

Result of the public consultation on the ability for investment funds to grant loans

The positions stated in this document stem exclusively from the consultation responses. The AMF's own position is only outlined in the last part of the document.

Between 24 October and 4 December 2015, the AMF held a public consultation on the possibility of French investment funds being allowed to lend directly to businesses. The aim of the consultation was to gather opinions from interested parties.

1. Responses received

The AMF received 26 responses from various stakeholders:

- ten French and international asset management companies;
- five legal firms;
- one bank;
- nine professional associations (AF2I, AFG, FFSA, FBF, AFTI, CCEF, AFIC, CFA, AIMA); and
- the Haut Comité Juridique de Place (*Legal High Advisory Committee for Financial Markets*)

2. Recap of proposals

In the consultation, the AMF proposed to draw together the rules applicable to insurers that grant non-guaranteed loans with the constraints provided for in EU Regulation 2015/760 on European long-term investment funds (ELTIFs). The consultation suggested new obligations based on three levels of rules applicable to asset management companies, to funds and to loans. Given that lending is a very specific business, the AMF proposed that authorisation for a management company to originate loans should be accompanied by a precise definition of responsibilities in terms of organisation, resources (human and technical), expertise (notably analysis of credit risk) and staff experience.

3. The main positions

Respondents to the consultation had fairly divergent views on what the new rules should provide for but regarded the possibility of a fund being able to lend as an additional opportunity to finance the economy.

Two respondents stated that the AMF's proposal to enable French funds to lend is unwarranted. They want the ability to lend to be restricted to authorised ELTIFs, in accordance with European regulations.

A dozen respondents supported the principal AMF proposals but suggested adjustments on matters such as the minimum loan term, additional responsibilities for management companies and new operational and legal risks stemming from direct lending as opposed to the acquisition of unmatured loans.

Around 15 respondents, mostly management companies, believed that it would be unwarranted to extend the constraints of the ELTIF regulation (no maturity transformation or leverage and no recourse to derivatives, securities lending or short selling) to other funds able to lend. According to five respondents, granting a loan does not generate risks over and above those already implicit in selecting loan receivables, as credit risk is the only risk that investors care about. These respondents argued that all funds authorised to invest in loan receivables should

also be able to grant loans, including funds open to retail investors (retail investment funds and private equity funds that can invest up to 10% of their assets in loan receivables).

Almost all the respondents to the consultation supported the proposal that management companies should be able to recover outstanding loans and debt themselves and that there should be no rule on the minimum quality of loans granted. In contrast, almost all respondents opposed the suggestion of a minimum two-year loan period and the proposal that loans should be restricted to European beneficiaries.

In conclusion, some stakeholders would like more liberalisation to enable French funds to become the most competitive in Europe, while two respondents do not want funds to be able to lend beyond the limits set by the ELTIF regulation.

4. Summary of responses to each question

Section 1: Constraints applicable to management companies wishing to grant loans

1. Do you think that the management company's authorisation under the AIFM directive should be sufficient to enable the funds it manages to grant loans?

The majority of respondents (22/26) support the proposal that management companies wishing to grant loans will have to be authorised in accordance with Directive 2011/61/EU (AIFM).

One respondent raised the question of lending powers being extended to management companies for securitisation vehicles that do not have AIFM authorisation; in contrast, three respondents emphasised the importance of having a depositary compliant with the AIFM directive rather than a securitisation vehicle depositary.

One respondent wanted management companies or funds to be authorised by the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR).

Another respondent envisaged that management companies specialising in lending should not undertake any other management activity.

2. Do you think that the proposed additional constraints, which would be applicable to all management companies henceforth authorised to select loan receivables or grant loans, would be sufficient?

As far as the introduction of new rules is concerned (notably those relating to the credit risk analysis system taken from the decree covering insurance companies and loan-to-real economy funds), four respondents underline the need to distinguish between different forms of debt or loan selection that require very different types of expertise:

- the acquisition of a large number of loans selected randomly on the basis of predefined criteria, as in the case of the securitisation of a credit institution's loan portfolio ('statistical' credit risk analysis);
- the individual selection of a small number of unmatured loans, for example in an infrastructure fund, a loan fund or a diversified fund granting loans; and
- the use of debt instruments issued by a company already present in the fund portfolio.

More generally, a dozen responses emphasised the importance of proportionality in the application of rules, and depending on the proportion of net assets that the loans would represent. Seven management companies wanted to be able to lend as part of a diversified strategy and considered that the proposed obligations would be too onerous from this point of view.

The AMF also proposed that management companies use an external independent assessor to analyse the risk of a loan when it is to be granted to a company with a capitalistic tie to that same management company. This proposal prompted numerous questions from respondents, who wanted to know what sort of assessor would be required and why the AIFM valuation rules would not be enough.

One respondent said that loans should always be assessed at their fair value rather than on an amortised cost basis, thereby taking account in the fund's net asset value of any change in the debtor's risk of default rather than waiting for a past due payment.

3. Do you believe other requirements should be applied to a management company that wishes to be able to select loans (rather than granting them) for one of its funds?

The majority of respondents (13/23) did not want additional constraints on loan selection.

4. Do you think that additional constraints should be imposed on management companies that would grant loans relative to the (amended) authorisation to select loan receivables?

Six respondents thought that constraints on French funds permitted to grant loans should be limited to those applicable to ELTIFs in order to maintain the Paris market's competitiveness.

A third of respondents emphasised that asset management companies should have enough legal resources to understand and apply all the obligations on lenders, including:

- banking monopoly and banking secrecy rules in the debtor country's country. In France, and quite apart from banking monopoly considerations, management companies will have to pay attention to other codes. The General Local Authorities Code prohibits local authorities from borrowing from bodies other than credit institutions and finance companies, for example;
- banking jurisprudence, which in France includes undue support, the obligation to warn the credit provider, the duty of vigilance and the duty of non-interference;
- money-laundering rules¹ and anti-terrorism financing at borrower level;
- up-to-date KYC obligations and the credit provider's duties of advice and information.

Section 2: Which funds could grant loans?

5. Will the granting of loans by specialised professional funds, securitisation vehicles and professional private equity firms improve the financing of the economy?

All the respondents to the consultation saw advantages in the possibility that funds could grant loans, particularly for long-term financing that new prudential regulations could deter banks from providing.

The other examples of uses for the proposed regime mentioned were loans to SMEs, infrastructure lending, loans to companies targeted by private equity funds and corporate treasury funding (although two respondents did not want to see funds lending for this purpose). Several respondents anticipated growing corporate interest for fund loans in the event of a shift to a less accommodating monetary policy.

Two respondents argued that authorising funds to grant loans would improve transparency for the borrower relative to the current situation, where the borrower is not necessarily informed of the sale of its debt to a fund.

¹ Management companies' efforts on anti-money laundering are focused essentially on fund liabilities (the sale of fund units); funds able to lend will have to focus on fund assets as well.

The majority of responses approved the limitation of the lending authorisation to professional funds.

That said, four asset management companies sought a wider scope, including all funds that can already invest in loan receivables. This would include retail investment funds, which can already invest up to 10% of their net assets in debt.

6. Would a requirement that funds granting loans must be closed-ended or limit their redemptions be a sufficient limitation? Do the conditions provided for in the ELTIF regulation to limit redemptions appear appropriate?

Half of respondents supported the AMF's proposal to limit redemptions, given the illiquid nature of loans.

More than a third of respondents believed that ELTIF rules should not be applied to all funds wishing to lend, however, and that they should not be subject to redemption constraints. They considered that certain loans – to CAC 40 companies, for example – could be sold on swiftly and did not want a fund's ability to grant loans as part of a diversified strategy to prevent it redeeming units using liquid assets held in its portfolio. Various respondents suggested the following alternatives:

- unlimited redemption possibilities twice a year;
- significant, regular redemption possibilities but with considerable notice; or
- not imposing any rules and leaving it to the asset management company to calibrate the liquidity of the fund's liabilities on that of its assets, in line with the obligations of the AIFM directive.

7. The proposed funds (specialised professional funds, securitisation vehicles and professional private equity investment funds) are currently declared funds. Should all funds be approved so that they are authorised to grant loans, or is the authorisation for the management company, as proposed in Section I, sufficient?

With the exception of one respondent, who wanted funds to be authorised by both the AMF and the ACPR, stakeholders did not consider it necessary for the fund to be authorised as well as the management company.

8. Are there any particular cases other than those explicitly provided for in the Monetary and Financial Code in which funds other than specialised professional funds, securitisation vehicles and professional private equity funds should be able to lend? Do you see any reason not to apply the additional constraints proposed in this consultation to them?

A dozen respondents considered that all funds exempted from banking monopoly rules should be able to lend, so long as debt is one of their eligible assets (notably retail and professional investment funds).

Three respondents highlighted the importance of excluding current-account advances from the new rules.

Responses included the following points:

- the importance of retaining the ability to grant participating loans or other loans that companies established under ordinary law can grant;
- provision should also be made for foreign funds that would be able to lend in France;
- the new rules must not affect the specific case of the restructuring of a company in the portfolio of a fund that has no authority to lend in any other way.

One respondent argued that funds should be able to repay non-invested capital to investors before the fund's closing date, just as with private equity, and should be able to reinvest capital and interest in new eligible loans.

Section 3: Constraints on funds granting loans

9. Does the restriction on leverage make it possible to limit the specific risks related to loan origination?

Half of respondents to the consultation wished the French regime to be competitive and voiced support for the Irish system, under which funds can borrow up to 100% of net assets to on-lend.

In contrast, the other half of respondents agreed with the AMF's proposal that limits on borrowing would limit risks and prevent loan funds being used by credit institutions wishing to avoid direct lending.

10. Do you believe the prohibition on short selling, securities lending and the use of derivatives other than for hedging purposes for a fund that originates loans would be effective in curtailing risk?

The majority of respondents supported constraints on short selling, securities lending and the use of derivative instruments. Some suggested authorising the use of derivatives for hedging purposes beyond interest-rate and currency risk, for example to hedge exposure to a commodity where an infrastructure project uses that commodity as a raw material.

Eight respondents wished to authorise short selling or derivatives for diversified investment funds able to lend.

Section 4: Constraints on loans

11. Should loans have a minimum and/or maximum maturity as proposed?

Three respondents wished loans to be reserved to long-term financing (longer than five years, according to one respondent). All others were opposed to a minimum loan maturity.

Opinions on a maximum loan maturity were mixed, just as they were on the possibility of permitting redemptions of units in lender funds. Seven respondents considered that a fund should be able to grant loans for a period longer than its own life if the management company believes it can sell those loans on upon the fund's liquidation (like shareholdings in unlisted companies).

12. Beneficiaries of loans:

a. What financing needs are the loans granted by funds most likely to meet (infrastructure, part of a bank syndication, SMEs, short-term, etc.)?

A wide range of examples was given, from SME financing to financing for agencies, infrastructure, real estate via short- or long-term loans, subordinated or senior loans, loans as part of banking syndications and leveraged buyouts (LBOs).

b. Do you think there is a risk that funds will grant loans only to companies whose loan applications have been rejected by banks?

The majority of respondents agreed that this adverse selection risk exists but considered that asset managers' experience would be a sufficient criterion for estimating this risk correctly.

- c. What do you think about the exclusion of loans to financial companies (credit institutions, insurers, common funds, holding companies, financial companies whose purpose is not to finance a commercial, industrial, agricultural, craft or real estate company or a physical asset, etc.)?**

Four respondents did not want the exclusion of loans to financial companies but the majority of respondents supported the AMF's proposal to limit loans to firms and holding companies that themselves invest in the economy.

- d. Should the beneficiaries of the loans be exclusively European?**

The vast majority of respondents opposed the AMF's proposal to limit loans to European companies on the grounds that the ELTIF regulation does not contain any such limitation and geographical diversification can be an effective means of diversifying risk.

Only three respondents favoured the limitation of loans to European countries.

- 13. Should there be less onerous constraints for loans guaranteed by a state, a credit institution or secured with specific collateral, as is the case for insurers?**

The few responses communicated on this matter did not propose less onerous constraints when loans are guaranteed.

- 14. Should loans granted by funds be of a minimum quality defined by regulation?**

All the respondents supported the AMF's proposal that no minimum quality should be imposed *a priori*, as the risk taken will depend on what investors want.

Section 5: Other matters

- 15. Should management companies be able to directly recover debt, or would it be necessary to provide, similarly to what is currently provided for securitisation vehicles that purchase loans (L. 214-172), that recovery be entrusted to another entity?**

The vast majority of respondents believed that management companies should be able to recover debt directly, as that forms part of the credit management process. One respondent suggested partnerships with bailiffs to provide a systematic recovery method.

Two respondents considered that it was not appropriate for the management company to recover debt, as "it is not their core business and requires specific expertise".

On collateral, several respondents asked that the AIFs authorised to grant loans would be able to benefit from the French Dailly Act provisions on the assignment of receivables for guarantee purposes.

As far as guarantees are concerned, two respondents noted that management companies will have to be vigilant on the failure to receive collateral or its pledge in favour of another lender, as well as on the eligibility of guarantees linked to the lender AIF's assets (non-financial instruments, for example) and their valuation (collateral in the form of illiquid assets or assets hard to realise in the event of default should be avoided).

16. Should other aspects of the granting of loans be restricted by the AMF?

Respondents raised the following points:

- the importance of tax incentives, particularly for ELTIFs open to retail investors;
- the importance of cross-border operations, both to sell fund units throughout Europe and to grant loans in any country;
- loan standardisation would increase their liquidity and make them more like securities;
- a legal definition of 'loan selection' would be helpful.

5. Conclusion : AMF's proposals

The French government is working on the *Conseil d'Etat* decree that could be adopted on the basis of Article 27 of the supplementary budget Law (*Loi de finances rectificative*) for 2015. The AMF will then publish its requirements to extend the programme of operations of a management company to grant loans.

The following proposals of the AMF were sent to the government for the drafting of the abovementioned Decree and will serve as guiding principles for the AMF policy.

1. The AMF would like the rules concerning the possibility of French investment funds being allowed to grant loans to impose equivalent principles between different lenders in a secure and clarified legal framework that takes into account each participant's business model.

2. Asset management companies wishing to grant loans should be authorised by the AMF in accordance with Directive 2011/61/EU (AIFM) and have a programme of operations approved by the AMF Board for this activity. The AMF will be particularly rigorous in authorising management companies to grant loans, notably in terms of organisation, resources (human and technical), expertise (a credit risk analysis system equivalent to that provided for in the Order of 9 December 2013 relative to loan investment rules for insurance companies) and the experience of the relevant staff (via experience in a credit institution, for example). Management companies will also have to carry out legal checks to ensure that they are meeting all the obligations required of lenders (banking jurisprudence, anti-money laundering rules, etc.) and will have to implement all appropriate risk management measures, including perhaps an increase in their own funds.

3. Non-French management companies that manage French funds from which they wish to grant loans should show that they are authorised to grant loans by their national regulator.

4. Specialised professional funds, securitisation vehicles and professional private equity funds should be the only funds able to grant loans. All of the following constraints on funds granting loans should apply whenever lending is no longer an ancillary activity, i.e. when loans represent more than 10% of the fund's net assets:

- these funds should be closed to redemptions, or redemptions must be limited to a percentage of assets, in order to prevent any liquidity transformation;
- loans granted by these funds should be limited to non-financial companies and should have a maturity shorter than the fund's own life to prevent any maturity transformation;
- recourse to leverage for the purposes of lending should be prohibited. Borrowing should be authorised up to 30% of the fund's net assets, and only on condition that it is not intended to finance lending, as provided for European long-term investment funds;
- funds granting loans should not have recourse to short selling, securities lending or derivative instruments except to hedge interest rate or currency risks;
- loans should be granted following a *buy and hold* strategy. The assignment of loans originated by the funds should be limited in order to prevent the emergence of *originate and distribute* models.

5. Asset management companies will have to submit a quarterly declaration to the AMF and Banque de France on all the loans they have granted. This will enable the authorities to monitor loan trends.
6. Management companies should be allowed to make direct recovery of loans they have granted.