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ESMA Lends Support for a Harmonised European Framework for Loan Origination Funds

A Legal Update from Dechert's Financial Services Practice

April 2016

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April 2016 / Authored by Dechert's Financial Services Practice

Introduction

The European Securities and Markets Authority ("**ESMA**") published its opinion on 11 April 2016 on the necessary elements for a harmonised European framework for loan origination by funds (the "**Opinion**")[1]. The Opinion is issued to the European Parliament, Council and Commission at the request of the European Commission as part of its Action Plan on Building a Capital Markets Union (the "**CMU**"), which was published on 30 September 2015. The goals of the CMU include assessing the need for a coordinated approach to loan origination by funds, and consulting on the elements of a European framework on loan origination. The European Commission intends to consult on that framework in the second quarter of 2016 (the "**Commission Consultation**") and the Opinion, while having no legal force, is a useful indication of the direction of travel.

Which funds are in scope?

The Opinion and Commission Consultation are of fundamental importance to EU fund managers of EU (and potentially also non-EU) funds that conduct loan origination. EU fund managers of other loan strategies, or of funds that invest through loans (for example, buy out or turnaround funds) and even managers of EuVECA, EuSEF or ELTIF could find themselves within the scope of the Commission Consultation and resulting framework. Funds managed by non-EU fund managers that originate loans in the EU could also be affected.

The Opinion focusses on "*loan origination*" which ESMA defines as providing credit while acting as a sole or a primary lender. It distinguishes "*loan origination*" from "*loan participation"* (defined as typically involving secondary market participations) and "*loan restructuring"* (defined as where a fund invests in reaction to the restructuring of debt). However, managers of loan strategies other than loan origination may not be out of scope of the Commission Consultation, which ESMA considers should include the harmonisation of loan participation and activities that fall between loan participation and loan origination. More fundamentally, ESMA's view is that funds "*should provide credit under a suitable framework such that systemic risk is mitigated … and is no higher than that posed by bank lending*".

ESMA considers that the Commission Consultation should review the exemptions relating to loan origination that are currently in place in Member States and available to private equity funds, venture capital funds and hedge funds, and threshold levels of loan originating activities. So the results of the Commission Consultation will be of importance to managers of a wide spectrum of fund strategies.

While the Opinion expressly does not cover the EuVECA, EuSEF and ELTIF regulations, ESMA acknowledges that loan origination is possible (to some extent) for those types of funds, and raises as an option mandatory authorisation under the loan origination regime for managers of such funds (views within ESMA diverge on this point).

ESMA could not reach common ground on all issues and so its Opinion includes more and less interventionist positions on important points. Given the spread of views within ESMA, input from the fund management industry bodies and participants will be important to the Commission Consultation to ensure that the outcome is an appropriate level of regulation.

[1] ESMA/2016/596

Background [2]

While a majority of Member States currently permit loan origination by funds, approaches differ. Some Member States have long permitted loan origination to corporates on an unregulated basis (for example, the UK) while others permit loan origination only through specific regulated fund regimes (such as Ireland[3], Germany[4] and Malta). ESMA considers "*a common approach at the EU level would contribute to a level playing field for stakeholders, as well as reducing the potential for regulatory arbitrage*". An overview of ESMA's assessment of Member States' differing approaches is annexed to the Opinion.

ESMA's key issues for loan origination

(i) Authorisation

ESMA considers that an "*authorisation gateway*" could be desirable for loan origination funds and their managers, particularly to allow assessment of credit origination operational capability, monitor systemic risk, and protect borrowers' and investors' interests. ESMA's desired end goal is a framework that provides national competent authorities with all necessary powers to monitor, supervise and enforce requirements set for both managers and their funds. However, rather than concluding that the AIFMD[5] is sufficient for this purpose, as a number of member states have already done in practice, ESMA appears to be indicating either a further legislative proposal or an instrument supplementing the AIFMD

(a) Authorisation of managers

ESMA recommends that the Commission Consultation should explore mandatory authorisation of managers of loan origination funds. As AIFMD already requires authorisation of managers above *de minimis* assets under management thresholds, the point here appears to be whether or not there should be a sub-threshold regime at all for loan fund managers. However, having re-opened this question, ESMA does not advance any cogent argument for differentiating loan fund managers from any other AIFM in this respect.

(b) Authorisation of funds

A key tenet of the AIFMD is that authorisation is at the level of the manager and not the fund. However, the Opinion suggests that the Commission Consultation should consider whether fund authorisation could be necessary, due to the "risks inherent in loan origination by funds". Again, this approach is at odds with AIFMD and ESMA does not explain why loan origination is perceived to be more risky than other AIF strategies beyond high-level assertions of systemic, liquidity, maturity transformation and imprudent lending risk; which are already addressed by AIFMD and are not unique to loan origination funds or to credit funds more generally.

Jurisdictions such as Luxembourg and Malta have introduced or are introducing fund structures which are AIFMD compliant but which are not subject to any regulatory approval (see for example, the Luxembourg RAIF[6]).

[2] For further information on loan origination, please see the Central Bank of Ireland Discussion Paper on Loan Origination by Investment Funds (July 2013) and, on the US side, an article entitled – "Mutual Funds and Loan Investments", in *The Investment Lawyer* (March 2015) by Stephen H. Bier and Julien Bourgeois of Dechert LLP.

[3] For more information on the Irish loan origination fund structure, please see Dechert OnPoint – "A Borrower and a Lender Be: Irish Central Bank's Loan Origination Fund Rules" (March 2015)

[4] For more information on the German loan origination fund structure, please see Dechert OnPoint – "OGAW-V Umsetzungsgesetz verkündet: Auswirkungen auf Kreditfonds" (March 2016)

[5] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[6] For more information on the Luxembourg RAIF, please refer to Dechert OnPoint "Pending Luxembourg Bill Introduces Widespread Changes Affecting SIFs, SICARs and Part II UCIs" (February 2016)

Luxembourg and other Member States also offer fund structures which are both AIFMD compliant and subject to regulatory approval, such as the Irish QIAIF and Luxembourg SIF. However, not all Member States offer regulated funds subject to a bespoke loan origination regime. For example, it has long been possible to structure private funds in the UK which engage in loan origination activity without any special authorisation at the level of the fund.

(ii) Types and scope of loan origination funds

(a) Liquidity

ESMA considers that loan origination funds should be closed-ended with limited redemption facilities at the manager's election and provided that investors are repaid on a non-preferred and equal basis at fixed intervals.

ESMA is concerned by maturity transformation and potential short-term liquidity problems, and therefore considers that loan origination funds should not be permitted to provide loans with a maturity beyond the life of the fund, and should be required to maintain "*a level of liquidity appropriate to their activities*".

(b) Scope of operations

ESMA notes that one Member State (Ireland) does not permit loan origination funds to conduct non-loan related investment activity (such as equity investment) in addition to originating loans while most other Member States allow loan origination funds to conduct other types of investment activity. The rationale for the Irish approach (following consultations with the European Systematic Risk Board) was to ensure that loan origination is seen as a specialist activity and not an "add-on". However, this has proven to be a commercially unattractive feature of the regime.

ESMA does not express a view as to whether loan origination funds should be restricted from conducting other investment activity, but raises this as an issue for the Commission Consultation and notes that if any resulting restrictions would reduce the types of funds permitted to originate loans, then there would be merit in a grandfathering or transitional regime.

(iii) Types of investors

Several of the Member States with existing loan origination fund frameworks do not permit investments by retail investors in loan origination funds, opting instead for the AIFMD professional investor based criteria. However, ESMA does not close the door to investment in loan origination funds by retail investors, particularly if afforded protections similar to those in the ELTIF Regulation.

(iv) Organisational requirements for managers

ESMA advocates a detailed operational and conduct framework for loan origination funds to mitigate the systemic, liquidity, maturity transformation, financial, legal, and "*imprudent lending*" risks that it identifies (but does not detail). As a minimum ESMA considers that fund managers of loan origination funds should be required to have policies, processes and procedures covering:

- risk appetite statement;
- risk management procedures;
- the assessment, pricing and granting of credit;
- credit monitoring, renewal and refinancing
- collateral management policy;
- concentration risk management policy;

- operational risk control appropriate to loan origination;
- assessment and scoring of borrowers;
- valuation, including collateral valuation and impairment;
- management of forbearance;
- identification of problem debt management; and
- capability and experience of staff.

These overlap substantially with the requirements of the Irish loan origination fund regime, perhaps unsurprisingly as those requirements resulted from consultations with the European Systemic Risk Board.

(v) General requirements for loan origination funds: leverage, liquidity, stress testing, reporting

Member States' approach to the amount of leverage permitted for loan origination funds ranges from outright prohibition (e.g. Spain and Malta) to no stated limitation (e.g. Luxembourg). Although ESMA considers that there should be a set limit on leverage, it notes that loan origination funds should be permitted to incur some leverage in order to allow them to lend to small and medium-sized enterprises, a key focus of the CMU. ESMA recommends that the Commission Consultation assess the permitted amount and types of leverage (whether from credit institutions only or from other sources as well).

ESMA recommends that loan origination funds should be required to conduct regular stress tests and that the results of the stress tests should be reported to the board of the fund manager on a quarterly basis (this requirement is consistent with the stress test requirements of the Irish regime). ESMA also recommends the inclusion of additional reporting requirements into the AIFMD Level 2 Annex IV reporting regime[7] to monitor the activities of loan origination funds and fund managers, and an assessment of possible mitigants to deal with systemic risk of loan origination by funds, including providing regulators with additional macro-prudential tools.

(vi) Diversification, eligible investments and eligible debtors

ESMA recommends that the Commission Consultation consider balancing the need for diversity at the investment level with the potential utility of funds specialised in industrial sectors with limited access to credit institution finance. It considers that loan origination funds should be prohibited from engaging in short-selling and securities financing transactions (including securities lending), from using derivatives other than for hedging, and (as is consistent, for example, with the Irish regime) from lending to individuals, financial institutions, collective investment schemes, its manager and other related parties (such as depositary, general partner, or delegates).

[7] Delegated regulation EU no 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, OJ L 83, 22.3.2013

Summary comparison of the ESMA Opinion against key jurisdictions' current regimes

	ESMA Opinion	Ireland	Luxembourg	UK	Malta	Germany	Italy
Leverage limit	Open	200%	None stated but may be imposed	None stated but may be imposed	No leverage permitted	130%	130% (retail) 150% (professional)
Stress test requirement	Yes	Yes	Risk management process required	Risk management process required	Yes	Yes (risk management)	Yes
Borrower restrictions	Yes	Yes	Yes	No consumer loans	Yes	Yes	Yes
Requirement for credit policies, processes and procedures	Yes	Yes	Risk management process required	Risk management process required	Yes	Yes	Yes
Closed-ended only	Yes	Yes	No	No	Yes	Yes	Yes
Mixed asset classes permitted	Open	No	Yes	Yes	Yes	Yes	Yes
Retail investors permitted[8]	Open	No	No	Limited	No	No	Yes
Diversification requirements	Open	Yes	No	No	Yes	Yes	Yes

Please note that this a high-level comparison which does not take account of the nuances and detail of each jurisdiction's regulatory regime.

Conclusion

The Opinion suggests that the conduct of loan origination by fund managers in the EU is likely to be subject to some sort of additional regulatory requirements following the Commission Consultation and resulting legislative measures. If appropriately implemented, harmonisation of Member States' loan origination regimes may benefit cross-border loan origination activity and the free movement of capital within the EU. Unless lessons have been learnt from AIFMD implementation, that seems a big "if".

Inappropriate implementation could result in an unnecessary additional layer of regulation, uncertainty and costs on top of a regime (AIFMD) that many consider to already be fit for purpose. This could constrict an important source of credit for EU companies (and SMEs in particular), contrary to the intent of the CMU to increase sources of funding for non-listed companies.

[8] Excluding ELTIF, EuVECA and EUSEF

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