Regulatory outlook

The regulatory reform agenda has continued steadily at global and EU levels, and the present landscape reflects the current policy priorities: financial stability and systemic risk; maintaining an open and well-functioning EU financial market; and promoting sustainable private finance. The main initiatives of interest to loan fund managers are summarised below.

EU Commission proposals on non-performing loans

In March 2018, the European Commission presented reform measures addressing the risks in Europe's banking system related to high levels of non-performing loans (NPLs). NPLs are loans where the borrower is unable to make the scheduled payments to cover interest or capital reimbursements. When the payments are more than 90 days past due, or the loan is assessed as unlikely to be repaid, the loan is classified as an NPL.

The measures also include a proposal for a directive on credit servicers, credit purchasers and the recovery of collateral. This new EU initiative is expected to foster the development of secondary markets for NPLs by harmonising requirements for credit servicing and the transfer of bank loans to third parties across the EU.

The key points of the proposal, which is still under discussion, are as follows:

- The activities of credit servicers are defined — and rules for common standards for authorisation, supervision and conduct rules have been set. This will mean that operators respecting these rules can be active throughout the EU without separate national authorisation requirements.
- Banks and borrowers may agree in advance on an accelerated mechanism to recover the value from loans guaranteed with collateral. If a borrower defaults, either the bank or another secured creditor is able to recover the collateral that underpins a loan in an expedited way, without going to court. Out-of-court collateral enforcement is strictly limited to loans granted to businesses, and subject to safeguards — with consumer loans being excluded.
- A new reporting requirement is on the way, obliging purchasers of bank loans to notify authorities when acquiring a loan.

Systemic risk authorities focus on liquidity risk in open-ended funds

The asset management sector has been under scrutiny by the European Systemic Risk Board (ESRB), given concerns that increased financial intermediation by investment funds may result in the amplification of any future financial crisis. At the end of 2017, the ESRB issued a set of recommendations calling for additional legislative measures to: reduce excessive liquidity mismatches; bring in stress testing of liquidity risk; and introduce liquidity management tools for redemptions (such as redemption fees, redemption gates or the ability to temporarily suspend redemptions). Given the highly illiquid nature of loans, managers should expect attention from the regulator if they structure open-ended loan funds.

Sustainable finance and ESG

The European Commission has made its first legislative proposals to establish a framework to foster more sustainable private investment — a priority of the Capital Markets Union (CMU). These proposals intend to provide institutional investors, including asset managers, with clear guidance on how to integrate environmental, social and governance (ESG) factors into their investment decision-making processes, as well as on how to improve transparency to investors regarding the processes and how asset managers achieve their sustainability targets.

The disclosure requirements mainly cover:

- online publication of the entity's written policy on the integration of sustainability risks into its investment decision-making processes

— pre-contractual disclosures on: the procedures and conditions for integrating sustainability risks in investment decisions; the extent to which these risks are expected to have a relevant impact on the returns of the financial products; and the consistency of remuneration policies

— information, for financial products that target sustainable investments, on any designated index or on how the investment target will be reached

— online publication, for each financial product, of a description of the sustainable investment target — as well as the methodologies used to assess, measure and monitor the impact of the investment

— periodical reports describing the overall sustainability-related impact of the financial product through relevant factors and, where relevant, its impact relative to any designated index.

Facilitating cross-border distribution of funds

In March 2018, the EU Commission published a proposal package as part of the CMU, aimed at improving the distribution frameworks for AIFs and UCITS. This stemmed from criticisms that the regimes were burdensome, unclear and subject to "gold-plating" by national legislators. If adopted as proposed, the key changes would be as follows.

— Member States would no longer be in a position to require AIFMs that market AIFs to retail investors to have a physical presence in the countries where those AIFMs market their funds, process investors' orders, make payments and provide the fund information and documentation.

— A definition of pre-marketing would be introduced in the Alternative Investment Fund Managers Directive (AIFMD), allowing AIFMs to test the appetite of investors in a Member State before launching a notification process for the fund.

— Common rules on marketing communications, with an equally prominent presentation of the risks and rewards linked to the purchase of funds instruments, would be introduced.

— AIFMs targeting retail investors would have to notify authorities of all marketing communications that they intend to use directly or indirectly.

Guidance on the substance rules for Luxembourg investment fund managers

In the summer of 2018, the CSSF issued Circular 18/698, which sets out extensive prescriptive guidance on its expectations regarding organisation, operations and substance, as well as on the management information systems and regulatory reporting to be in place to facilitate its ongoing supervision of investment fund managers (IFMs).

The new circular is a useful compilation of guidance on the required level of local substance, how core business activities and internal control functions should be organised — including the conditions for the delegation of activities — and the concept of proportional application of the rules.