ii) the loan was originated; (iii) origination was undertaken by the transferring AIF; (iv) the loan is transferred to a third party. The conditions are currently surrounded by uncertainties and no relevant (authoritative) guidance is available. This presents challenges for the industry. Our below insights may assist in establishing market practices.

Condition 1: A loan is transferred

AIFMD II does not define the loan concept, but it can generally be held that loan agreements and transferable debt securities are different legal concepts. A loan is characterized by a lending agreement negotiated between a lender and a borrower, while a debt security is characterized by standard terms and is issued by an issuer to a subscriber. Both products are reported separately under AIFMD's supplementary reporting rules.

Given this distinction, and in the absence of any explicit provision in AIFMD II stating that debt securities fall within the scope of the loan concept, we consider that debt securities, such as bonds and notes are excluded by default from the RR Rules.

Condition 2: The loan was originated

If one would, contrary to the analysis outlined above, take the position that a debt security falls within the "loan" concept, it remains relevant to analyse whether there was an origination process. AIFMD II defines origination as the process whereby the AIF or its AIFM is involved in structuring, establishing or defining or preagreeing the loans characteristics, prior to gaining exposure to the loan.

While a loan agreement undergoes such a process, a classic debt security, such as a bond, is typically not subject to such process, as the issuer is responsible for structuring the bond and determining its terms and conditions; subscribers may choose to accept or decline them, but they generally do not have the ability to define them. Therefore, debt products structured as securities should generally not satisfy the origination condition.

In our view, Conditions 1 and 2 remain subject to a substance over form approach. Therefore, if a debt position is drawn up in the form of a security but has undergone an origination process similar to that of a loan, a substance over form analysis may reclassify it as a loan for AIFMD II purposes.

Condition 3: Origination was undertaken by the transferring AIF

If an origination process is identified, such process must have been carried out by the transferring AIF. If the transferred loan was acquired on the secondary market by the AIF, the RR Rules do not apply. This aligns with the moral hazard concerns, as only the originator is usually aware, because of private negotiation, of any weaknesses in the loan that could be exploited through a subsequent transfer. If the origination process takes place for or on behalf of a transferring AIF, for example through a special purpose vehicle of the AIF or through an agent, AIFMD II clarifies that the loan is originated by the AIF. That clarification makes sense, as the moral hazard risk can arise if the AIF originates the loan directly or does so through a controlled entity or agent.

Condition 4: The loan is transferred to a third party

The third-party concept remains undefined under AIFMD II. What does emerge from AIFMD II is that the third-party condition must be assessed from the perspective of the transferring AIF. To assess whether the transferring AIF is a third party to the transferor AIF, in our view three analytical lenses may be reasonably applied.

First, one may assess whether the two AIFs are ultimately controlled by substantially the same investor base. The approach whereby solely that lenses is applied (irrespective of the criteria mentioned in the second and third approaches below) is the most restrictive: it switches off the RR Rules only if the two AIFs have (substantially) the same investors. What advocates for that view is that it seems fully aligned with the purpose of the RR Rules, as moral hazard cannot arise in such situations as the exposure that comes with the origination process and the risk that come with bad credit will sit with the same investors. Second, the analysis may focus on whether the general partners (or equivalent governance bodies) of the respective AIFs are ultimately controlled by the same sponsor group. Third, one may look to whether the parties responsible for portfolio management of the AIFs -typically the EU AIFM or its delegates – are under common control.

The second and third approaches are less restrictive, yet they can certainly be supported since it is difficult to contend that AIFs overseen by the same manager or under the control of the same sponsor constitute genuine third parties. That usually also follows from the fact that conflict of interest policies are triggered when transfers occur between such funds, which suggests that the funds are not genuine third parties. With the purpose of the RR Rules in mind: moral hazard concerns can arise in such situations, but it is clearly less likely that the same fund manager would disadvantage investors in its fund X for the benefit of investors in its fund Y.

Since the third-party concept has not been further defined, we are of the view that sponsors can, absent further guidance, rely on the second and third lens.

Exceptions to the RR Rules

Even if all four conditions are met, according to one of the exceptions under AIFMD II, a cross-trade of a loan for its full value is not within the scope of the RR Rules if it is carried out because it is necessary to implement the AIF's investment strategy in the best interest of investors. Other exceptions under AIFMD II apply but these are less controversial and are therefore not addressed in this article. Two questions arise with respect to the exception mentioned: (i) what exactly must be evaluated as being necessary and (ii) who decides what is necessary?

On the first point: The text of AIFMD II itself is clear that the necessity of the loan transfer must be assessed in, but the recitals to AIFMD II suggest that it is the necessity of the transfer of also the 5% slice is to be assessed. As the clear text of a directive should take priority over the recitals, and in the absence of any guidance, the view can be validly taken that it is the necessity of the loan transfer that must be evaluated, rather than the necessity of also transferring the 5% slice.

On the second point: An investment strategy defines the fund's targeted assets and risk return profile, whereby the AIFM has discretion to determine what is required to implement the strategy. The view can therefore be validly taken that the necessity of a loan transfer is a rather open norm and subject to the AIFM's reasonable discretion. On the other hand, the recitals to AIFMD II may be interpreted as suggesting a more restrictive approach, in the sense that a transfer would only be deemed necessary if it is implemented to avoid a breach of the investment policy or the regulatory requirements. In the absence of any meaningful guidance on the concept of "necessity," we do not see a clear basis for adopting a restrictive interpretation on the concept. Such a restrictive approach is not expressly reflected in AIFMD II and could, in certain circumstances, run counter to investors' interests.

Conclusion

In the absence of clarifications and authoritative guidance on the RR Rules, a reasonable interpretation of these concepts generally means that the four cumulative conditions set a relatively high bar for application. If the four conditions are met, exceptions may still switch the rules off.