Association for Financial Markets in Europe

Response to European Commission Consultation Document on Undertakings for Collective Investment in Transferable Securities ("UCITS")

24 October 2012

The Association for Financial Markets in Europe ("**AFME**")[1] thanks the European Commission ("**EC**") for the opportunity to comment on its Consultation Paper (the "**Consultation**") titled "Undertakings for Collective Investment in Transferable Securities ("**UCITS**"). The comments in this response letter reflect the views of certain members of AFME, which represents global and European banks, investors and other significant players in Europe's wholesale financial markets, many of whom invest in or sell UCITS-eligible assets. AFME and its members are keen to be a part of any future ongoing dialogue in relation to this issue and would welcome an opportunity to meet with you and discuss these concerns in more detail.

This response letter will address the following areas of the Consultation:

1) Eligible Assets and Use of Derivatives, and

2) Long Term Investments.

In addition, the letter will make a few observations with respect to liquidity in the UCITS context.

I. Eligible Assets and Use of Derivatives

Question (1) – Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?

Yes, we do consider that there is a need to review the scope of assets that are eligible for UCITS funds. Currently, leveraged loans do not generally qualify as an eligible asset (although in some jurisdictions they may be included under the 10% unlisted basket). This exclusion is essentially based on a historical view of the relevant asset classes and

[1] AFME promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). For more information please visit the AFME website www.afme.eu.

does not take into consideration the evolution of the capital markets post the European Monetary Union. Leveraged loans share far more similarities than differences with high yield bonds (which everybody widely accepts as an eligible asset class), particularly with respect to liquidity and payment risk. Furthermore the ongoing continuation of this regulatory distinction is largely responsible for current market distortions, to the detriment of both corporate borrowers and potential investors.

For these and other reasons, the definition of "eligible assets" in Article 50 of UCITS should permit investments in certain types of loans. The inclusion of loans as an eligible investment in the current UCITS' scheme would be beneficial to all European market participants:

- European banks will benefit from an orderly redistribution of risk to the UCITS' professional investor community as tighter regulations and economic conditions force them to curb their risk exposure to corporate borrowers.
- Borrowers will benefit from this regulatory change as their refinancing risk would diminish if UCITS become an end investor of loans.
- UCITS managers will benefit as they will expand the universe of eligible investments to include loan instruments to gain exposure to the senior secured and unsecured part of the borrowers' capital structures.

There has been an ongoing discussion about the so-called "Wall of Maturity". It has been estimated that approximately EUR 133 billion of European leveraged loans will mature between now and 2015. Due to current economic conditions and bank capital requirements, as well as other regulatory restrictions, European banks will largely be unable (or unwilling) to provide refinancing for much of this maturing debt. It would be beneficial for borrowers, lenders and investors to increase non-bank participation in loans as a means of making more funds available to borrowers for refinancing existing leveraged loans, and will help to provide much needed breadth, liquidity and efficiency to the market.

The U.S. leveraged loan investment market can provide an illustrative example. For 2012, inflows into US loan funds exceed U.S. $6.5 billion year to date (12.2% of total assets). For the first nine months of 2012, U.S loan mutual fund assets under management expanded by 17.5%. In September 2012, U.S. loan mutual fund assets reached a record $82.1 billion. The U.S. market is stronger and more mature than the European market, as least partly, because of a specific, and remediable, problem – European restrictions on investment in leveraged loans by alternative investors (i.e., pension funds and retail investors, among others). For example, in September 2012, retail investors in the U.S. put $1.7 billion of new cash into loan mutual funds. Making leveraged loans UCITS eligible would be a positive step in providing access to the loan market for a large group of willing investors and would increase the likelihood that

European entities would have greater access to funds to meet (and/or restructure) their financing requirements.

In addition, The U.S. has a capital market structure where pricing is linked to credit quality and institutional investor appetite. In Europe, although institutional investors have increased their market presence over the past decade, banks remain a key part of the market. Consequently, pricing of loans in Europe is not fully driven by capital market forces. Permitting loans to be UCITS eligible would go a long way towards realigning loan pricing with credit quality and retail and institutional investor appetite. This would help to increase both the size and the efficiency of the European loan markets.

Historically leverage loans have exhibited some of the highest risk adjusted returns of any liquid market. Due to the fact that they are largely secured by both tangible and intangible corporate assets, recovery rates post default tend to be much higher than for high yield bonds. The combination of high recovery rates and large spreads help to dampen the mark-to-market volatility of leveraged loans, thus accounting for the attractive risk return profile.

Another beneficial aspect of loans as an asset class is that investors in bank loans receive yields based on floating rates. Currently, despite the historically low LIBOR rates, loan investors are able to realize 4.5%-6% cash yields. In the US, where leveraged loans are widely available to retail investors, they represent the best opportunity for investors to diversify their portfolio with floating rate assets, while still generating a reasonable level of return in the form of yield. Due to the UCITS eligible asset rules, this opportunity is completely unavailable to European retail investors. There is simply no way for European investors to recreate the opportunity set represented by leveraged loans in the European marketplace.

Of course, loans are already being used to a degree in UCITS as reference entities in Total Return Swaps ("TRS") under OTC ISDA rules. The use of TRS on loans may entail some degree of leverage embedded in the TRS, subject to funding arrangement among contracting counterparties. Making loans an eligible investment in UCITS removes the incentive to use TRS on loans as a conduit to gain that exposure by allowing investors to allocate directly into the preferred loan exposure. By eliminating, or reducing, the use of TRS on loans the indirect benefit is that unintended leverage is removed from UCITS vehicles, which would make portfolios more transparent. If UCITS funds are permitted to invest in loans via alternative strategies where additional counterparty risk and leverage is imposed, then direct investment in loans would be to the benefit of UCITS investors.

Including Loans as a UCITS eligible asset would serve also investor interests. Companies have historically profited from the fact that loan investors (bank and CLOs) are distinctly different from High Yield Investors (retail investors and pension funds). Under this regime, competitive tension only benefitted issuers, and was often to the

detriment of both loan and high yield investors. The inclusion of loans in UCITS would help retail investors and pension funds get a "better deal".

Finally, as stated above, providing credit to the broader economy is becoming more and more difficult, because there is no transfer mechanism. Banks can no longer adequately lend funds directly into the economy because they are capital constrained by economic conditions and various European regulatory restraints. Alternative investors (pension funds and retail investors) who should be able to take advantage of current conditions (and make a good return in the process) are prevented from doing so by regulatory barriers. There has been an ongoing discussion for a number of years as to why the high yield and leveraged loan markets in the U.S remain so much larger and more mature than those in Europe. When, as now, we are given the opportunity to take concrete steps that will help the European capital markets grow and become more mature, we should take it. Including loans as UCITS eligible assets as a means to increase investments by pension funds, insurance companies, and other institutional investors would be a major catalyst in encouraging growth in the European capital markets.

(2) Do you consider that all investment strategies currently observed in the marketplace are in line with what investors expect of a product regulated by UCITS?

Investors should expect access to a broad range of products that represent a spectrum of risk return profiles. Because leveraged loans are a significantly lower risk investment than equities and other speculative bonds (i.e. high yield) and unlike other fixed income investments carry no duration, or interest rate risks (in a rising interest rate environment the current income levels on loans will increase with principal remaining unchanged while other fixed income investments will see cash coupons unchanged with principal values decreasing), their investment characteristics are unique. These characteristics offer material diversification benefits and as such should be available to investors through a diversified investment pool represented by the common UCITS structures.

(3) Do you consider there is a need to further develop rules on the liquidity of eligible assets?

The liquidity profile of the leverage loan market is very similar to that of the high yield and as such the asset class could be managed under the existing UCITS liquidity requirements.

(4) What is the current market practice regarding the exposure to non-eligible assets?

Depending upon local interpretation of various UCITS rules, most specifically dealing with unlisted securities, some jurisdictions may allow for loans to be included in UCITS eligible funds. Loans are also occasionally structured into SPV's in which the loans are

the only asset and investors purchase notes issued by the SPV. These structures enable investors to "look through" the SPV to the underlying loan exposure with all cash being passed through the SPV to the investor. Although this structure mirrors the underlying economic interest of holding the loan directly, there is a significant impact on liquidity with the SPV structure suffering from a material decrease.

(5) Do you consider there is a need to further refine rules on exposure to non-eligible assets?

While it would be possible to define specific risk limits with loans (most prominently credit risk based on 3rd outside 3rd party evaluations), to the extent that existing regulations are silent on this with regard to other fixed income products, there is no reason to single out leverage loans for this treatment.

II. **Long Term Assets**

(2) Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand alone initiative be more appropriate?

A UCITS structure that encompasses leveraged loans could easily be modified to enable the inclusion of longer term infrastructure type loans. Ultimately the UCITS criteria should focus on underlying asset liquidity, which may be completely independent of asset maturity structure.

(4) Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced?

Under existing UCITS guidelines, there must be evidence that a preponderance of a fund's assets must have a high degree of liquidity (or at a minimum, expectation of liquidity) in order to satisfy the redemption requirements. Unless those redemption requirements are heavily modified (essentially moved to a closed-end structure) there must be an expectation of liquidity, as evidenced by numerous participants, free transferability of assets, and availability of independent, 3rd party valuations. If these criteria are not present, investors would be best served by investing in long-term, illiquid assets, through closed end vehicles. At least in this manner, investors would have some degree of liquidity on their investment interests without forcing liquidity into the underlying fund, which would be disadvantageous for an illiquid portfolio.

(III) **Liquidity and Counterparty Risk**

In general, liquidity is positively impacted by the number of market participants that trade in the relevant security. Expanding, in an appropriate manner, the list of eligible assets, and therefore the investor base in such assets, would improve the liquidity currently existing in the European leveraged loan market.

From a strictly UCITS regulatory perspective, the critical factor is that liquidity in loans be comparable to other eligible liquid instruments at the moment of divestment. Whilst liquidity varies across the loan universe in the same way that it does across the bond universe, it is possible to classify the loan universe in terms of loan quality, security, maturity, sponsorship and distribution. This classification can ultimately result in a better definition of liquidity rules from a UCITS perspective. The Commission should consider modification of the Article 84 liquidity rules to allow appropriate categories of loans to be investible instruments.

For the purposes of UCITS, liquidity is generally measured in terms of ease and speed of redemption. In the current loan market, loans are quite liquid and can generally be redeemed relatively quickly. Most unsettled trades result from a party purchasing a loan that the relevant counterparty does not own. In this case, settlement may be delayed until the loan is located and transferred to the fund. If this is the case, the fund would be compensated in the interim.

In any case, this aspect of settlement delay is not really a concern of the EC with respect to UCITS. The relevant question is whether the investor can access cash when redeeming shares of a fund. In this case the fund might have to go to sell a loan to generate proceeds from which to honour a redemption and the counterparty to the fund (usually a bank) simply settles in cash, which typically results in far fewer settlement delays.[3]

With respect to counterparty risk, UCITS are already subject to a number of regulatory constraints as to what constitutes maximum exposure to a single counterparty. We believe that the current rules in this regard are adequate and should treat counterparty risk exposure on loans in the same manner as the current group of eligible assets.

In addition to the reasons stated above, the inclusion of loans as an eligible asset in UCITS would be beneficial as it would help to reduce a disadvantage currently affecting European market participants *vis-a-vis* their US counterparts ("RIC's), which are already permitted to use loans as permissible investments.[4]

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[3] The Loan Market Association ("LMA") is already working towards reducing settlement periods from 90 days to 21 days, with a further target to 10 running days. Electronic platforms already tested put the industry well within the 10 day target.

[4] Perhaps we should further develop this argument to really focus on how European stakeholders are at a commercial disadvantage.

Please contact me at the email (or number) below if you have any questions or require any additional information. In addition, we would welcome an opportunity to discuss these issues with you in person, and are therefore available for a meeting (or call) at your convenience.

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