CENTRAL BANK OF IRELAND, LOAN ORIGINATION BY INVESTMENT FUNDS: DISCUSSION PAPER (JULY 2013): RESPONSE TO CONSULTATION[1]

Q1 Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibiting from originating loans? Q5 Do respondents agree with the analysis of the funding gap?

Yes. The Discussion Paper makes a compelling and empirically-robust case for permitting loan origination by investment funds within an appropriate regulatory framework.

A series of studies (from the crisis-era but also more generally) attest to the financial system instability and macro-economic risks which can follow from over-dependence on bank-based credit intermediation. A more diversified credit intermediation system, with stronger market-based credit intermediation channels, should support financial stability and more stable and diversified funding of the real economy. While the financial crisis has underlined the risks of intense levels of market-based intermediation, it remains the case that market-based channels for financial intermediation generally and credit intermediation in particular provide an important source of funding and serve to diversify risk.[2]

It is also the case that, as the major financial-stability-driven elements of the crisis-era reform programme complete, that the efficiency of financial markets in supporting the real economy should become the subject of practical and targeted reforms which facilitate productive market intermediation. The repaired financial system (and the very high costs of the repair) must be put to productive use. Evidence suggests that the major equity markets are struggling to support equity capital-raising and are increasingly platforms for supporting the monitoring of firms and generating returns in the secondary markets.[3] The corporate bond market in the EU, however, appears to be strengthening significantly (if the current trend persists)[4] in response to the impaired bank credit channel; this strengthening suggests that market-based funding may be entering into a

[1] Please note: not all questions are the subject of this response.

[2] A recent IMF study has highlighted the importance of the financial system supporting different intermediation channels: IMF, Global Financial Stability Report, October 2012, ch. 4 (Changing Global Financial Structures: Can they Improve Economic Outcomes).

[3] Eg, The Kay Review of Equity Markets and Long-Term Decision Making, Final Report (2012))

[4] Eg, ECB, Financial Stability Review, May 2013 (2013) 43

new phase in the EU. Similarly, the 2013 Commission Green Paper on Long Term Financing,[5] referenced in the Discussion Paper, queries whether the EU's historical heavy dependence on bank-based intermediation for long-term funding will give way to more diversified market funding, including through institutional investors and alternative financial markets, and proposes a range of reforms to support market-based funding. In particular the Commission has highlighted the need for 'other intermediaries to complement the role of banks by channeling financing to long-term investments in a more productive way.'[6] It is also the case that funding channels for SME funding must be stabilized and strengthened; the current series of EU-driven reforms are, however, heavily based on equity funding[7] and so are unlikely to facilitate materially easier SME access to funding; the growth in the corporate bond funding similarly does not support most SMEs. Loan origination investment funds may accordingly come to provide a specialist channel for SME funding (as is also implicit in the recent series of EU reforms to the fund sector, including the venture capital, social entrepreneurship and (proposed) long term investment fund reforms). The proposal for investment funds to be permitted to engage in loan origination is accordingly a targeted and proportionate response to an evidenced funding need. It also responds to a wider public interest in the productive functioning of the repaired financial system.

The proposal also has a risk mitigation function. The overall impact of the crisis-era reforms on real economy funding costs remain to be seen, although some studies suggest that its impact may be less severe than sometimes projected.[8] It is, however, the case, that, taken in the round, the reforms may have unintended effects on funding to the real economy. Market-making in corporate bonds, for example, may become more costly. The September 2013 Commission Proposal for the regulation of Money Market Funds may (if adopted) lead to a contraction in the funding activities of money market funds, which represent a major source of short-term debt funding. The implications of the proposed 2013 Financial Transaction Tax proposal (if adopted) remain unclear, but it is likely to have spill-over effects outside the FTT-zone. It is accordingly appropriate that mitigating regulatory action is taken in the form of facilitative but proportionate changes to the regulatory framework, directly targeted to the support of funding.

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[5] Commission, Green Paper. Long Term Financing of the European Economy (2013) (COM (2013) 150/2)

[6] Ibid, 7-8.

[7] Eg, the MiFID II/MiFIR proposal for an 'SME Growth Market.'

[8] Eg, Santos, A, and Elliott, D, Estimating the Costs of Financial Regulation, IMF Staff WP (2012).

Finally, investment fund regulation (particularly in Ireland) has a long history; there is significant regulatory and industry experience with portfolio and risk management regulation. While loan origination would represent a change, by contrast with the more novel elements of the crisis-era programme (notably the OTC derivative market reforms), the regulatory devices to hand are relatively well-tested (if in different contexts). This augurs well for the likelihood of an empirically-sound response. The most effective regulatory response is one which facilitates prudent loan origination by internalizing the cost of risk within funds; investment fund regulation includes a number of channels through which the appropriate placement of costs can be supported. The FSB policy framework/toolkit also provides a flexible basis for developing a regulatory response.

Q2 What are the 'shadow banking' risks raised by the relaxation of the current policy? Q6 Do respondents agree loan origination funds would fall squarely into the first and second of the FSB defined economic functions if open-ended and even if structured so as not to do so, could still be argued to fall under function five?

The Discussion Paper appropriately identifies the risks related to maturity and liquidity transformation and, in particular, the mismatch between long-term assets and short-term liabilities, exacerbated by the vulnerability of open-ended funds to runs.

Q7 Respondents are asked whether they agree with the main risks with loan origination identified in Section 5 and whether there are other risks?

The risks identified seem to capture appropriately the major classifications of risk; risks 2-3 appear the most acute and specific to investment fund loan origination and to general shadow banking risk.

In addition (albeit to a lesser degree), the different operating and regulatory environment for funds may lead to a weakening of risk controls given pressure from competition. There may be some risk of leakage to the retail sector (where the illiquid nature of these funds poses significant risks) where distribution controls are not sufficiently robust and distribution channels are not subject to continuous oversight. Risks to market integrity may arise where market sensitive information is acquired in the process of loan origination.

Q8 Respondents are asked for their views on the analysis of the difference between loan origination and loan participation and the resulting risks which arise?

Loan origination is a fundamentally different exercise to loan participation, not least given the different nature of risk assessment. Of particular importance are the market standards which have developed with respect to the highly-organized syndicated loan market, and the related monitoring devices which have shaped loan origination risk-management practices. Scale issues also arise as do the incentives provided by capital regulation. The monitoring of credit risk across the wide investor base of investment funds is of a different nature to the monitoring of credit risks across bank purchasers in the syndicated loan market (not least given the different regulatory environment within which banks operate and the capital costs imposed on loan assets), and suggests that the investment fund loan origination process would be subject to different monitoring dynamics, and could go through an unstable evolutionary phase, in the absence of a regulatory framework.

Q10 How is a geographic diversification requirement best addressed within the requirements?

The Discussion Paper highlights the importance of diversification as a risk management tool for investment funds. Diversification strategies have not, however, been used to their maximum effect within the regulatory structure; the UCITS issuer/counterparty investment limits, for example, provide little protection against sector risk; while investors are rewarded for taking on risk (including sector risk), the diversification achieved through the regulatory system is often limited, and the investor risk/reward calculation is not a complete proxy for financial stability. The focus on geographic risk is therefore welcome. The most effective form of regulation, however, internalizes the costs of risk, albeit within a strong regulatory framework. Prescription of geographic diversification would be difficult to achieve, could stifle commercial judgment, and expose the regulator to risk. Governance- and risk-management requirements, which require documented evidence of senior management consideration of geographical risk (and related strong supervisory oversight) seems to be the more proportionate response. In addition, clear (non-boiler-plate) disclosures of geographic risk should strengthen market discipline.

Q15 Respondents are invited to offer views as the appropriateness of a capital/co-investment requirement?

This requirement seems of fundamental importance. Ensuring appropriate interest alignment between the fund and its investors (given the agency costs) and between the fund and the wider public interest in financial stability is of central importance to the proposed new regulatory framework – not least given the difficulties in capturing the risks from loan origination through prescriptive asset allocation requirements. Experience from the private equity sector underlines the importance of participation as a risk alignment device. While capital provides a means of costing and internalizing risk, it is a costly and often blunt device and could restrict productive activity; the internalization of risk through participation requirements should achieve better allocation of risks and costs.

Q17 Respondents are asked whether they agree with the analysis of the main risks and mitigants for loan origination investment funds? Are there others?

The menu of regulatory tools, which addresses the different elements and stages of the risk chain, seems to appropriately capture the potential risks and to be functionally equivalent, to the extent necessary, to the regulation of loan origination by banks. Intensive supervision, however, would be required, particularly of governance, processes (including distribution to qualified investors) and internal models.

Q18 Respondents are asked if they agree that closed-end investment funds with limited leverage mitigate against many of the financial stability risks? Q12 Respondents are asked whether they agree that it appears difficult to make a case for anything other than such investment funds being closed-end?

Yes. The very different risk profile of Money Market Funds underlines the risk mitigation which a closed-end fund provides. The closed-end fund structure provides an efficient regulatory proxy for the otherwise intensive regulation and supervision needed to support a fund against the risk of runs; the impact of redemption fees and gates, for example, is uncertain. Similarly, the intensive portfolio regulation of the UCITS fund underlines the scale of regulatory intervention needed to support funds against redemption demands. A closed-end fund structure also implies close

monitoring by investors given the illiquidity risks (the private equity and hedge fund sector provide useful comparators). As the FSB toolkit emphasizes focus and proportionality, a targeted reform based on closed-end funds seems appropriate.

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