ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

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Submitted via email to: michiel.hoogeveen@europarl.europa.eu

31 May 2022

Dear Michiel,

Sustainability requirements for ELTIFs

The Alternative Credit Council (ACC)[1] believes that the proposed reforms to the European Long-Term Investment Fund (ELTIF) Regulation will see it develop into a key pillar of the Capital Markets Union. A fully developed ELTIF market will address the SME financing gap provide EU business with and provide savers across the EU with greater access to investment opportunities. At a time of growing inflationary pressures and macro-economic uncertainty, unlocking new sources of capital will also promote a more resilient business finance environment for EU businesses looking to invest and grow. While we remain strong supporters of the proposed reforms overall, I am writing to you today to highlight a critical issue which, if taken forward, will significantly hinder the uptake of the ELTIF vehicle across its targeted investor market.

A number of amendments put forth in the European Parliament's second draft compromise text would introduce a new category of an 'environmentally sustainable' ELTIF.

[1] The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over $600bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

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We do not believe it is appropriate to introduce specific ESG-related product requirements, labels or additional rules beyond those already required by the Sustainable Finance Disclosure Regulation (SFDR).[2] The SFDR already provides a consistent and comprehensive framework for sustainable finance in the EU, to which ELTIFs are subject. Introducing further sustainability-related requirements risks creating complexity and uncertainty for investors while also undermining the attractiveness of ELTIFs as an investment structure.

In addition, such amendments will present several practical difficulties that will undermine the attractiveness of the vehicle as outlined below. Detailed comments on specific Articles and Recital are included in the draft compromise text are provided as an Annex to this letter but we would highlight four key principles to support your consideration of the current proposed compromise amendments.

1. 'Environmentally-sustainable' ELTIFs will compare unfavorably to other fund structures

Mandating strict criteria for an 'environmentally sustainable' ELTIF will harm the competitiveness of the ELTIF compared to other investment structures such as AIFs. While an 'environmentally sustainable' ELTIF will be an opt-in product, it will also create uncertainty and risk with respect to how ELTIF managers launch and market other ELTIF products where these incorporate ESG related characteristics. For example, many prospective ELTIFs are likely to have some percentage of sustainable assets as part of their investment strategy but it is extremely unlikely that any would be able to reach 100% as required by the new 'environmentally sustainable' ELTIF. The inclusion of an environmentally sustainable ELTIF product type will require ELTIF managers to differentiate other ELTIFs which will create challenges in terms of how they design and market ELTIFs. This will introduce an additional element of risk and uncertainty to the Regulation which risks undermining the reforms that the Parliament is seeking to introduce more generally to enhance the ELTF regime.

2. Target assets of 'environmentally-sustainable' ELTIF are significantly limited

It is unlikely that ELTIFs will be able to meet the proposed requirements for environmentally sustainable ELTIFs to invest in assets that meet the Taxonomy requirements as laid down in the delegated acts adopted pursuant to Regulation (EU) 2020/852. The target assets of ELTIFs are primarily unlisted SMEs and mid-market companies, most of which are outside the scope of current Taxonomy Regulation requirements. Similarly, unlisted businesses are typically not within scope of the Corporate Sustainability Reporting Directive (CSRD) and will not be able to meet the requirement to report on this basis.

As most assets eligible for investment by ELTIFs will not be covered by the basic disclosure requirements of Taxonomy Regulation or CSRD, it will be almost impossible to understand whether or how those eligible assets comply with the various criteria suggested in the proposed amendments. We do not believe it is appropriate to introduce product requirements for the ELTIF that will be almost impossible for them to meet.

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[2] Sustainable Finance Disclosures Regulation.

3. ESG data challenges for unlisted businesses

Research published by the European Investment Fund[3], confirmed that the availability and quality of data are the key barriers to private credit firms implementing an ESG strategy. The ACC's own research[4] on this topic also highlighted the lack of financial and technical capacity in the SME and mid-market space to provide high quality and consistent ESG data.

The ACC industry is working with our members to address this challenge has and have partnered with the UN Principles for Responsible Investments (UNPRI),the Loan Syndication and Trading Association (LSTA) and the Loan Markets Association (LMA) to form the ESG Harmonisation Credit Consortium.[5] This group is developing a harmonised ESG reporting template and resources to support borrowers in providing ESG related data. We would strongly recommend that policymakers do not undermine the value of this initiative by introducing additional requirements for ELTIFs that may not be met under this approach.

4. Recognise how private markets are already incentivising businesses towards sustainable transitions

Many private credit managers are incentivising borrowers by introducing ESG-linked financial incentives (so called 'ratchets') into their loan agreements. These reward entities that meet pre-determined sustainability goals or KPIs with lower interest payments. As well as introducing financial incentives many private credit firms also provide support to their portfolio companies through technical support on guidance on how to improve the sustainability of their business. The growing integration of ESG by private credit managers and development of sustainability linked loans provides strong evidence of how this market actively driving sustainability outcomes without the need for regulatory intervention.

In light of the above, the ACC would urge you to consider the following policy options:

Preferred option: *If another 'ESG focused' investment vehicle is deemed necessary by policy makers, it should be introduced as a separate product*.

Regulatory interventions to introduce an ESG focussed investment vehicle for SMEs using tools designed for large corporates and publicly listed entities are unlikely to succeed. If there is a desire to introduce ESG focused products for private markets, these should be tailored to the specific features of the market. For example, using their existing capacity to capture and report ESG data to develop proportionate reporting requirements. While we recognise the value of such an approach in supporting the SME finance markets, it requires further analysis and is likely to be more successful if pursued outside of the ELTIF review.

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[3] EIF Working Paper 2022/80, EIF Private Debt Survey 2021 - ESG considerations in the lending strategy of private debt funds.
[4] See Financing the Economy 2021.
[5] See press release.

Alternative option: *If sustainability-focused amendments are to be retained in the ELTIF Regulation, it should be clarified that any requirements would be upheld on a voluntary, opt-in basis.*

We have outlined above the significant limitations of an 'environmentally-sustainable' ELTIF product and would strongly advise against any mandatory provisions which intend to oblige fund managers to pursue a sustainably focused ELTIF strategy. If it is deemed necessary to retain some references to sustainability in the ELTIF Regulation, fund managers should be afforded the flexibility of opting into such requirements on a voluntary basis.

In addition, the scope of the Taxonomy Regulation and CSRD is not applicable to the majority of the ELTIFs investible assets. While we recognise the attraction of using existing frameworks these are simply not sufficiently developed to work effectively in the SME and unlisted markets.

If policymakers wish for ELTIFs to support sustainable investment into SMEs and unlisted companies, this should be done in a way that recognises that SMEs are unlikely to meet the current taxonomy and CSRD requirements and develops more proportionate requirements to support investment in these businesses as they move towards more sustainable business practices. This can be better done at level 2 to allow greater consideration of this issue and ensure that any requirements can be met and incentivise investment in the way policymakers intend. This could be further augmented by reducing the timeframe by which the Commission is required to review the impact of proposed changes from 6 years to 2 to 3 years after the entry into force for the new requirement introduced in Article 37(1)ia.

We would be happy to elaborate further on any of the points raised in this letter and have enclosed our comprehensive comments on all amendments put forth by the European Parliament in a separate document. For further information please contact Nicholas Smith, Managing Director, Private Credit at nsmith@aima.org.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs, AIMA
Global Head of the ACC

Annex – Detailed comments

We have provided comments below on specific articles/recitals included within the latest ELTIF compromise text. Text in red highlights the aspects where we see the amendments having a negative impact on the regime, those in yellow as having a broadly neutral impact, and those in green as having a positive impact on the regime.

Environmentally-sustainable ELTIF category:

- Article 7 (4): The proposed requirement under for environmentally sustainable ELTIFs to be either Art 8 or 9 under SFDR seems redundant. If these ELTIFs are already Article 8 or 9 funds then investors will already have the tools to assess whether they meet with their ESG expectations and compare with other funds on a consistent basis. While we do not see this providing a material benefit to investors we do not think it will harm the take up of ELTIFs

- Article 9 (1)a and Article 13 (1)a: The requirement for environmentally sustainable ELTIFs to invest only in eligible investments assets which meet taxonomy requirements will be virtually impossible to meet. The target assets of ELTIFs are primarily unlisted SMEs and mid-market companies, most of which are outside the scope of current Taxonomy Regulation requirements. Similarly, unlisted businesses are typically not within scope of the Corporate Sustainability Reporting Directive (CSRD) and will not be able to meet the requirement to report on this basis. As most assets eligible for investment by ELTIFs will not be covered by the basic disclosure requirements of Taxonomy Regulation or CSRD, it will be almost impossible to understand whether or how those eligible assets comply with the various criteria suggested in the proposed amendments. We do not believe it is appropriate to introduce product requirements for the ELTIF that will be almost impossible for them to meet and would encourage policymakers to reconsider this amendment.
- Recital 21a: We do not think it is appropriate to require ESMS to develop RTS setting out assets which are at risk of becoming stranded assets. This is unlikely cause significant challenges for ELTIF managers.

Disclosure requirements:

The most recent compromise amendments proposed expand the disclosure requirements on ELTIFs in several areas. This will reduce the attractiveness of the entire ELTIF regime as all prospective ELTIF managers will have to meet these requirements which go beyond those required for other investment funds, particularly in respect of how they will disclosure their sustainability features. As noted above, creating bespoke requirements for ELTIF beyond existing sustainable finance rules will only add further confusion to investors and create operational challenges for ELTIF managers.

- Article 13 (4)a: ELTIFs will already disclosure the nature of their investments to investors and are permitted to invest in assets outside the EU. If the goal is to promote greater investment in EU assets policymakers should look at other ways to make EU assets more attractive. Creating an additional reporting requirement based on an arbitrary threshold of 70% investment in the EU will not provide any benefits to investors but could be managed if needed.

- Article 23 (3)fa, g and h: This would impose significant disclosure obligations into the prospectuses for all ELTIFs not just environmentally sustainable ELTIFs. We would encourage policymakers to reconsider this amendment and reduce this requirement to only apply to environmentally sustainable ELTIFs rather than all ELTIFs.

Miscellaneous:

- Amendment 129 to recital 25 seems unnecessary as ELTIF managers (AIFMs) are already subject to AIFMD. Making this explicit is unlikely to negatively impact ELTIF managers.
- Amendment to recital 34 seems unnecessary, any fees charged on subscription and redemption fees will be subject to the same disclosures as other types of retail funds and investors already benefit from other protections within PRIIPs and KID. It is likely that such a requirement can be met within the existing disclosure framework making this explicit should not negatively impact ELTIF managers.
- Recital 40 is a welcome amendment. Allowing ELTIFs to opt into the new requirement prior to entry will support speedy take up of the ELTIF vehicle.