

13 September 2011

European Securities and Markets Authority  
103 Rue de Grenelle  
75007 Paris  
France

Your ref: ESMA/2011/209

Submitted online at [www.esma.europa.eu](http://www.esma.europa.eu)

Dear Sirs

**Re: Draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive – Response to Consultation Paper 2011/209**

**Introduction**

The Loan Market Association (the "**LMA**") has established a working group of CLO investment managers, who collectively have approximately €740bn assets under management across various asset classes and other CLO market participants (a participant list is attached as Appendix 1) (the "**Working Group**"). The Working Group appreciates the opportunity to comment on the European Securities and Markets Authority's ("**ESMA**") draft technical advice to the European Commission on the possible implementing measures of the Alternative Investment Fund Managers Directive (the "**AIFMD**") set out in consultation paper ESMA/2011/209 (the "**Consultation Paper**").

The Working Group is particularly focused on Part IV.VI (*Possible Implementing Measures on Investment in Securitisation Positions*) of the Consultation Paper.

The Working Group recognises that the AIFMD along with Article 122a of the Capital Requirements Directive ("**Article 122a**") and the corresponding provisions of the Solvency II Directive ("**Solvency II**") are designed to address issues surrounding the "originate-to-distribute" model of bank lending and securitisation and in particular the conflicts of interest which may arise under this model.

In this letter, when we refer to CLOs, we are referring to independently managed collateralised loan obligation transactions which lend primarily to corporations and whose portfolios are selected and managed by investment managers who are independent of any originator(s) or trading desk(s) from whom the assets are acquired.

We note that at paragraph 5 of Part IV.VI of the Consultation Paper, ESMA states:

*"Certain concerns have been raised by the respondents to the call for evidence which ESMA has acknowledged and taken account of. It has been argued that 'actively managed securitisations' should be exempt from the retention requirement (versus 'balance sheet securitisations'). ESMA does not see an economic justification for such an exemption as the fundamental alignment of the interests of the relevant originator, sponsor or original lender to the interests of the investors may not be achieved by mere active management. In fact, the active management*

*of e.g. a CLO may, depending on the specific economics of the transaction structure, make evident, that such CLO manager may be the person whose interests are most optimally aligned with those of the investors of the securitisation transaction. In these cases, the manager may 'opt in' to retain."*

The Working Group is concerned that ESMA's comments in this paragraph appear to overlook the fundamental characteristics and economics of CLOs and the regulatory framework to which the investment managers of CLOs are already subject. Accordingly, we wish to provide ESMA with further comments and information on these matters, which have also been provided to the European Banking Authority ("**EBA**") and other interested parties in connection with the application of Article 122a.

We agree that actively managed securitisations should not necessarily be exempt from ensuring that the appropriate party has its interests aligned with those of investors. To the contrary, we would like to point out that in regards to CLOs, the regulatory and practical measures required to ensure such alignment already exist.

CLOs already have such alignment through the subordination of a substantial portion of investment management fees, such that the majority of compensation received by the CLO investment manager is directly related to the performance of the underlying portfolio of assets selected and managed by the CLO investment manager. In addition, in the case of CLOs which are managed by regulated investment managers, such alignment is already achieved both through the current European regulatory framework (in particular, the requirements relating to conduct of business and the management of conflicts of interest in the Markets in Financial Instruments Directive ("**MiFID**") and, in due course, the AIFMD). An actively managed securitisation such as a CLO is not an "originate-to-distribute" model of securitisation which the retention requirements of Article 122a and the AIFMD are attempting to address. The CLO investment manager is not originating assets but rather is actively involved in the selection and on-going management of loan assets purchased in the primary or secondary market. As such, a CLO investment manager receives the majority of its compensation only when the portfolio is performing. In short, a CLO is more akin to an investment fund than it is to a traditional securitisation.

The Consultation Paper, Article 122a and Solvency II currently do not fully reflect the unique economic and structural characteristics of independently managed CLOs which differentiate them from the "originate-to-distribute" securitisation structures, which the retention requirements of AIFMD, Article 122a and Solvency II are clearly intended to capture. Particular points which should be noted in relation to CLOs include:

- (a) a CLO consists of a portfolio of investments managed by an independent investment manager or one of its affiliates who is itself regulated;
- (b) a CLO's portfolio in its entirety is selected by the CLO investment manager (or by its affiliates) who is charged with making an independent analysis of each investment and is not itself the originator of any of the assets;
- (c) the interests of the CLO investment manager and the investors are inherently aligned through the subordination of a substantial portion of investment management fees to both the payment of interest on the more senior notes and the payment of a minimum return to the holders of the first loss tranche; and
- (d) the historical performance of CLOs, during the very challenging market conditions of the past three years, has demonstrated that the alignment of interests between CLO investment managers and investors has already been achieved using such structures.

A detailed discussion of certain of the unique structural and economic characteristics of independently managed CLOs is set out below under "*How are independently managed CLOs different from an "originate-to-distribute" securitisation?*".



## **Role of CLOs in lending and historical CLO performance**

The growth of the non-bank institutional lending market has been an important imperative of governmental authorities. As CRD IV (Basel III) comes into effect, non-bank institutional lending will be necessary in order to inject much needed capital into the loan markets. The continuing development of the CLO market is, in the view of the Working Group, a key component of this initiative.

We attach a short presentation, which highlights the important role CLOs have played in the syndicated loan market for sub-investment grade corporates in the UK and Europe. We also attach a research report prepared by Standard & Poor's which highlights the link between a spike in European default rates and the absence of new CLOs.

As the slides demonstrate, as the "refinancing wall" approaches, there is a significant risk that many European corporate borrowers will be unable to refinance their existing debt through their relationship banks or the syndicated loan market. Whilst the high yield bond market or the IPO market can fill an element of this refinancing gap, many borrowers will be unable to access these markets for a number of reasons, such as their enterprise value, size or credit profile. In addition, the regulatory capital treatment of European credit institutions following the implementation of CRD IV (Basel III) will make lending to the sub-investment grade sector less attractive for European Credit Institutions. Furthermore, it is not feasible for borrowers in Europe to access retail loan funds, which have proven an important source of capital and liquidity in the USA as the current UCITS requirements do not permit a significant portion of loans in a UCITS compliant fund.

However, it is important to note that the data provided in the attached slides reflects the syndicated loan market. In addition, there are many European corporates, which are dependent on bilateral or club loans from their relationship banks. Given the pressures on banks, these companies will be seeking to diversify their funding sources over the coming years. We have already seen this trend with certain larger companies tapping the high yield bond market. However, as mentioned above, this market will be unavailable to many of these companies and future CLOs could represent a critical source of debt finance both for larger and medium size corporates.

## **How are independently managed CLOs different from an "originate-to-distribute" securitisation?**

There are clear structural and economic differences between independently managed CLOs and originate-to-distribute securitisations. These include:

*Role of the independent CLO investment manager:* Unlike traditional asset-backed securities, the underlying portfolios of CLOs are typically not purchased from one originator or seller but are typically sourced in the primary or secondary market by regulated investment managers who are independent of any originator or seller of the loans. The CLO investment manager is able to independently assess the quality of the portfolio and is free of the negative incentives which can arise in an originate-to-distribute securitisation model.

*CLO investment managers already have "skin in the game":* CLO investment managers are already incentivised to act in the best interest of the CLO noteholders through the structure of their fees. CLO investment managers only receive a small fee (typically 15 to 25 basis points (0.15-0.25 per cent.)) prior to the receipt of interest by any debt holders. This fee covers only a portion of the operating overheads of the CLO investment manager. In addition, there is a subordinated fee (typically 40-50 basis points (0.40-0.50 per cent.)) to cover any remaining running expenses of the CLO investment manager. However, this fee is only payable following the payment of all interest due to the debt holders in a CLO (save for any interest relating to the first loss or "equity tranche"). If there is underperformance by the CLO investment manager these fees are "switched off" and amounts are instead used to repay the debt holders in accordance with documented repayment requirements. Lastly, CLO investment managers are usually entitled to an incentive fee which is only paid if the interest due on interest-bearing notes has been paid and the unrated first

loss or "equity tranche" has received a pre-agreed rate of return, hence it is back-ended in nature. This compensation structure ensures that the interests of CLO investment managers are appropriately aligned with those of investors in CLOs throughout the life of a transaction.

**Managed CLOs should be exempt from the retention requirement, provided investors are appropriately protected**

As discussed above, the retention requirements of the AIFMD, Article 122a and Solvency II are intended to address the potential conflict of interest inherent in the "originate-to-distribute" model of bank lending and securitisation. However such a conflict of interest does not arise in relation to independently managed CLOs, for the reasons set out above.

Nonetheless, it is recognised that any different treatment for CLOs in Europe may have to be based on explicit conditions which provide assurance that (i) investors' interests will be protected and that any potential conflicts of interest which may arise will be appropriately managed and (ii) this different treatment will only be offered to investment vehicles that meet objectively defined criteria.

We would encourage ESMA to consider that AIFMs should be permitted to invest in CLOs without requiring an explicit retention requirement, at least where the conditions specified below are satisfied. We believe that this is appropriate as CLOs are, in any event, subject to regulatory and market restrictions which already adequately address the risks that the retention requirements in the AIFMD are intended to address. In particular, retention should not be required where:

- (i) the securitised exposures are managed on a continuing, discretionary basis by:
  - (A) an EEA investment firm which is required to be regulated in its Home member State and which is subject to MiFID or an affiliate thereof; or
  - (B) a firm authorised under the AIFMD or an affiliate thereof; or
  - (C) a firm or an affiliate thereof which would fall within (A) or (B) above if its head office was situated in the EEA and which is subject to equivalent regulation in relation to the conduct of its business and its management of conflicts as a firm established in the EEA (for instance investment advisors registered under the US Investment Advisers Act of 1940, as amended);
- (ii) the CLO investment manager of the securitised exposures undertakes to the investors in the CLO to comply with the regulatory requirements applying to it in relation to the management of conflicts of interest, in connection with its management of the securitised exposures (i.e.: compliance with MiFID and/or AIFMD or equivalent legislation); and
- (iii) the transaction documents in relation to a CLO contain provisions whereby the interests of the CLO investment manager are appropriately aligned with the interests of the investors during the whole life of the securitisation. It is recognised that this may be achieved by a material part of the CLO investment manager's compensation for carrying out its duties being structured as an incentive fee, which will only become payable upon appropriate performance thresholds of the securitised exposures having been met.

MiFID and the provisions of the AIFMD relating to the conduct of business of firms authorised thereunder both address the conflicts of interest which the retention requirements of the AIFMD, Article 122a and Solvency II were intended to address. MiFID and the conduct of business provisions of the AIFMD require regulated firms to act honestly, fairly and professionally and in the best interests of their clients, and to manage conflicts of interest so as to avoid damage to clients' interests. Accordingly, firms must comply with these obligations when managing the portfolios of CLOs and other funds. This regulatory framework coupled with the fee arrangements and on-going role of the CLO investment manager properly and adequately address, as far as managed CLOs are



concerned, the conflict concerns which the retention requirements of the AIFMD, Article 122a and Solvency II were intended to meet.

### Definition of a CLO

In addition, the following portfolio characteristics could be provided for in a definition of CLOs to ensure that only certain types of structures would actually constitute a CLO for the purposes of the special treatment described above:

- (i) it is comprised of no less than 75% senior secured bonds or loans to corporates;
- (ii) it does not contain any asset-backed securities; and
- (iii) it is managed by an independent investment firm or an affiliate thereof which satisfies paragraph (i) under "*Managed CLOs should be exempt from the retention requirement, provided investors are appropriately protected*" above and who independently reviews, and individually selects, each asset to purchase in the primary or secondary market (with no obligation to purchase from any individual bank or originator).

The characteristics above would ensure that any CLO would be required to have a portfolio comprised of mainly senior secured bonds or loans to corporates selected by independent investment managers or their affiliates. In addition the above restrictions would prevent many of the higher risk structures (i.e., CDO squared) from being classified as CLOs.

We would welcome ESMA's views on whether an exemption for CLOs from the risk retention requirements of the AIFMD is achievable on the basis described in this and the preceding section.

### Conclusion

CLOs can play a very important role in providing capital to European corporates especially at a time when capital is scarce. We do understand and accept the need for investors' interests to be protected. Our proposals would codify the unique characteristics of CLOs and ensure that any future CLO structures will continue to effectively protect the interests of investors whilst allowing the CLO market to function as an important source of capital in Europe.

Representatives of the Working Group would be happy to answer any questions ESMA may have and to meet with any representatives of ESMA to discuss the content of this letter. Please do not hesitate to contact Nicholas Voisey of the LMA (nicholas.voisey@lma.eu.com or + 44 (0) 20 7006 5364) or James Perry of Ashurst LLP (james.perry@ashurst.com or +44 (0) 20 7859 1214).

Yours faithfully



Nicholas Voisey  
Director  
**The Loan Market Association**

## **Appendix 1**

### **Working Group Participating Organisations**

Alcentra Limited

Allen & Overy LLP

Ashurst LLP

Avoca Capital

AXA Investment Managers

Bank of America Merrill Lynch

Barclays Capital

Citigroup

CQS (UK) LLP

Credit Suisse

CVC Cordatus

Deutsche Bank

Intermediate Capital Group PLC

M&G Investment Management Ltd

Oak Hill Advisors (Europe) LLP

Pramerica Investment Management Limited

The Carlyle Group

The Royal Bank of Scotland

# **Loan Market Association – Article 122A**

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**13 September, 2011**

## The adverse implications of 122a on the European economy...

- 122a has adversely restricted the re-opening of the European CLO market.
- CLOs\* are an essential financing tool. They provide liquidity by purchasing sub-investment grade loans primarily issued by private businesses which chose not to access public capital markets .
- After banks, CLOs are the predominant buyer of sub-investment grade loans in Europe.
  - CLOs have provided up to 40% of loans for a broad range of European companies in many industrial sectors.
- The requirement for European banks to de-lever, and build capital reserves to comply with Basel III and more stringent national regulator tests, will restrict their ability to provide sub investment grade loans.
- Concurrently, a large amount of sub-investment grade loans need to be re-financed in the next eight years, **with over €115bn of loans requiring re-financing inside five years alone.**
- Restrictions on new CLO issuance combined with other market factors (**including Basel III and Solvency II**) means there is an imminent financing gap.
- This will likely **restrict the growth and refinancing of European businesses and could in extreme cases lead to company failure.**
- In the volatile macro-economic environment of today, this may lead to **job losses and a loss of tax revenue.**

*\*CLO: A Collateralised Loan Obligation, i.e. an investment vehicle which lends to a variety of European businesses. The loans are pooled together and the interest earned from these loans is passed on to investors in the CLO.*

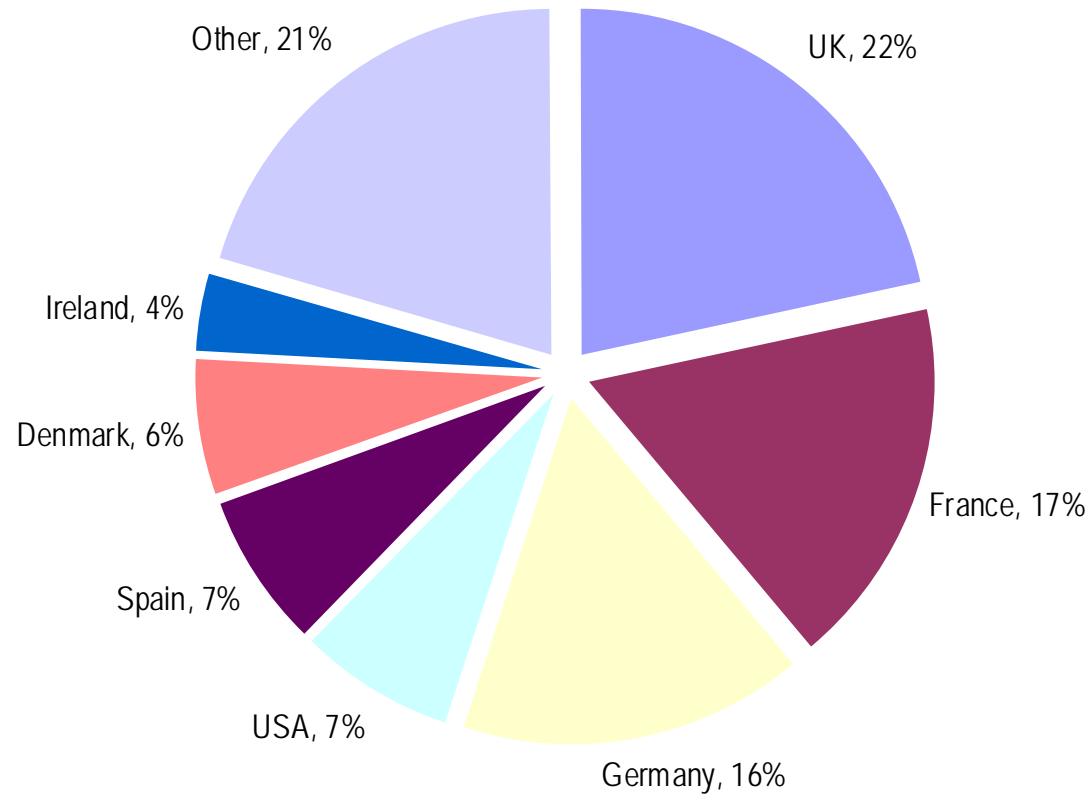


## European CLOs have a different investment philosophy and track record to the wider securitisation market...

- The European CLO securitisation market is a **key component of long term stable funding by non-bank institutional investors**.
- CLOs can alleviate the pressure on financing stemming from:
  - the requirements for European banks to de-lever and
  - Volatile capital markets, shutting alternative financing markets for example High Yield Bonds.
- These are **actively managed long only vehicles with no capacity to short sell**.
- CLOs are not a part of the originate and distribute model:
  - Underlying portfolio sourced from multiple providers.
  - Managers independently assess the quality of individual assets in the portfolio and are paid predominantly on performance.
  - CLOs are in the majority independently managed with portfolios selected and managed by investment managers who are independent of any originators or trading desks from whom the assets are acquired.
- These structures **have performed as they were marketed and have not posed systemic risks**.
  - Under substantial macro-economic pressure the CLOs have performed – de-levering if at risk.
  - No mark to market triggers.
  - Not one European CLO default and no central bank capital support has been required.
- Long term stable financing where “**skin in the game already exists**”:
  - A substantial portion of Management fees are paid subordinate to debt holders thereby aligning the Manager's interests with that of the CLO investor.
  - CLO Managers benefit from incentive fees only if the collateral pool performs.
- However, CLOs have a finite investment period (typically 4-7 year re-investment periods) after which they have limited ability to support the capital markets. The majority of European CLO's are nearing the end of their finite investment period.
- Ability for Managers to refinance existing CLOs and re-issue to grow the market is essential.

...and have a material impact on most states in the European Union...

**Outstanding Sub-Investment Grade Loans by Geography**

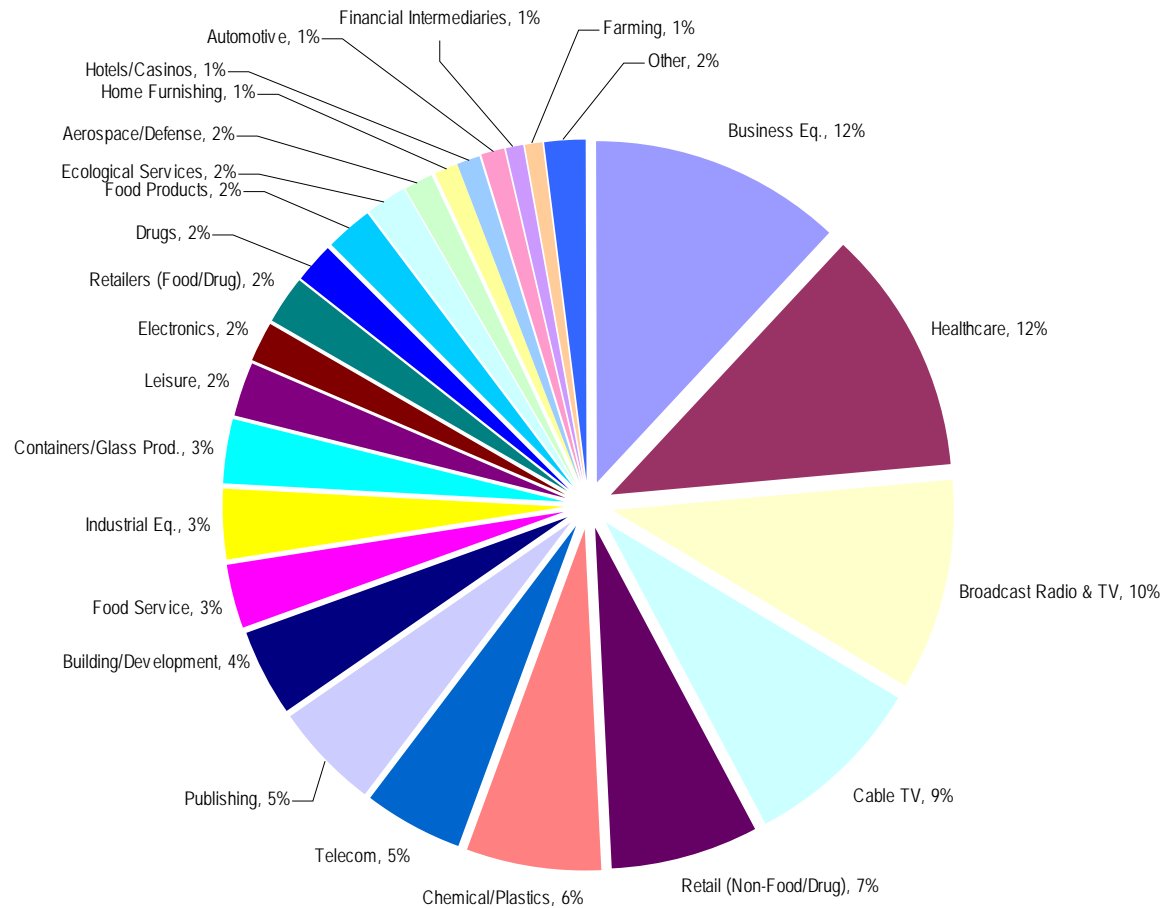


Source: S&P LCD

- “The UK, France and Germany have the highest amount of LBO [i.e. syndicated sub-investment grade loans] debt” *Moody’s Special Comment 16-Jun-11*

...and a broad array of sectors of employment.

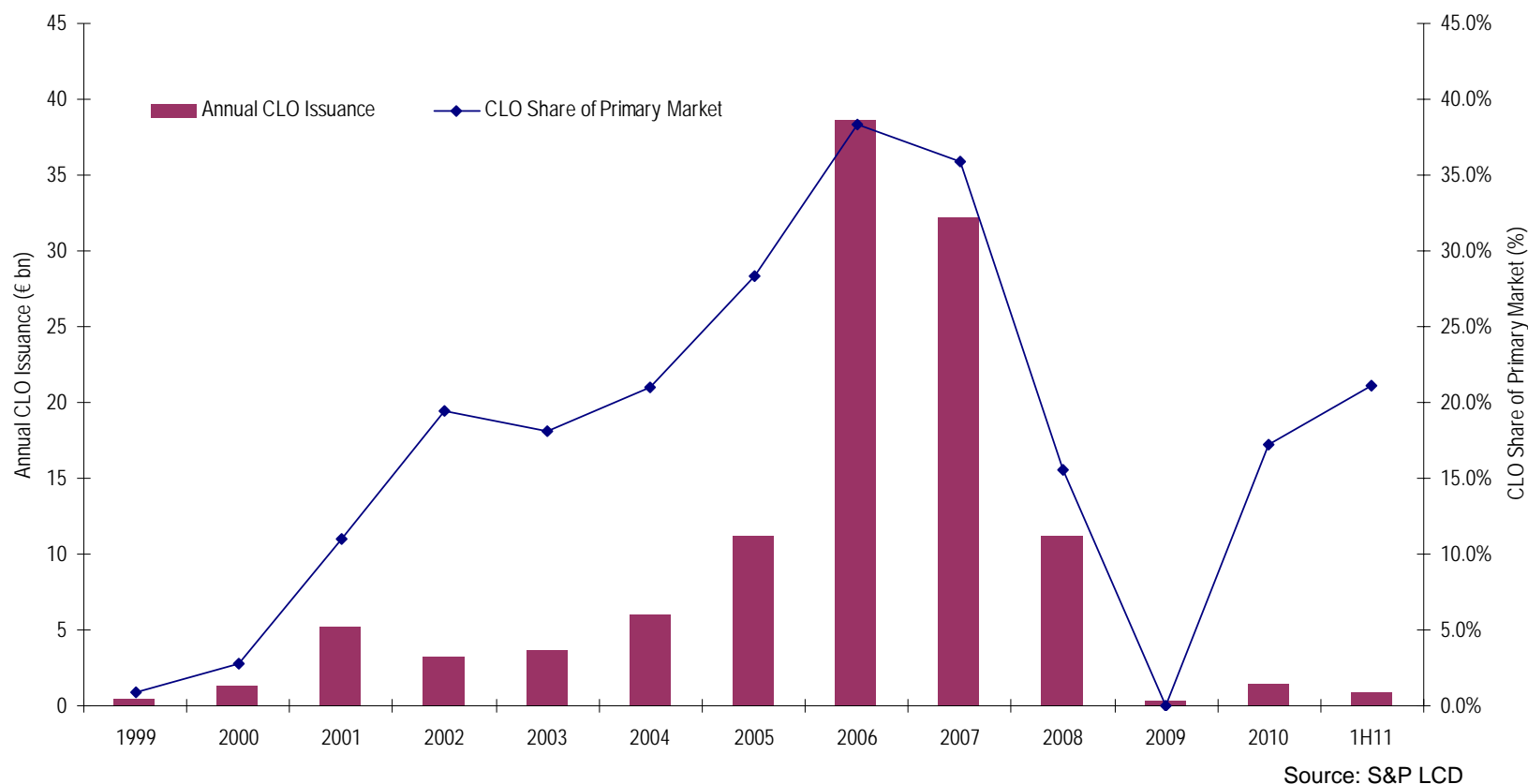
**Outstanding Sub-Investment Grade Loans by Sector**



Source: S&P LCD



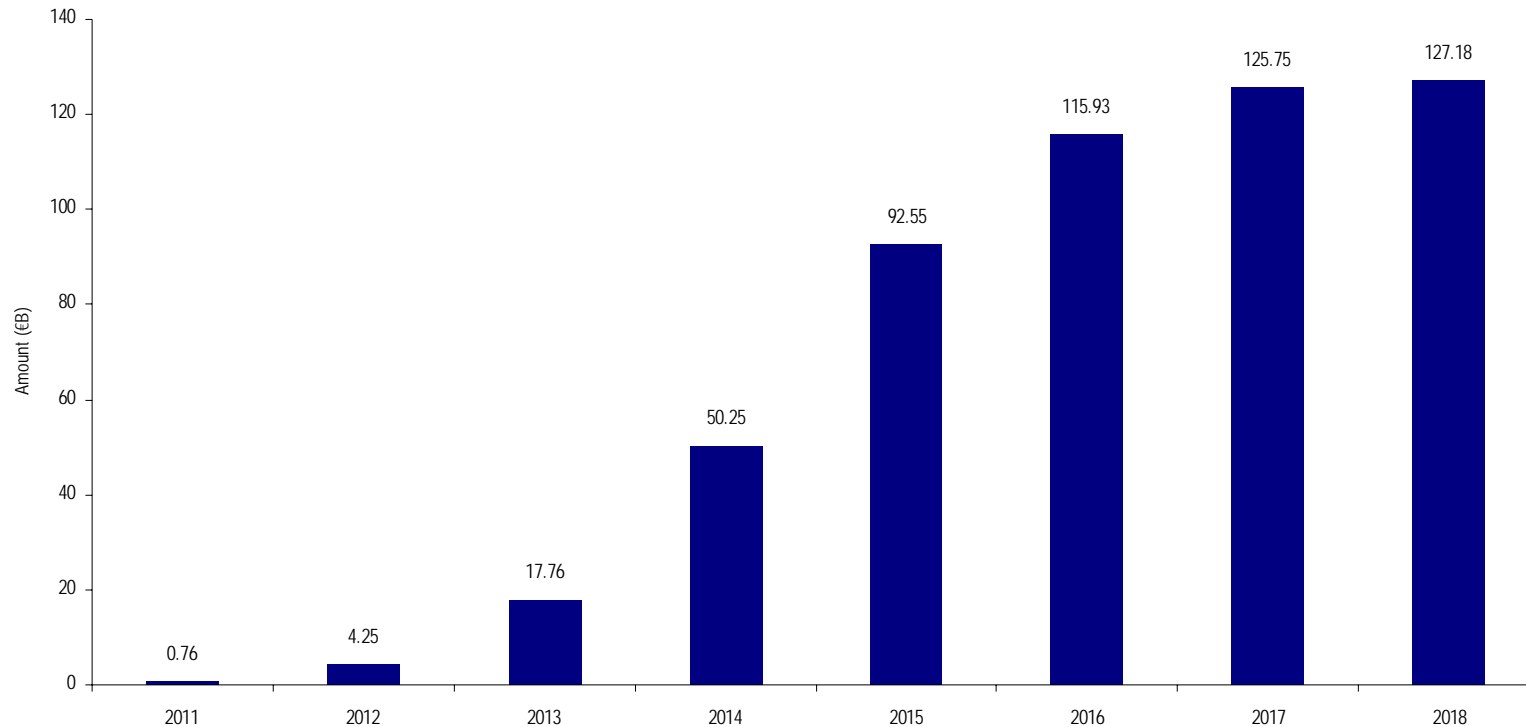
## CLOs are an important component in the success of the European sub investment grade market.



- With €38.6bn of CLOs issued in Europe in 2006 the contribution of CLOs to primary new issue peaked at 38.3%.
- Despite almost non-existent new CLO issuance, whilst incumbent CLOs remain in their reinvestment periods they continue to be a material contributor to the primary market with over 21% market share in 2011 year to date.

## The European sub-investment grade refinancing wall remains...

**Cumulative Par Amount of Sub-Investment Grade Loans Maturing (€bn)**

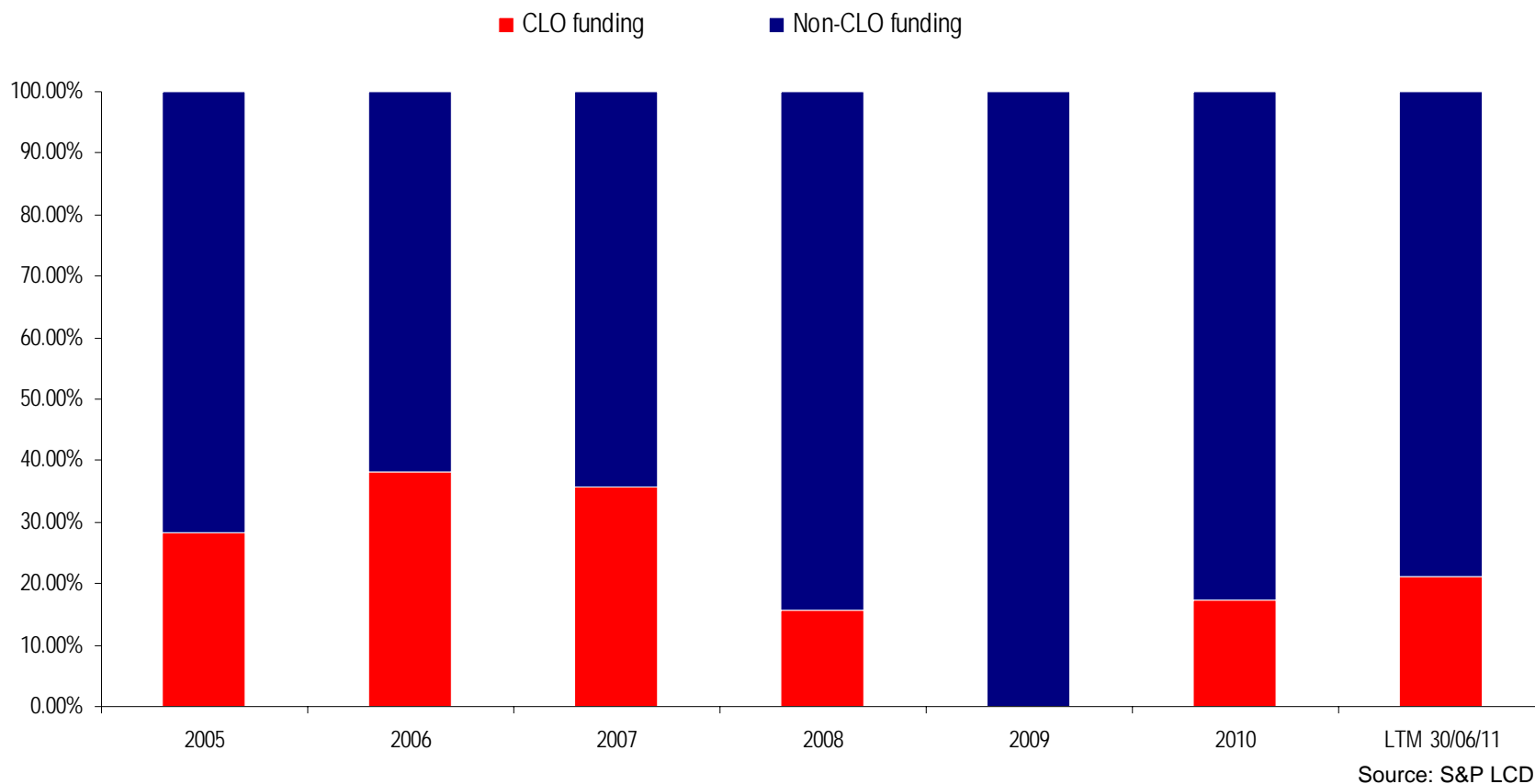


Source: S&P LCD

- €127bn of outstanding loans to European borrowers requires refinancing by 2018.
- “Material Challenges Remain” & “...the sheer quantum of outstanding debt remaining to be refinanced over the next three years continues to raise questions...” *Moody’s Special Comment 16-Jun-11*.
- As demonstrated by today’s challenges, healthy capital markets require a wide range of financing options.

**...and without new CLOs, a replacement for >20% of historic loans is needed whilst dealing with Basel III and Solvency II.**

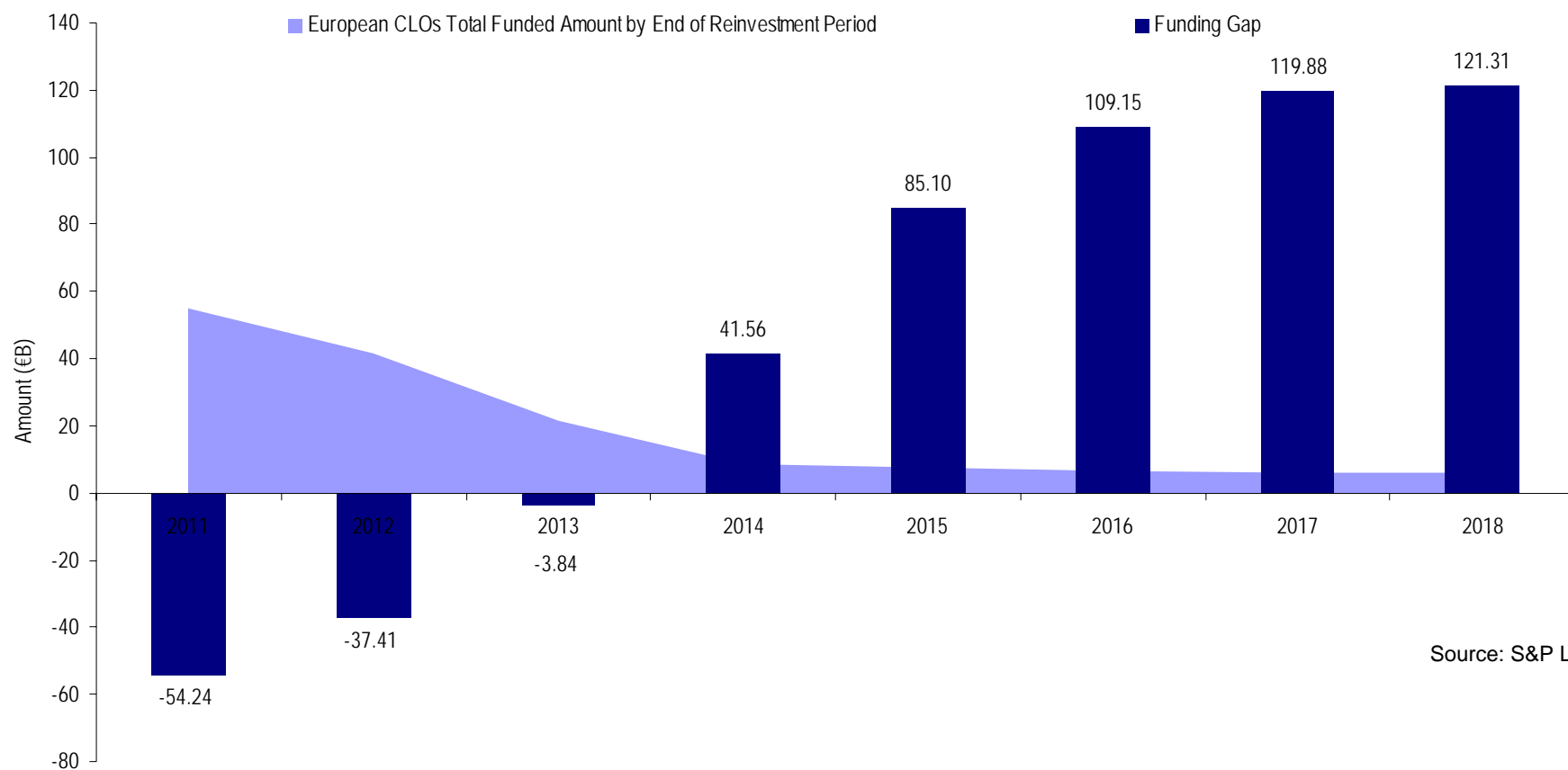
### Historic CLO funding of primary deals (2005-present)





**In parallel existing CLO investment capacity is diminishing for European sub-investment grade issuers.**

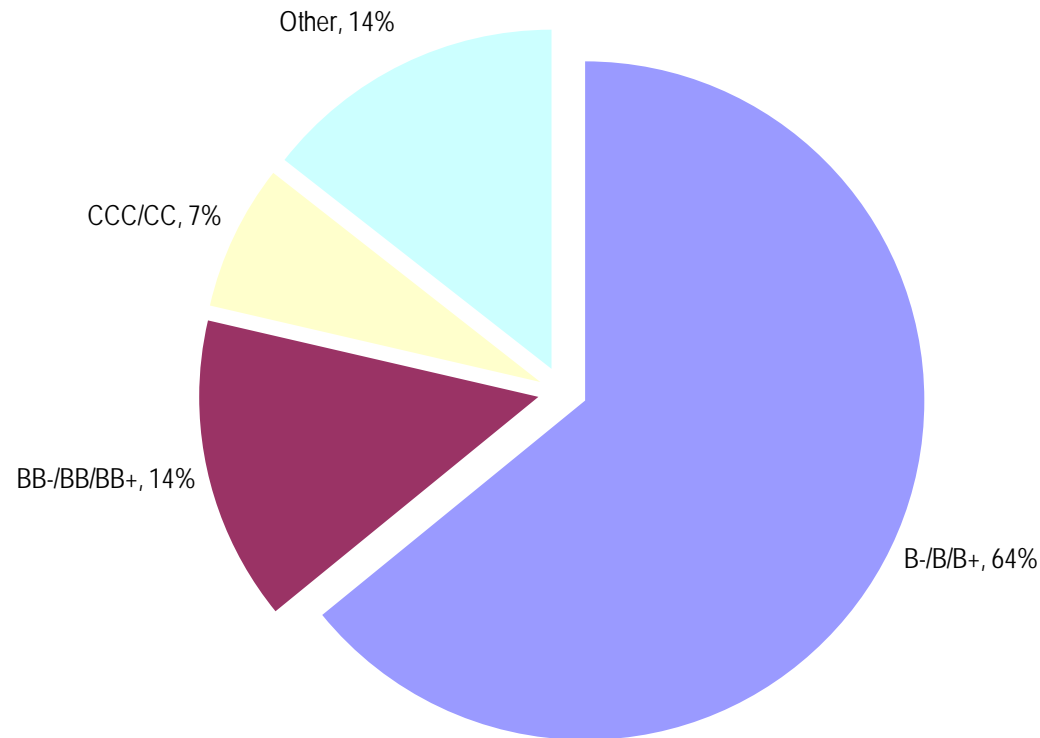
**The €120bn funding gap – the required refinancing versus European CLO investment capacity**



Source: S&P LCD

## Investment grade refinancings are NOT an option...

Outstanding Sub-Investment Grade Loans by Rating

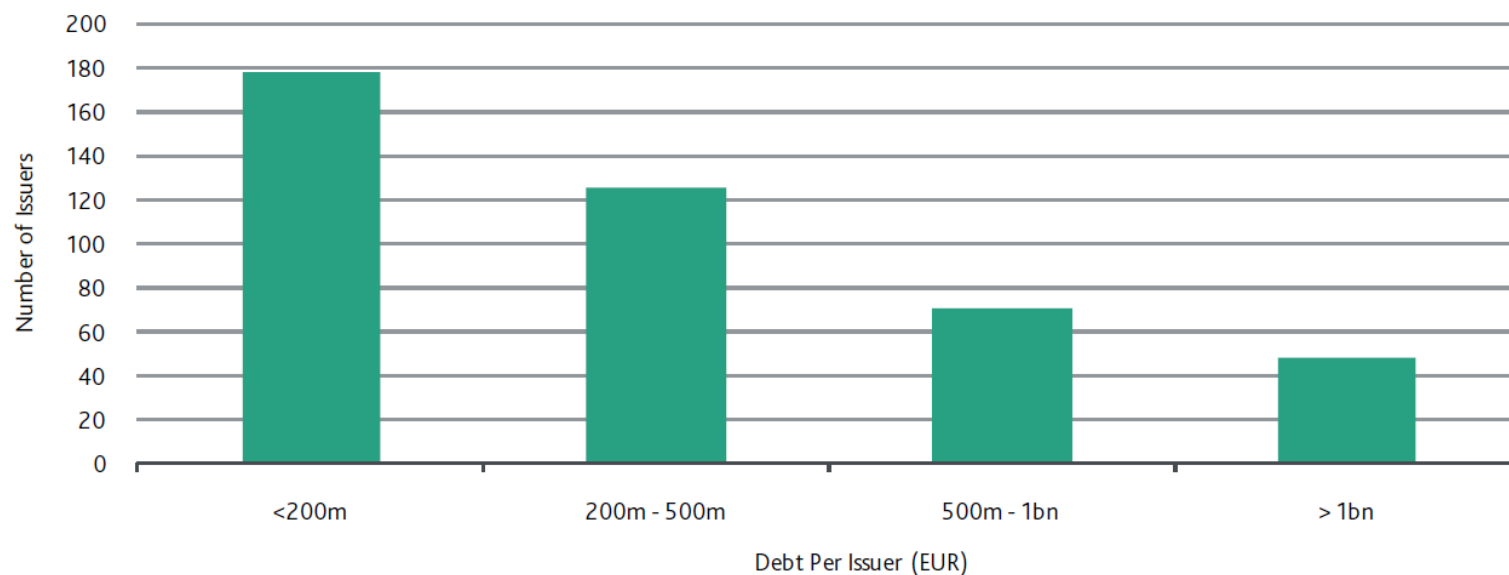


Source: S&P LCD

- In addition over 175 companies that require refinancing have less than €200m of total debt issued.
- Such companies **do not** have access to the public markets.

## ...and the high yield bond market is not an appropriate option for many...

Debt of European Unrated LBOs

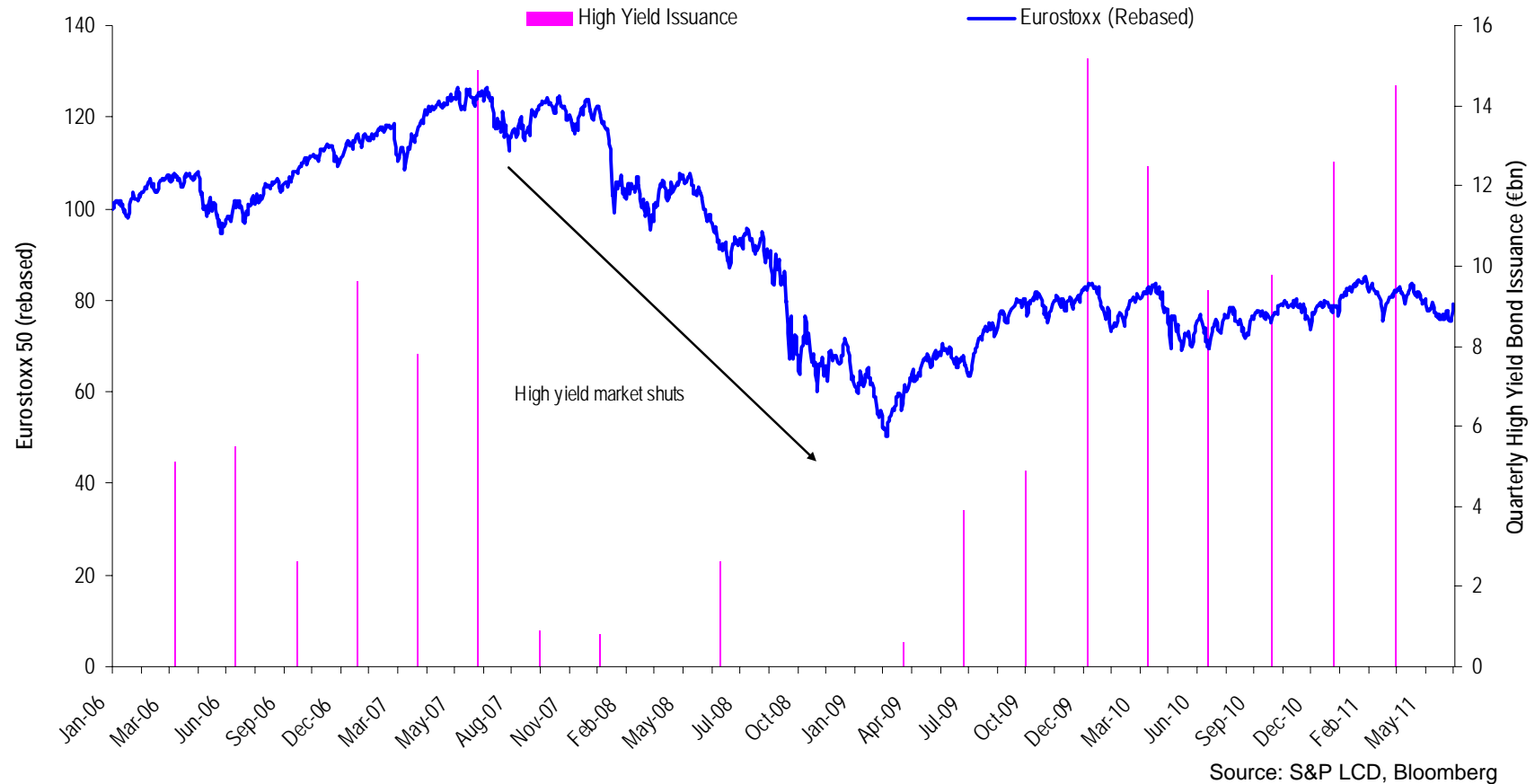


Source: Moody's

- According to Moody's research a minimum debt size of about €200m is required for a borrower to issue high yield bonds.
- 40% of privately rated companies in Europe have an insufficient debt quantum.
- In addition high yield issuance creates onerous public quarterly reporting requirements for mid cap companies.
- Bonds are a less flexible source of finance than loans








## ...and the market can shut due to contagion from wider financial markets.



- The European high yield bond market has historically closed for new issuance when there is wider market unrest, this presents a material risk to refinancings through 2013-18 given the unsolved sovereign and macroeconomic risks (e.g. USA, Greece).
- Current market dislocations illustrate that the market window is closed.

## So where does the financing come from to maintain European economic growth and ultimately high levels of employment...

Options	Issues	Lending capacity?
Investment Grade market	Companies do not have appropriate balance sheets or access to equity capital	
European High Yield Bond market	The market has minimum size constraints and can struggle in a challenging macro environment	
Banks / Insurance companies	Requirements to de-lever due to increased regulation (Basel III, Solvency II) expected to reduce their ability to offer financing	
Retail Funds / UCITS	Loans are not transferable securities therefore not currently available to retail investors. UCITS vehicles are subject to a 10% restriction on non transferable securities	
Pension Funds	Some appetite exists from pension funds, however allocations to this asset class are restricted by similar issues to retail funds discussed above	
CLO's	Implications of Article 122a on new issue market	