Legal high Committee for
Financial markets of Paris

OPINION

of the Legal High Committee of the Paris Financial Center (HCJP) regarding the French Markets Authority's (AMF) request for public comments on the possibility for investment funds to grant loans

Paris, November 25, 2015

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The French Financial Markets Authority (hereafter called "AMF"), in a public consultation running from October 19 to December 1st, 2015, has requested the opinion of all interested parties regarding the possibility for French investment funds to lend money directly to companies.
The Legal High Committee of the Paris Financial Center approved the following opinion at a meeting held on November 25, 2015.

Although French legislation currently allows certain funds, including securitization entities, to acquire receivables, it does not allow investment funds to grant loans directly to companies.

European Long-term Investment Funds (ELTIF) will have such an opportunity following a European regulation dated April 29, 2015 which is to come into force on December 9, 2015. Meanwhile, a number of Member States have opened up this possibility to alternative investment funds, generally reserved to professional investors only.

1- These developments have led the AMF to consider allowing some French funds -specialized professional funds, professional private equity funds and securitization entities- to grant loans to non-financial European companies, on the following conditions:

a) Management companies that wish the funds they manage to have such a right should be approved according to the Alternative Investment Fund Managers (AIFM) Directive and have an approved activity program for the purpose of managing receivables. These companies, therefore, in particular, should develop specific procedures for analyzing, measuring and monitoring credit risk, as provided in the Decree dated December 9, 2013 on investment rules for insurance companies providing loans or investing in loan funds to the economy.

b) Funds allowed to lend money should ban or seriously limit redemptions during the existence of said funds, so that the loan can be performed without maturity transformation.

c) For the same purpose, the maturity of the loans should not exceed the term of the funds.

d) Loans should not be financed by borrowing, so that the funds cannot leverage the loan. In the same spirit, the funds should not engage in short sales, loans/borrowing of securities or repurchases and should use derivative instruments only to hedge their risks.
These characteristics justify that the funds involved should not be subject to capital adequacy and liquidity ratios set out for banks.

2- These provisions are inspired by the provisions applicable to the ELTIF. They differ from them, however, in the following respects:

a) Such funds may be marketed only to professional investors, as defined by the MiFID Directive, whereas ELTIF may also be marketed to retail investors with a portfolio of at least 100,000 euros, which is much less restrictive than the requirements set out under MiFID to be admitted as a professional investor.

b) Even if management companies are subject to the AIFM approval, as well as to approval of their activity program aiming to manage receivables, the French funds concerned are simply reported, whereas the ELTIF must obtain a product license.

c) Assets eligible for ELTIF are not only loans to unlisted non-financial companies or to companies the capitalization of which is below 500 million Euros –conditions that could be transposed to the French funds as well, given that this directs investment towards SMEs- but also physical assets of over 10 million euros.

d) A minimum period of 2 years for the loans is proposed for the French funds, which is not specified for the ELTIF.

3- The Legal High Committee of the Paris Financial Center approves the proposed provisions, subject to the following observations:

a) Since the ELTIF European regulation is directly applicable and allows no exceptions, the competent authority may not deny approval to funds that meet the criteria of said regulation, including the possibility of commercializing them to non-professional investors in accordance with the requirements of said European regulation.

b) Regarding the French funds, amendments to harmonize the contemplated rules with the ELTIF rules could helpfully be introduced as follows:

• Regarding eligible companies, the condition to be unlisted or, if listed, to have a capitalization below 500 million euros should be applied, in order to direct the collected funds towards the financing of SMEs, which is a priority.

• Regarding the length of the loans, while it is essential to limit their duration to the term of the funds, the Committee does not see the usefulness of setting a minimum term of the loans to two years. Indeed, this requirement would make impossible any cash loan, which may be useful to meet the companies' temporary needs.

c) Finally, in addition to the possibility of constituting a diversified portfolio of loans, which rightly reserved to professional funds, subject to significant requirements regarding control of credit risk, it would be appropriate to open to private equity funds, even non-professionals, the possibility, as an accessory to their activity, of making loans other than the advances made by partners, which are already permitted, to companies in which the funds have a significant shareholding. Indeed, they can be subject to lighter requirements regarding control of credit risk because they are, as shareholders, in a position to monitor and assess their solvency.

The Chairman, Michel PRADA

ANNEXE

Public consultation of the French Markets Authority's (AMF) on the possibility for an investment fund to originate loans

The purpose of this consultation is to gather the opinions of all interested parties about the possibility for French investment funds to lend directly to businesses. This consultation is open from 22nd October to 4th December 2015.

Groups concerned

This consultation is open to everyone and is directed particularly to asset management companies, institutional investors, and any other players in the financial markets (particularly industry groups), as well as companies likely to borrow from investment funds.

How to submit your response

Contributions to this consultation must be sent, by 4th December 2015, to the following e-mail address: directiondelacommunication@amf-france.org

Background

The AMF would like to clarify the possibility for French funds to grant loans.
Currently, a banking monopoly exemption, provided for in Article L. 511-6* of the Monetary and Financial Code for UCITS** and certain AIF***, allows certain funds to acquire unmatured loans. However, this exemption is not enough to authorise them to lend since the specific regimes of each of these AIF have specific provisions which specify in particular their purpose and the assets that are eligible to them. Articles R. 214-19 I for UCITS and R. 214-32-28 I for retail investment funds (FIVG) explicitly specify that these funds cannot grant loans. Article L. 214-154 and Article D. 214-219, which respectively define the assets eligible for specialised professional funds (FPS) and securitisation vehicles (OT), do not explicitly authorise loan origination****. In addition, there are many financial instruments eligible for the assets of a fund that have economic effects equivalent to a loan (swaps, repurchase agreements, long dated bonds, etc.).

** Which refers to "UCITS [and] AIF under paragraphs 1, 2, 3, and 6 of sub-section 2, and sub-sections 3, 4, and 5 of section 2 of chapter IV of title I of book II".*

*** Undertakings for collective investment in transferable securities (UCITS) are governed particularly by directive 2009/65/EC.*

**** The alternative investment funds (AIF) concerned are retail investment funds, professional private equity funds, funds of alternative funds, funds open to professional investors and employee investment undertakings, and securitisation vehicles.*

***** Article D. 214-219, applicable to securitisation vehicles, stipulates that "The loans mentioned in 1° of Article R. 214-218 that are eligible as assets in the securitisation vehicle are:*

1° Loan resulting from either an act that has already occurred or an act that is to occur, regardless of whether the amount and due date of these loans have been determined or whether the debtors of these loans are identified, including capitalised, doubtful, or disputed loans;

2° Loan securities, each representing a loan claim on the entity that issues them, transferable by book entry or by physical delivery.

The acquisition of loans by the securitisation vehicle is done through the assignment of loans to the vehicle. However, the vehicle may directly subscribe to the issue of the loan securities referred to in this 2°."

The entry into force of regulation no. 2015/760 on European long-term investment funds (ELTIF) in December 2015 raises the issue of the possibility for French funds to grant loans. This directly applicable regulation allows European long-term funds to lend under restrictive conditions. However, a fund applying to be authorised as ELTIF must be a French AIF and will have to comply with both the French law applicable to the legal form chosen for the AIF and the European regulation. As such, if the French legal form does not allow the fund to grant loans, the fact of being authorised as an ELTIF will not mean the fund can grant loans, because both French and European constraints apply. Given the issues in terms of investor protection and competitiveness of the Paris market, the AMF is considering the possibility of adapting the French rules to allow French funds to grant loans.

General principles of the AMF's consideration

The AMF's consideration of the possibility for funds to lend is based mainly on i) the ELTIF regulation and ii) the regulatory provisions applicable to insurance companies so as to ensure uniform treatment between lenders within a secure legal framework. However, investment funds present specific characteristics and differ from banks, which lend with the transformation of maturity and an obligation to return their customers' deposits. This justifies the prudential requirements in order to restrict liquidity risk and ensure solvency.

Rules applicable to insurance companies and loan-to-real economy funds:

Insurance companies can grant unsecured loans in accordance with Article R332-2 paragraph 12 of the Insurance Code, under the conditions defined in Article R 332-13.
According to Article R 332-13, loans must have a maturity of at least two years and could possibly not be backed by collateral when they have a sufficient credit quality and are granted, as part of a programme authorised by the Prudential Control and Resolution Authority, to non-financial private legal entities* or private legal entities holding stakes in the capital of financial companies**.
The decree of 9 December 2013 relating to investment rules for insurance companies in loans or loan-to-real economy funds specifies the system for analysing and measuring risks that must be put in place. This decree extends these obligations to management companies that manage loan-to-real economy funds on behalf of insurance companies.

** a) Private legal entities of Member States of the European Union, engaging primarily in a commercial, industrial, agricultural, craft, or real estate activity, to the exclusion of financial activities and collective investment undertakings other than real estate collective investment undertakings;*

*** b) Private legal entities of Member States of the European Union whose purpose is exclusively or, depending on the case, mainly, in addition to the performance of a commercial, industrial, agriculture, craft, or real estate activity, to the exclusion of financial activities, to directly or indirectly hold one or more stakes in the capital of legal entities mentioned in point a, or to exclusively finance the export, acquisition, or operation of equipment or infrastructures, for the benefit of a Member State of the European Union, a regional or local authority, or a public institution of a Member State of the European Union or a person or entity mentioned in point a.*

The AMF's proposal is built around three levels of rules applicable to the management company, funds, and loans. The details of these rules are subject to consultation. However, the AMF assumes that funds granting loans will need to limit redemptions and target qualified investors because of the illiquid nature of the loans. In addition, loans granted by funds are not intended to be granted to individuals or financial companies, and their term must be restricted.

Beyond the regulatory principles proposed in this consultation, the AMF will be particularly demanding when approving management companies to grant loans. As lending activity is by nature very specific, the authorisation for a management company to grant loans will need to be accompanied by a precise definition of strong obligations in terms of organisation, resources (human and technical), expertise (credit risk analysis in particular), and experience of the persons involved in the management companies.

1- Constraints applicable to management companies so that they can grant loans for their funds

Proposal: management companies wishing to grant loans will need to be authorised in accordance with directive 2011/61/EU (AIFM) and have an authorised activity programme to manage loans (instrument listed in article 7 of AMF instruction 2008-03).

Management companies currently authorised to select loans or manage loan-to-real economy funds are not necessarily authorised in accordance with the AIFM directive (like management companies managing securitisation vehicles that fit in the exemption in article 2. 3) of the AIFM directive).

In particular, the application of the AIFM directive and its transposition into national law to management companies wishing to grant loans would add the following obligations that seem essential to lending by funds, notably:

- the obligation to have an asset valuation that is external or independent from the management team;
- effective and documented risk management procedures adapted to credit analysis;
- a policy for managing conflicts of interest;
- an in-depth inspection by a depositary;
- a policy of variable compensation for risk-takers permitting an alignment of interests between risk-takers and investors.

It is proposed that no specific authorisation be created for management companies that want their funds to be able to grant loans, but the existing constraints for the authorisation to select loans should be reinforced by adding the obligations of analysing and measuring risks provided for in the decree of 9 December 2013 relating to rules of investment in loans or loan-to-real economy funds for insurance companies.

It is thus proposed that the system for analysing the credit risks of management companies should consist of:

1° A written procedure for investing in loans, defining exposure policies by credit risk category;

2° A procedure for selecting credit risks including:

a) The establishment of credit files to collect all qualitative and quantitative information about counterparties;

b) A procedure for taking a decision to invest in a loan, which must be clearly formalised, describing the organisation of delegations, relying on an analysis in which the responsible person has no direct interest in the investment decision, and adapted to the characteristics of the company, particularly its size, organisation, and the nature of its activity. Decisions to invest in a loan are taken by at least two persons.

3° A system for measuring credit risks making it possible to:

a) identify, measure, and aggregate the risk resulting from credit operations and understand the interactions between this risk and the other risks to which the company is exposed;
b) understand and control the concentration risk and the residual risk through documented procedures;
c) verify the appropriateness of the diversification of loans for the investment policy.

4° A procedure for proportionate monitoring, on a quarterly basis, of changes in quality of each of the loans taken individually to determine, as necessary, the appropriate levels of impairment to be applied to the value of the loans.

These additional constraints would make it possible to generalise to funds that select loans the obligations applicable to managers of loan-to-real economy funds and insurance companies that grant loans, particularly in terms of quarterly monitoring of changes in credit risk and human resources. They would be applicable to all new requests for approval to select loans but not applicable retroactively to management companies already authorised, unless they also wish to be able to grant loans. At the end of a three-year transition period, all the management companies authorised for the selection of loans would be subject to these new requirements.

In addition to the rules on conflicts of interest of AIFMs, it is proposed to require management companies to use an independent external assessor* to analyse the risk of a loan, when it is granted to a company that has a capitalistic tie with the management company.

** This independent external assessor would not be the same independent assessor provided for by the AIFM directive.*

Questions :

1. Do you think that the management company's authorisation under the AIFM directive is a rather secure framework to allow the funds it manages to lend?

2. Do you think that the proposed additional constraints, which would be applicable to all asset management companies authorised going forward to select or grant loans, are sufficient?

3. Do you see other requirements that should be applied to an asset management company that would like to be able to select loans (without granting any) for one of its funds?

4. Do you think that additional constraints should be imposed on fund management companies that would grant loans in relation to the authorisation for the selection of loans?

2- Which funds could grant loans?

Proposal: specialised professional funds, securitisation vehicles, and professional private equity investment funds would be the only funds that could grant loans. These funds should be closed to redemptions or should limit redemptions to a previously defined share of their assets.

First of all, the choice of professional funds limits the investors who are able to invest in a fund that would grant loans, in line with what is currently applicable for the selection of loans by funds.

As loans are illiquid assets, it is proposed that lending by funds be done without transformation of maturity. This would require funds to be closed or redemptions to be limited and the maturity of loans to be restricted (see section 4). Such a limitation could be devised like regulation no. 2015/760 on European long-term investment funds (ELTIF), which provides for the possibility of lending but limits the eligible investment undertakings to closed AIFs or, by exemption (article 18), provided that all the following conditions are met:

a) redemptions are not granted before the investment limit date;

b) at the time of the authorisation and throughout the life of the ELTIF, the manager is able to demonstrate to the competent authorities that an appropriate liquidity management system and effective procedures for monitoring the liquidity risk of the ELTIF are in place, which are compatible with the long-term investment strategy of the ELTIF and the proposed redemption policy;

c) the manager sets a defined redemption policy, clearly indicating the periods of time during which investors may request redemptions;

d) the redemption policy guarantees that the overall amount of redemptions within any given period is limited to a percentage of liquid assets of the ELTIF [which are limited to 30% of the net assets in the regulation]. This percentage shall be aligned to the liquidity management and investment strategy disclosed by the manager;

e) the redemption policy guarantees that investors are treated fairly and that redemptions are granted on a pro rata basis if the total amount of requests for redemptions within any given period of time exceeds the percentage indicated in point d) of this paragraph.

Questions :

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

6. Does the obligation that funds granting loans must be closed or must limit their redemptions seem to be a sufficient limitation? Do the conditions provided for in the ELTIF regulation to limit redemptions seem appropriate?

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

Proposal: The other collective investment undertakings mentioned in chapter IV of book II of the Monetary and Financial Code could grant loans only if these loans are explicitly mentioned in the list of assets that are eligible for them (current account advances, loan in garbage ratios, etc.). The cases of other financing tools similar to loans, particularly participating loans, would also need to be specified.

Participating loans are designated credit contracts, governed by Articles L. 313-13 to L. 313-20 of the Monetary and Financial Code, which may be granted by commercial companies* and are expressly not subject to the banking monopoly. In the absence of a specific legislative clarification on investment undertakings, these may grant participating loans when they are formed as a commercial company. The possibility for investment funds to grant participating loans should be clarified.

Certain funds can already grant current account advances. The AMF does not wish to revisit this possibility or add additional constraints to management companies that grant them through their funds. However, the AMF wishes to clarify the possibility to grant current account advances by authorising them only for funds for which this is explicitly mentioned in the Monetary and Financial Code.

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

** Article L. 313-13 of the Monetary and Financial Code lists, among the persons authorised to create equity loans, "other commercial companies", including those listed in Article L. 210-1 paragraph 2 of the Commercial Code.*

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3- Constraints on funds granting loans

Proposal: **funds granting loans will not be allowed to use leverage, short-selling, lending of financial securities, or derivatives except for hedging.**

It is proposed, like the constraints imposed by the ELTIF regulation, that funds that lend would not be able to use leverage, as defined in point VI of L214.24.20*. This constraint makes it possible to limit the risks and prevent funds from being used by credit institutions that do not wish to grant loans directly. Similarly, it is proposed that a fund that grants loans should not engage in any of the following activities:

i. short-selling of assets;

ii.entering into securities lending, securities borrowing, repurchase transactions, or any other agreement which has an equivalent economic effect and poses similar risks, if thereby more than 10% of the fund's assets; and

iii. using financial derivative instruments, except where the use of such instruments solely serves the purpose of hedging the risks inherent to other investments of the fund.

Questions :

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

10. Does the prohibition of activities of short-selling, lending of financial securities and use of derivatives, except for hedging purposes, for a fund that originates loans seem efficient to curtail risks?

4- Constraints on loans

Proposal: **loans granted by funds may be granted only to non-financial companies and for a maturity greater than two years and less than the life of the fund. However, no minimum credit quality requirement is proposed.**

Companies eligible for loans:

Loans by funds should not be granted to individuals or be used for the financing of a financial company (insurance, credit institution, or other financing company) whose purpose is not to finance a commercial, industrial, agricultural, craft, or real estate company or a physical asset. However, an exception is proposed to allow lending through a holding company that would invest in a commercial company or physical assets. The limiting of loans to European companies could be envisaged, as is the case for loans eligible for loan-to-real economy funds.

** Leverage is any method by which the AIF's exposure is increased, whether through the borrowing of liquidity or financial instruments, derivative positions, or by any other means.*

For the sake of comparison, the ELTIF regulation excludes investment in a financial company* unless it invests exclusively in portfolio companies directly eligible for the fund (physical assets or non-financial companies). Similarly, in accordance with point II of Article R. 332-14-2 of the Insurance Code, loan-to-real economy funds can invest in loans issued by:

- EU Member States;

- regional or local authorities or public institutions of the EU;

- individual companies that have a SIREN number or private legal entities of Member States of the European Union, engaging primarily in a commercial, industrial, agricultural, craft, or real estate activity, to the exclusion of financial activities and collective investment undertakings other than real estate collective investment undertakings;

- private legal entities of Member States of the European Union whose purpose is exclusively or, depending on the case, mainly the performance of a commercial, industrial, agriculture, craft, or real estate activity, to the exclusion of financial activities, to directly or indirectly hold one or more stakes in the capital of legal entities mentioned [previously].

Maturity of the loan:

It is proposed not to allow funds that grant loans to transform maturity by having liabilities that are more liquid than the granted loans. This requirement is taken directly from the ELTIF regulation, which provides that the loan's term cannot exceed the life of the fund, and this requires the fund to be closed.

Minimum term and minimum quality of the granted loan:

Article R. 332-13 of the Insurance Code specifies that loans granted by insurance companies must have a total term of at least two years and could possibly not be backed by collateral when they have sufficient credit quality.

At this stage, it is proposed that the minimum term criterion be kept at two years.

However, it is proposed that there be no required minimum quality of loans granted by the fund, as long as the risk is properly analysed and transparent for the investor. If a fund's investors wittingly want to take high credit risk, the asset management regulations should not prevent them from doing so, but must ensure that the risk is understood. The logic is therefore different from a prudential logic.

Questions :

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

12. Beneficiaries of loans:
a. What financing need(s) are the loans granted by funds most likely to meet (loans to infrastructures, loan as part of bank syndications, loans to SMEs, short-term loans, etc.)?

** "Financial company": one of the following entities: a) a credit institution; b) an investment company; c) an insurance company; d) a financial holding company within the meaning of the CRR regulation; e) a mixed holding company within the meaning of CRR; f) a management company within the meaning of the UCITS regulation; g) a manager within the AIFM meaning.*

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

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.)?

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

13. Should there be constraints that are less strict for loans that would be guaranteed by a State, a credit institution, or backed by specific collateral, like what is done for insurers?

14. Should loans granted by funds have a minimum quality defined by regulation?

5- Other matters

Recovery of loans and loan contracts:

Management companies that select loans for their investment undertaking do not perform the recovery of loans.For example, for securitisation vehicles, according to Article L. 214-172 of the Monetary and Financial Code, "When loans are transferred to the vehicle, their recovery continues to be ensured by the originator or by the entity that was responsible for them before their transfer, under conditions defined by an agreement entered into with the vehicle's management company."

Certain management companies would like to be able to perform the recovery of their loans themselves. Given that the activity is already regulated, particularly by the Code of Civil Enforcement Procedures (Articles R124-1 to R124-7), it is proposed that no supplementary regulations should be added. However, in the event that a management company performs the recovery tasks amicably or through the courts, it will be necessary to ensure that the sums collected from defaulting debtors be intended for the fund (or the special account opened for its exclusive benefit as part of a securitisation vehicle) and that the costs applicable to the recovery be clearly indicated in the prospectus.

De même, il est proposé de ne pas imposer de règles sur les contrats de prêts octroyés par les fonds d'investissement car le prêt à intérêt est régulé, notamment par le code de commerce, le code civil et le code monétaire et financier.

Questions :

15. Can management companies directly perform the recovery, or is it necessary to provide, similarly to what is currently provided for securitisation vehicles that purchase loans (L. 214-172), that the recovery be entrusted to another entity?

16. Do you see other aspects of the granting of loans that should be restricted by the AMF?