Group Briefing

13 April 2016

# ESMA opinion on European framework for loan originating funds

#### BACKGROUND

In an opinion published yesterday, ESMA set out its view on a potential European framework for loan origination by investment funds. ESMA believes that a common approach at EU level would contribute to a level playing field for stakeholders, as well as reducing the potential for regulatory arbitrage. This could, in turn, facilitate the take-up of loan origination by investment funds, in line with the objectives of the Action Plan on Building a Capital Markets Union (CMU) published by the European Commission.

The Commission intends to consult on a European framework for loan origination in the second quarter of 2016. ESMA is of the view that the elements presented in its opinion should ideally form part of a harmonised European framework on loan origination through legislation or by way of an ESMA instrument supplementing AIFMD.

The key elements of ESMA's opinion are set out below.

#### LIQUIDITY

Because of the illiquid nature of loans, ESMA is of the opinion that loan-originating AIFs should be set up as closed-ended vehicles. However, provided that certain conditions are fulfilled, the possibility for redemptions (instigated by the fund on the recommendation of the fund manager) could be offered to investors, on a non-preferred and equal basis, during the life of the AIF, taking place at fixed intervals.

#### MIXING LOAN AND NON-LOAN ASSETS IN A FUND

ESMA notes that member states take different approaches on whether loan-originating AIFs can invest in non-loan assets. ESMA does not make a definitive statement as to whether a limitation on the activities of loan-originating AIFs to investment solely in loans is preferable over a regime in which AIFs can participate in loan-origination and invest in other asset classes.

ESMA states that, should further work by the European Commission result in a reduction in the types of funds permitted to originate loans, a grandfathering regime should apply to funds that no longer meet the requirements of the loan origination framework.

#### LEVERAGE

A limit should be set on leverage employed by loan-originating AIFs. It notes that in Ireland the national legislation provides that the gross assets of loan-originating AIF shall not exceed 200% of the NAV of the AIF. In Italy, the draft legislation on loan origination limits the leverage (the ratio between total assets and the NAV) to 130% for funds marketed to retail investors and 150% for funds marketed to professional investors. In Malta and Spain, loan-originating AIFs cannot be leveraged at all.

#### DIVERSIFICATION

ESMA notes that while the AIFMD does not provide any diversification limits for AIFs, several national loan origination frameworks have introduced such limits. ESMA considers that mandatory diversification is a tool to spread risks. ESMA is of the view that further work conducted by the Commission should focus on the balance between the need for diversification and the potential for loan origination by funds to benefit specialised industrial sectors with limited access to financing through credit institutions.

#### ELIGIBLE INVESTMENTS

In order to limit risk-taking by loan-originating AIFs, AIFs should not engage in short-selling or securities financing transactions, nor make use of derivatives, except for hedging purposes.

### ELIGIBLE DEBTORS

Loan-originating AIFs should not be able to originate loans to the following debtors:

» individuals;

» financial institutions;

» collective investment schemes;

» the AIFM and related parties (e.g. the depositary, general partner, or delegates).

Loans should not be granted to consumers, as this might raise conflicts with the Consumer Credit Directive (CCD), or to other individuals, as there might be national legislation further to CCD regulating lending to individuals.

### ORGANISATIONAL REQUIREMENTS FOR AIFMS MANAGING LOAN-ORIGINATING AIFS

AIFMs managing loan-originating AIFs should be required to have specific policies, processes and procedures in place, governing at least the following:

» risk appetite statement;

» risk management procedures, taking into account specific risks arising from loan origination;

» the assessment, pricing and granting of credit (including criteria, governance and decision making committee structures);

» credit monitoring, renewal and refinancing (including criteria, governance and decision making committee structures);

» 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;

» capability and experience of staff in regard to the specific tasks connected with loan origination.

### STRESS TESTING

ESMA recommends that loan-originating AIFs should also be required to conduct regular stress tests, tailored to their type and level of activity. Results obtained under the stress testing programme should be reported to the board of the AIFM regularly, preferably on a quarterly basis.

### CONCLUSION

Readers familiar with the regime introduced in October 2014 by the Central Bank of Ireland for loan-originating qualifying investor alternative investment funds (QIAIFs) will note that substantial elements of the ESMA opinion are informed by the requirements imposed on loan-originating QIAIFs. Therefore, the Irish loan-originating QIAIFs should be well-positioned to operate within any future European-wide framework. It will be particularly interesting to see what conclusions are reached at an EU level on the ability of loan-originating AIFs to invest in non-loan assets and the levels of leverage permitted. We will keep you updated on developments in this area.

### KEY CONTACTS

If you have any queries on this briefing or require any further details on any aspect of this briefing, please do not hesitate to contact a member of our team.

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