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AFG Answer – ESMA Consultation on the RTS on loan-originating open-ended AIFs

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AFG actively supports the growth of the French asset management industry for the benefit of savers, investors, and businesses.

AFG is dedicated to promoting stable, efficient, and competitive regulation, with a strong focus on helping individuals finance their life goals while channelling private savings towards businesses in transition.

AFG ANSWER – ESMA CONSULTATION ON THE RTS ON LOAN-ORIGINATING OPEN-ENDED AIFS

Q1: Are there any elements other than the redemption policy, the availability of liquid assets, the performance of liquidity stress tests and ongoing monitoring that AIFMs shall take account to demonstrate that the liquidity management system of the OE LO AIFs they manage is sound? If yes, please specify.

AFG Answer:

No

Q2: Do you agree with the list of factors set out in Article 2 of the draft RTS to be considered by AIFMs to establish an appropriate redemption policy for an OE LO AIF? If not, please justify your position.

AFG Answer:

We agree with the list, which is already quite extensive with 15 factors.

Regarding this article 2, it would be interesting to state that all factors should be considered "where relevant", as in "the AIFM shall, at least and where relevant, consider the following factors".

On the last factor, there would be merit to remove the term "realisable". It's neither an accounting nor a banking term, is not really used in asset management and could prove misleading.

As a matter of fact, we should like to emphasize that item"k", "cashflows of the portfolio" is quite important for the management of liquidity in the loan fund asset class.

Q3: Are there any other factors that AIFMs shall consider to demonstrate that the redemption policy of the OE LO AIFs they manage is appropriate? If yes, please provide a list of such factors and explain why they shall be included.

AFG Answer:

No.
We do not see other factors to consider.

Q4: Do you agree that AIFMs that intend to manage OE LO AIFs shall determine an appropriate proportion of liquid assets to be able to meet redemption requests? If not, please justify your positions?

AFG Answer:

Yes. This determination should remain at the discretion of the fund manager. Indeed, more important than the proportion of liquid assets that would be maintained or targeted at all times, is the appropriate fund and loans' design and structuring to generate liquidity in various scenarios (e.g. covenants, etc.).

This relevance of manager discretion is also illustrated by the Annexes I and II of ELTIF RTS, where in the 1st one there is no minimum percentage of liquid assets that is required at all times.

Q5: Do you agree with the list of factors that AIFMs shall consider to establish the appropriate amount of liquid assets? If not, please justify your position. Shall AIFMs consider other factors, and if yes what are these factors?

AFG Answer:

Yes. We generally agree with the list of factors that AIFMs shall consider. As proposed in article 3(n), "estimated investors subscription and redemption pattern" would be preferable to the modelisation of behaviours, which is not something that is considered for funds. Patterns on the other hand are considered with VaR models used by asset managers.

It would make more sense to rearrange the items referred to in article 3(1) (o) and (p). Leverage would make more sense in the p) with the other liabilities, considering hedging is meant to decrease the level of risk of the fund.

We would suggest the following :

> o) ~~If any, the targeted level of leverage, including leverage arising from~~ Hedging strategies, and the related financial obligations; and
>
> p) If any, leverage, and any other material liabilities.

There would also be merit to limit to "material" liability in the RTS provisions.

Q6: Do you agree that cash flow generated by the loans granted by OE LO AIFs shall be considered as liquid assets? If not, please justify your position.

AFG Answer:

Yes. Actually, this is of utmost importance in investment structuring in the loan's asset class (often much more than the ability to sell loans).

Q7: Do you agree that AIFMs may consider other assets as liquid if they can demonstrate that these assets can be liquidated within the notice period, to meet redemption requests, without significantly diluting their value? If not, please justify your positions.

AFG Answer:

Yes

Q8: Are there any other types of assets that could be considered as liquid for the purpose of the availability of liquid assets? If yes, please give examples and explain why they could be considered as liquid for the purpose of the availability of liquid assets. Conversely, are there any other types of assets that shall not be considered as liquid? If yes, please specify.

AFG Answer:

Yes, there are various sources of liquidity in loan funds, stemming for example from the structural design of the loans (e.g. covenants, etc.). Moreover, what is important is overall liquidity at portfolio level, as individual assets can have different liquidity profile in time and market environments.

As the AFG guide on liquidity risk management tools in open-ended funds states: "*Even if a presumed hierarchy of liquidity exists among the various asset classes, liquidity is not naturally attached to one asset class or another. The relative liquidity of assets can vary over time, affecting the cost or the time needed to liquidate the position held in the portfolio, and can sporadically be reduced or even disappear in case of a serious liquidity crisis in a given market segment. Liquidity is a dynamic and relative notion*." Link :

https://www.afg.asso.fr/app/uploads/2020/03/afg-liquidityrisk-200403web.pdf

For this reason, it would not be accurate, or relevant to try to identify a list of liquid assets, or non-liquid assets.

Q9: In your practical experience, how do AIFMs that manage OE LO AIFs determine the level of liquid assets to be held by the fund to meet redemption requests? In particular, how do they calibrate the amount of liquid assets with respect to the maturity of the loans granted and the number of loans in the portfolio?

AFG Answer:

Apart from recognising the generally more significant and diverse sources of cash flows generated by loan portfolios, there are no specific management practices for the determination of liquid asset levels of open-ended loan originating funds, compared to other open-ended funds.

Therefore, there is no need for additional specific rules for loan originating funds compared to the existing ones for open-ended funds. Moreover, this would avoid creating overlaps and risk further harm EU funds competitiveness, compared to non-EU ones.

Q10: Do you believe there should be a regulatory minimum amount of liquid assets to be held by an OE LO AIFs and, if yes, please specify it? Should this minimum apply across all types of OE LO AIFs, or should it differ among OE LO AIFs and, if yes, how?

AFG Answer:

No. Both the FSB and IOSCO have stated this recently.

For the FSB – it can be found in the footnote 8 of the "Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations Consultation report" from July 2023.

Link : https://www.fsb.org/uploads/P050723.pdf

"*OEF managers are well positioned to determine the appropriate level of liquid asset holdings for each OEF they manage". And "While a requirement to hold a minimum level of liquid assets could complement other elements of a regulatory framework [...] it may have unintended consequences.*

Therefore, the FSB is not including minimum regulatory requirements for liquid asset holdings across the OEF sector this time."

IOSCO recent work has also stated this clearly: "*IOSCO is not recommending a minimum level of liquid asset holdings across the open-ended fund sector*" Box 3 page 18 from the Consultation report "*Guidance for Open-ended Funds for Effective Implementation of the Recommendations for Liquidity Risk Management*". Such obligations result in pro-cyclical effects, exacerbating vulnerabilities, deviating from investors desired asset allocation and moral hazard.

Link : https://www.iosco.org/library/pubdocs/pdf/IOSCOPD771.pdf

Q11: Do you agree with the draft provisions on liquidity stress testing set out in Article 4 of the draft RTS? If not, please justify your positions.

AFG Answer:

There are already ESMA guidelines regarding all AIF / UCITS in Europe. Therefore, we see no reason to have specific provisions for loan originating funds compared to other open-ended AIF. OE LOF should align with ESMA guidelines that states: "*LST should be carried out at least annually and, where appropriate, employed at all stages in a fund's lifecycle*".

And notably we should remind that dedicated funds should be excluded from LST requirements.

We would also propose the following changes to the drafting of the RTS:

2. AIFMs that manage open-ended loan-originating AIFs ~~shall~~ should stress test separately ...
3. AIFMs ~~shall~~ should apply ~~conservative~~ reasonable scenarios in terms of change in interest rates, credit spread and potential defaults in loans granted, as well as in redemptions requests considering the investor base and the liquidity offered and the liquidity management tools put in place in case of redemption pressure from investors, on a proportionate and relevant basis.
4. AIFMs ~~shall~~ should employ liquidity stress tests ...

Q12: What other parameters, if any, AIFMs managing OE LO AIFs shall take into account when performing liquidity stress tests?

AFG Answer:

There are no other parameters that should be mandatory for AIFMs managing OE LO AIFs to consider when performing liquidity stress tests. Such stress tests must be built in the same way for loans as compared to other fund assets, without any need for additional specific parameters, as for stress test considerations, the fact that the fund have originated the loan or not is not relevant.

It would be interesting to add language that could further allow for more proportionality and a risk-based approach.

Q13: What could be the criteria that would justify a frequency of liquidity stress tests higher or lower than on a quarterly basis?

AFG Answer:

There are already ESMA guidelines regarding open ended funds requiring at least annual stress testing. As stated above, open-ended loan originated funds are no different from other open-ended funds, especially other funds invested in private debt, hence we would propose either to delete that provision or align all those requirements.

« *LST should be carried out at least annually and, where appropriate, employed at all stages in a fund's lifecycle. It is recommended to employ quarterly or more frequent LST. The determination of a higher or lower frequency should be based on the fund's characteristics and the reasons for such a determination should be recorded in the LST policy. Flexibility is allowed for on this issue depending on the fund's nature, scale and complexity and liquidity profile*".

Link: https://www.esma.europa.eu/sites/default/files/library/esma34-39-897_guidelines_on_liquidity_stress_testing_in_ucits_and_aifs_en.pdf

Q14: Do you agree with ESMA's proposal on ongoing monitoring set out in Article 5 of the draft RTS? If not, please justify your position.

AFG Answer:

As proposed above, all elements are not necessarily relevant for all funds and at all time. Therefore we would propose to add "*where available and relevant*" in the article 5.

One thing that might be important to emphasize again, is the importance of cash flows in loan originating funds, as loans generate cash flows naturally and also by design (i.e. following carefully crafted origination: e.g. "cash sweep" clauses, covenants, etc.), without the need for selling assets.

Also, we believe that c) and e) address the same issue, as redemption and subscription and behaviour or pattern of unitholder are looking at the same idea of investment and withdrawal from the fund.

You can find hereafter the proposal we would make to article 5:

"AIFMs shall, at least, monitor on an ongoing basis the following elements, where available and relevant:

b) The expected cash flows and ~~potential future~~ liabilities;

~~c) The amount of subscriptions and redemptions;~~

e) The behaviour or other patterns of shareholders or unitholders;"

Q15: What are the parameters that AIFMs managing OE LO AIFs shall monitor to ensure that the AIF has a sufficient level of liquid assets to meet redemption requests?

AFG Answer:

As stated in other questions, we do not see any need for a specific approach to ongoing monitoring regarding open-ended loan originating AIFs, as compared to their more general obligations related to fund assets.

Liquidity must be looked at by the fund manager from a holistic perspective. Plus, as answered in question 14, loans naturally -and by careful ex ante structuring- generate cash flows over time without the need for selling them or other assets, which is a very important feature to bear in mind for liquidity monitoring.

Q16: How do AIFMs that manage OE LO AIFs monitor the liquidity of the loans originated by the AIFs?

AFG Answer:

Open-ended loan originating AIF monitors the liquidity of the loans by looking at the scheduled cash flows and at the amortization of the loans. As we've stated in other answers, there is no difference between open-ended loan-originating funds and other private debt funds in terms of liquidity monitoring.

Q17: If you are managing an open-ended loan-originating AIFs, please indicate:

a) the size of these funds, specifying the smallest size as well as the average size;

AFG Answer:

1 fund of EUR 1.85bn

b) the number of loans originated by these funds, specifying the smallest number as well as the average number of loans;

AFG Answer:

45 loans originated
37 loans under management
8 loans repaid

c) the loan-origination strategy you implement (direct lending, mezzanine, distressed debt, venture debt, diversification strategy etc);

AFG Answer:

Senior secured loans through direct lending in infrastructure debt
Geographical and sectorial diversification in OECD investment grade rated countries only

d) the policy of the fund regarding the management of non-performing loans;

AFG Answer:

NPLs are managed by an experienced portfolio management team having an average experience of 20 years in the asset class.

e) the shortest, highest and average redemption frequency and, if any the notice period;

AFG Answer:

Quarterly redemptions, 30-calendar-day notice,

f) among the loans you granted, please indicate (as a % of the number of loans granted, and as a % of the total amounts of the loans):

i. the share of shareholders' loans[8];

AFG Answer:

Zero (assuming shareholders loans means loans granted to the shareholders to bridge their equity injection obligations)

ii. the share of non-performing loans;

AFG Answer:

Zero

iii. the share of loans whose maturity has been extended;

AFG Answer:

This question may be misleading. A loan can be extended because it has matured under normal conditions (typical "amend and extend" at or before contractual maturity) or because it is a non-profitable loan, and the amortization schedule has to be rescheduled (rescheduling).

- Amend and extend: 15%
- Rescheduling: zero

This question should also include the loans repaid in advance, as the loans may be repaid in full or partially in advance as borrowers manage their whole indebtedness.

- In advance: 15% of loans granted

Q18: If you are managing an open-ended loan-originating AIFs, have you already sold loans to meet redemptions requests? What were the main characteristics of the secondary market you used to sell them (i.e.: types of counterparties, time required to achieve the sales process, liquidity, overall cost of transaction etc)?

AFG Answer:

As described in our answer to question 14, open-ended loan originating funds rely on cash flow for meeting redemption, without the need for selling assets. Funds liquidity is adjusted to the scheduled cash flow from loans, and from the amortization of loans.

Asset managers manage very dynamically those characteristics, with a wide array for "ex ante" structuration, before any need for "ex post" liquidity management tool activation. Funds have the capacity, being the ones who originate, to contractually set up specific covenants, cash sweeps, triggers, set-up margins, etc. allowing for a dedicated structuration of the liquidity profile at fund level – a sort of "*structuring know-how*".

It is worth noting that the banking secondary market is an important liquidity provider, and that there are no transaction costs. The borrower usually pays break costs (replacement costs and make-whole if any).

> **Q19: If you are managing OE LO AIFs, what are the types of loans originated, how frequently do you value them and what is their level of liquidity?**

AFG Answer:

It is complicated to answer precisely without providing a very long list of individual loans, as the loans originated can take a wide variety of forms: with different maturity, covenants, also aiming toward different sectors, offered to companies of different sizes, with different seniority, and of course in the end very different risk profile.

Those loans are no different from those found in the private debt sector, for which there is already a strong structuration know how from asset managers, well established and seasoned.

> **Q20: If you are managing OE LO AIFs, what are the liquidity management tools you are using to comply with the obligations set out in Article 16 (1) and (2) of the AIFMD? Are you also using liquidity management tools other than those listed in Annex V of AIFMD, and if yes, what are these tools?**

AFG Answer:

As described in our answer to question 18 – the heart of open-ended loan-originating AIFs liquidity lies in its structuration, a more "ex ante" vision, before any need for "ex post" liquidity management tool activation, having set-up contractually specific covenants, cash sweeps, triggers, set-up margins, etc.

As for liquidity management tools, they are no different from other open-ended funds. Flexibility is what is needed from asset managers to cater for all their needs, for different types of investors or investments. They do not need a bespoke regime, but a tool list from which to pick up from.

Q21. Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits of the option taken by ESMA as regards the RTS on open-ended loan originating AIFs? Which other types of costs or benefits would you consider in that context?

AFG Answer:

Yes. We completely agree.

Q22. Is there any ESG and innovation-related aspects that ESMA should consider when drafting the RTS under the AIFMD?

AFG Answer:

No. The focus of this RTS should remain on liquidity issues only in OEF LOF.

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