Joint Position Paper Re. The European Commission's Proposal Amending Directive 2011/61/EU Alternative Investment Fund Managers (Procedure 2021/0376/COD)

1. Introduction

The European Commission published on 25 November 2021 a draft proposal to amend Directive 2011/61/EU on Alternative Investment Fund Managers (the "**Proposal**").

The Proposal aims to regulate *inter alia* the so-called 'loan-originating' alternative investment funds ("**AIFs**"). In particular, article 16(2a) of the Proposal requires that the alternative investment fund manager ("**AIFM**") shall ensure that the AIF it manages is closed-ended if the notional value of its originated loans exceeds 60 % of its net asset value ("**NAV**").

The Proposal directly affects the activities of private debt focused impact investing funds with a significant portfolio of loans granted to private enterprises in developing economies to promote financial inclusion, sustainable agri-food value chain and other sustainable investment objectives (the "**Debt Impact Investing Fund(s)**" or "**DIIF(s)**"). These DIIFs make an important contribution to the achievement of the European Commission's action plan on financing sustainable growth[1] (the "**EC's Action Plan on Sustainable Finance**") and the United Nations' Sustainable Development Goals[2] ("**SDGs**"). Both initiatives aim to reorient capital flows towards sustainable investments. The DIIFs mobilise private capital of European investors by making investments in developing economies with the objective to help realising the EC's Action Plan on Sustainable Finance as well as the SDGs, without putting any undue strain on the limited public resources of the EU Member States.

This paper sets out the ***common position of the world's leading impact investing firms*** that manage DIIFs: BlueOrchard, Developing World Markets, Finance in Motion, Incofin Investment Management, MicroVest, responsAbility Investments, Symbiotics, Triodos Investment Management and Triple Jump. The assets under management of the DIIFs managed by the undersigned impact investing firms amount to more than EUR 10 billion. These firms represent an important part of the asset management sector that is directly affected by the Proposal.

First, we will address the challenges that the impact investing sector would face if the Proposal would be adopted. Second, we will analyse the reasons invoked by the European Commission and test if such reasons are valid for impact investing. Third, we will outline our current best practices to mitigate liquidity risks and ensure investor protection. Finally, we will launch an urgent call for action.

2. Challenges for Debt Impact Investing Funds

Most DIIFs are structured as open-ended funds[3]. This structure is mainly justified by investor demand: desire to make a long term investment that gives both financial return and positive, measurable social or environmental impact. We note that most of the DIIFs' investors are professionals and make a well-informed conscious decision. The open-ended form also caters for the needs of the investees: debt financing with diversified tenors.

[1] https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en#action-plan

[2] https://sdgs.un.org/goals

[3] We note that the Proposal does not include a definition of open-ended AIFs.

If the aforementioned article 16(2a) of the Proposal would become effective, this would mean that the existing open-ended DIIFs would have to (i) change their fund structure, (ii) dilute their portfolios to bring it below the (arbitrary) threshold of 60% of their NAV, or (iii) cease their activities entirely, as the Proposal does not provide for a grand-fathering regime. Changing open-ended DIIF to become closed-ended funds will prove to be virtually impossible as most investors (in particular retail investors or third parties that distribute to or act on behalf of retail investors) will not appreciate the required lock-in periods. Diluting impact loan portfolios by adding other types of assets could make the impact and return proposition to investors unattractive, and potentially endanger compliance with article 9 of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector ("**SFDR**"). Furthermore, any future initiatives to develop a new open-ended AIF with a loan portfolio exceeding 60% of its NAV would be impossible. In other words, the proposed article 16(2a) will disrupt the business model of the DIIFs.

We strongly believe that this would have a destructive effect on the valuable impact realised for private business in developing countries. This will also limit the possibilities for investors to put their private capital at work towards realising genuine positive social or environmental impact. Additionally, it would mean a major setback in realising the EC's Action Plan on Sustainable Finance and the SDGs. We wish to highlight that the points set out in this position paper are by no means aimed at limiting any investor protection measures. We merely argue that the Proposal unintentionally harms the DIFFs, their investors and its investees.

3. Reasons for the Proposal: are they valid for Debt Impact Investing Funds?

According to the European Commission, the AIFMD today does not have requirements which are *"specific enough to fully capture the specificities of managing direct lending activities by AIFs and to address the potential micro and macro risks"*[4]. We furthermore read that article 16(2a) is proposed to avoid maturity mismatches that may create financial risks[5]. We understand that the European Commission is concerned that AIFs will originate loans that will be immediately sold off on the secondary market without retaining any economic interest in the disposed loans[6]. The growing exposure of AIFs to leveraged loans and collateralised loan obligations poses risks for the stability of the EU financial system[7].

In summary, the concerns of the Commission can be divided in three categories: (i) maturity mismatches, (ii) moral hazard situations, and (iii) financial stability concerns. We will assess if these reasons and concerns are valid for the lending activities of the DIIFs.

DIIFs are not prone to maturity mismatches that may create substantial liquidity risks for their investors. The loan portfolios in DIIFs typically show an approximate average maturity between 24 to 36 months, which creates natural liquidity due to constant cash inflows from principal repayments and interest payments. Such naturally liquidity allows the DIIFs to answer redemption demands, even under stressed market conditions. DIIFs have a long-standing track record in managing this type of liquidity risks. Moreover, investors are fully aware of the risk of gating of funds in the event that redemption requests would surpass accumulated liquidity.

[4] Proposal of the European Commission (Procedure 2021/0376/COD), Explanatory Memorandum, page 2.
[5] *Ibid*, page 12.
[6] *Ibid*, page 12
[7] Commission Staff Working Document Impact Assessment Report (SWD(2021) 340 final) accompanying the Proposal, page 23.

DIIFs grant loans and keep them in their books until full repayment. Consequently, the investment strategies of the DIIFs eliminate the moral hazard situations that occur if the originated loans are immediately sold on the secondary market. Impact investing's value proposition is founded on the principle that the originated loans are held to maturity.

Financial stability concerns are not relevant for impact investing as the DIIFs do not have any exposure to the leveraged loan market, nor are they part of systemic liquidity management or investment links between actors in the European financial system. DIIFs do not provide leveraged loans: (i) in the financial inclusion sector, they finance the loan portfolio of financial service providers, and (ii) in the sustainable food sector, they provide trade financing, working capital loans and capex financing. Collateralised loan obligations in the financial inclusion sector have been limited and do not pose any risk for the stability of the European financial system. To the contrary, we are convinced that the impact investing sector contributes to the stability of the financial system in developing economies. We wish to emphasise that DIIFs provide financing to private enterprises in developing economies that have difficulty accessing the regular financial services offered by local actors. The undersigned impact investing firms have proven track records of more than 20 years. DIIFs have faced times of stress, both regionally (*e.g. 'no pago'* movement in 2008 in Nicaragua) and globally (*e.g.* the financial crisis of 2007/2008 and the ongoing COVID-19 pandemic), but have shown resilience.

During the current COVID-19 pandemic the impact investing firms have supported their investees to overcome liquidity problems. The DIIFs and their managers have demonstrated that in the long term they can generate financial return and create positive social or environmental impact. Social inequality has increased during the COVID-19 pandemic. From an impact perspective, the DIIFs' investments are more needed than ever to fuel local real economy activities.

4. Liquidity management tools applied by Debt Impact Investing Funds

The Proposal sets out that AIFMs managing open-ended AIFs should have access to the necessary liquidity risk management instruments to effectively address micro-prudential and macro-prudential risks[8]. We wish to underline that impact investing firms, including the undersigned organisations, have already been applying the following liquidity management tools in respect of the open-ended debt funds to mitigate liquidity risks and ensure investor protection:

- Loan portfolio management: The composition of the DIIFs' portfolio is such that the product has a self-liquidating structure and can easily generate liquidity. A portfolio consisting of revolving loans with an average maturity of approx. 24 months (generating principal repayments and interest payments) means that liquidity generation through loan amortisations is around 4% per month.
- Liquidity buffer: An appropriate level of liquidity buffer in cash and cash-equivalent investments is maintained in the funds.
- Liquidity stress testing: DIIFs apply regular liquidity stress testing to ensure that they can adequately manage the assets and liabilities of their balance sheets.
- Liquidity credit lines: DIIFs have committed credit lines to answer short time liquidity needs in case of heightened redemption requests.

[8] Proposal of the European Commission (Procedure 2021/0376/COD), Explanatory Memorandum, page 12.

- Redemption gates: The right of an investor to request redemption is limited to a certain percentage of its shareholding and to a certain percentage of the fund's NAV over a specified time period. Redemptions are also done on a monthly or quarterly basis.
- Notice period: Investors have agreed to give advance notice to request redemption.
- Ultimate remedies: the fund documentation allows for temporary suspension of subscriptions and redemptions for legitimate non-speculative reasons.

5. Urgent call for action

We sincerely hope that our urgent call for action will be answered by the co-legislators of the European Union. We propose that the Council of the European Union and the European Parliament limit the scope of application of the proposed article 16(2a) to the AIFs that originate loans with the sole purpose of selling them immediately on the secondary market. Alternatively, the European co-legislators could decide to apply an exception for financial products within the meaning of article 9 of the SFDR.

*   *

*

BlueOrchard (www.blueorchard.com)

Developing World Markets (www.dwmarkets.com)

Finance in Motion (www.finance-in-motion.com)

Incofin Investment Management (www.incofin.com)

MicroVest (www.microvestfund.com)

responsAbility Investments (www.responsability.com)

Symbiotics (www.symbioticsgroup.com)

Triodos Investment Management (www.triodos-im.com)

Triple Jump (www.triplejump.eu)