European Leveraged Finance Association

ELFA perspectives on the EU AIFMD review (loan funds) – November 2022

Introduction

- We welcome the targeted nature of the European Commission's legislative proposal to amend the EU AIFMD framework and acknowledge the pursuit of greater harmonisation across the EU regarding the authorisation, operation, and supervision of loan origination funds.
- Indeed; we also welcome the European Commission's acknowledgement that loan funds contribute to the objectives of the EU's Capital Markets Union agenda, as well as the EU's broader climate change agenda and the European Green Deal by providing an alternative source of funding to European corporates, in particular SMEs.
- **However, in our view, there remain a number of key provisions relating to the regulation of loan funds that require further calibration. This is to ensure that loan funds can continue to contribute towards the objectives of the EU's Capital Markets Union agenda and that their operation is not "unnecessarily disrupted" – a key objective of the European Commission in launching the EU AIFMD review. These include:**
    - Ensuring a clearly defined and appropriately scoped framework for loan funds
    - Providing appropriate optionality to managers to structure their loan funds in a way which best suits the underlying investment strategy, including the ability to operate open-ended loan funds;
    - Avoiding provisions that would fundamentally disrupt the provision of an alternative source of financing to EU corporates, such as the proposed introduction of a risk retention requirement;
    - Ensuring appropriate implementation and application of the framework with grandfathering provisions;
- This note provides perspectives for policymakers to consider in seeking to introduce a harmonised framework governing the operation of loan funds in the EU which supports, rather than undermines, the increasingly important role that loan funds play in providing an alternative source of finance to EU corporates and supporting the EU's broader Capital Markets Union agenda.

Ensuring a clearly defined and appropriately scoped framework for loan funds

- In seeking to introduce a harmonised EU framework for loan funds, it is essential that policymakers clearly and accurately define activities relating to the operation of loan funds and, more broadly, appropriately calibrate the overall scope of the framework. Of particular importance are the definitions of 'loan origination' and 'loan originating AIF', which, if properly defined, will ensure an appropriately scoped EU framework for loan funds and related activities.
- Loan origination, in the context of the broader EU AIFMD framework, should be defined as "the granting of loans by an AIF as the original lender". This definition should not include, either explicitly or implicitly, the purchasing of loans originated by a third party on the secondary market nor participation in a syndicated loan, as these activities do not meet the criteria of facilitating a loan as the original lender.
- A loan originating AIF should be defined as "an AIF whose principal activity is loan origination and for which the notional value of the loans it has originated and retained on its balance sheet exceeds 60% of its net asset value". Per the above, this definition should not include, either explicitly or implicitly, an AIF, which purchases loans originated by a third party on the secondary market, nor participates in a syndicated loan, as an AIF which undertakes either or both of these activities, would not meet the criteria to be defined as a loan originating AIF.
- Ensuring a clearly defined and appropriately scoped EU framework for loan funds is crucial to avoiding the detrimental unintended consequences of including AIFs that do not, as their principal activity, originate loans, such as reducing even further the provision of alternative financing to EU corporates (see further comments below in this regard).

Providing appropriate optionality to managers in structuring loan funds

- We believe that the new regulatory framework governing the operation of loan funds must allow for funds to be structured as open-ended or closed-ended investment vehicles where either fund structure most appropriately supports the underlying investment strategy being pursued.
- This would allow managers to implement a broader suite of investment strategies and prospective investors to invest via their preferred structure. Narrowing the optionality afforded to mangers of loan funds would only serve to undermine the European Commission's objective of unnecessarily disrupting the operation of and investment opportunities available to such funds.
- While we note the proposal to require certain loan funds to adopt a closed-ended structure should the notional value of their originated loans (i.e., loans they have themselves originated, in line with the proposed definition of a loan originating AIF) portfolio exceed 60% of their net asset value (NAV) for a continuous period of 15 days, we believe there are more effective liquidity management tools available to manage liquidity within such funds than applying arbitrary thresholds which would, in practice, be challenging to implement.
- An example, supported and adopted by the Council of the EU, recognised that where an AIFM that intends to manage an open-ended AIF can demonstrate to its national competent authority (NCA) that the liquidity management tools it proposes to make available for use in the operation of the AIF are robust. Additionally, it recognised that the redemption profile of the fund would appropriately reflect the liquidity profile of the underlying assets (e.g., through the use of lock-up or run-off periods, prescribed redemption windows, notice periods etc.), then the NCA should be able to authorise the AIFM to operate the open-ended AIF.

Avoiding provisions that would fundamentally disrupt the provision of alternative financing to EU corporates, such as a risk retention requirement

- We believe that requiring an AIF that originates individual loans to EU corporates to retain 5% or even 10% of the notional value of a loan on its balance sheet upon disposal will slow origination activity in the sector, hinder the provision of alternative financing to EU corporates and, ultimately, undermine the EU's Capital Markets Union agenda.
- For example, applying a risk retention requirement as proposed will mean that an AIF would retain an exposure to a loan without any control over the contractual arrangements underpinning the loan, creating potential investor protection concerns where there are issues relating to the performance of the contract and negatively impacting the value of the asset for end investors.
- Instead, to ensure the EU loan fund sector remains globally competitive and that EU corporates retain access to this increasingly important alternative source of funding, we strongly advise policymakers to remove the proposed risk retention requirement and introduce an express prohibition on an AIF pursuing a so-called 'originate-to-distribute' operating model.
- If policymakers believe that it is necessary to further address the risk of loans being originated by an AIF for the sole purpose of onward distribution, we propose the introduction of a minimum holding period for loans held by an AIF where it is the original lender. This minimum holding period could be three months, for example.
- Of course, in introducing a minimum holding period requirement, it would be important to ensure complementary investor protection provisions are introduced in parallel so that an AIFM retains appropriate flexibility to manage any relevant AIF it manages in the best interests of investors (i.e., there may be circumstances in which shortening or disapplying a minimum holding period, upon approval of the relevant NCA, would be in the best interests of investors in the AIF).
- If, despite the known negative consequences for the EU loan fund sector and EU corporates requiring alternative sources of financing, policymakers pursue a risk retention requirement, it is crucially important that, like the broader framework itself, the provision is clearly defined and appropriately scoped. This should include exemptions from the risk retention requirement for AIFs which purchase loans originated by a third party on the secondary market and AIFs which participate in syndicated loans as, again, AIFs which undertake either or both of these activities would not meet the criteria to be defined as loan originating AIFs.

Ensuring appropriate implementation and application of the framework with grandfathering provisions

- While the stated intention of the European Commission in seeking to establish a harmonised EU framework for loans funds was to ensure that such funds can continue to contribute towards the objectives of the EU's Capital Markets Union agenda while ensuring that their operation is not "unnecessarily disrupted", it is clear that the new rules, as proposed, will have significant implications for AIFMs, in-scope AIFs and investors therein. As such, it is essential that grandfathering provisions are introduced to ensure that the new framework for loan funds can be appropriately implemented and applied across the EU.
- Such provisions should align with those set out in the Council of the EU's General Approach, which proposes that: (i) loan originating AIFs constituted before the adoption of the new rules are deemed to comply therewith where they do not raise any additional capital; and (ii) loan originating AIFs constituted before the adoption of the new rules are granted five years to comply therewith where they do raise additional capital.

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