Alternative Investment Management Association

Loan Originating Qualifying Investor AIF
Markets Policy Division
Central Bank of Ireland
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Submitted electronically to: fundspolicy@centralbank.ie

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Dear Sirs,

AIMA's response to the Central Bank of Ireland's consultation on loan originating Qualifying Investor AIFs

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to submit its comments on the Central Bank of Ireland's (CBI) Consultation Paper CP 85 (the 'Consultation Paper') regarding loan originating qualifying investor alternative investment funds ('QIAIFs').

We welcome the CBI's proposal to permit loan originating by QIAIFs as we believe it is important to introduce an appropriate regulatory framework for non-bank financing of the economy. We believe that the asset management sector is particularly suited for such an activity due to the direct risk-bearing nature of investors' participation in the loan funds. This is one of the reasons why the need to introduce or copy banking regulation into the asset management sector in this space is greatly mitigated or unnecessary. Investors, unlike depositors, can and should be able to bear losses associated with their investments.

That said, we agree that this type of activity requires certain risks to be addressed. In particular, we agree that the closed-end structure of the vehicle proposed, certain organisational and operational requirements as well as the inability of retail investors to participate in loan funds go a long way in achieving the stated policy goals related to financial stability and investor protection. However, we do have several concerns with certain restrictive provisions of the proposal which we believe could make the new fund vehicle much less attractive for managers and investors. Our concerns relate to the following points:

- **Leverage:** We consider that imposing a leverage limit on loan originating QIAIFs is unnecessary as the Alterative Investment Fund Managers Directive ('AIFMD') permits alternative investment funds ('AIFs') to employ leverage limits in accordance with the relevant strategy and obliges managers to ensure that the levels of leverage to be employed are demonstrably reasonable. Furthermore, AIFMD imposes additional requirements on those AIFs that employ leverage on a 'substantial' basis. We consider that limiting a loan originating QIAIF's leverage to 200% is therefore overly restrictive. If a limit is to be imposed, we would suggest that allowing a loan originating QIAIF to employ leverage of up to three times the fund's NAV would be more appropriate and consistent with the AIFMD. In addition, we would suggest that the CBI also retains a possibility to authorise QIAIFs which could use leverage above that of statutory maximum as long as heightened risk management and reporting requirements are met;

[1] As the global hedge fund association, the Alternative Investment Management Association (AIMA) has over 1,300 corporate members (with over 6,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors.

- **Eligible assets:** We consider that loan originating QIAIFs should be permitted to invest/hold a portion of their assets in (i) loans and loan participations purchased on the secondary market, loan securitisations, bonds, convertible debt securities, and equity instruments; (ii) derivative instruments which will allow them to hedge their risks; and (iii) where necessary, any assets posted by a borrower as collateral in the event of a default or restructuring. This will allow these types of funds to more adequately diversify their portfolios and potentially alleviate the problem of the timing of the sale of assets received as a result of a debtor's default or restructuring having an adverse pro-cyclical impact;

- **Liquidity:** The Consultation Paper envisages that redemptions or distributions may be made by a loan originating QIAIF during the life of the fund, but will require approval of unitholders when assets of the QIAIF are valued on a basis other than by reference to prevailing market prices. However, we consider requiring approval of the unitholders on each occasion would be overly cumbersome and costly in situations where the redemption or distribution is being made pro rata to all unitholders or in situations clearly envisaged by the loan originating QIAIF's rules or instrument of incorporation and/or its offering document (e.g. failure of the investor to provide information necessary for AML/KYC or FATCA reporting purposes). The directors of the fund should therefore be given discretion to instigate distributions or redemptions on a pro rata basis or in circumstances clearly envisaged by the loan originating QIAIF's rules or instrument of incorporation and/or its offering document, regardless of the method of valuation to the extent that there is unencumbered cash or liquid assets available for the distribution or redemption and where such distributions or redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating QIAIF; and

- **Requirements with respect to certain loans acquired from a credit institution:** We would welcome clarification that the requirements set out in paragraph 13, subparagraphs (i) and (ii) should be viewed as conjunctive (i.e. and) rather than disjunctive (i.e. or) and these requirements are meant to apply only when there is an ongoing course of dealing between a bank and a loan originating QIAIF rather than with respect to the occasional acquisition of a single loan or a small number of loans from a bank.

A full discussion of each of these matters is included in the Annex. We hope you find our comments useful and would be more than happy to answer any questions you have in relation to this submission.

Yours faithfully,

Jiří Król
Deputy Chief Executive Officer
Head of Government & Regulatory Affairs

ANNEX

AIMA's response to the Consultation Paper

Leverage

The Consultation Paper states that a leverage limit is to be imposed on loan originating QIAIFs in order to mitigate pro-cyclical vulnerabilities in funds that originate loans. We do not consider that restrictions on the use of leverage should be imposed on loan originating QIAIFs as they will be a professional product and the AIFMD does not impose leverage restrictions on AIFs. However, if a leverage limit is to be imposed, we consider that the limit should be higher than 200%. Whilst we understand that the limit on leverage aims to tackle certain identified risks, we consider that imposing a limit on leverage such that the loan originating QIAIF has total asset coverage of at least 200% is overly restrictive, especially when this limit is compared with other international limits on leverage.

There are several leverage metrics that are used internationally for measuring and monitoring risk which the CBI could look to when considering where the appropriate level of leverage for a loan originating QIAIF should be set. For example, in the United States, the Financial Stability Oversight Council (FSOC) identified a 15 to 1 leverage ratio as a potential screening factor for the purposes of systemically important financial institution (SIFI) determination.[2] This is just a screening criterion which does not necessarily lead to such a determination that an entity which has a higher leverage ratio than 15:1 will be a SIFI. In the EU, the Alternative Investment Fund Managers Directive (AIFMD) imposes additional requirements on those managers who are managing funds 'employing leverage on a substantial basis'[3]. Article 111 of the AIFMD Level 2 Regulation[4] states that leverage is considered to be employed on a substantial basis when the exposure of an AIF exceeds three times its net asset value. Funds under this limit are still subject to certain disclosure requirements in relation to leverage, which all QIAIFs will already be subject to. The European Commission considered in the Level 2 implementing Regulation that those AIFs which employed less than three times leverage were not 'substantial' and therefore did not need to be subject to additional reporting requirements.

Only permitting very low levels of leverage is likely to mean that loan originating QIAIFs will exclude lower risk projects from their strategies as they will not produce the returns that would be generated by riskier projects. With this in mind, we consider that it would be more appropriate to permit loan originating QIAIFs to employ leverage such that the loan originating QIAIF has total asset coverage of at least 300% as this is more in line with EU legislation and will allow broader access to finance for those who are seeking a loan, such as small-to-medium sized enterprises.

In addition, we would suggest that the CBI also retains a possibility to authorise QIAIFs which could use leverage above that of statutory maximum as long as heightened risk management and reporting requirements are met. Such requirements could, for example, include more regular reporting than that which is required under the AIFMD as well as potentially more rigorous stress testing and risk management procedures.

We recognise that the AIFMD uses a different measure of leverage than that which is set out in the proposal and we presume, based on the wording of Paragraph 19 of Section 4, that leverage for purposes of these requirements will be measured by indebtedness and not using the gross or commitment methods set out in the AIFMD. We strongly support this approach. Neither the gross nor the commitment methods have been developed with in a way which would have specialised loan and credit vehicles in mind. Both methods were largely inspired by existing UCITS legislation which does not contemplate the holding and originating of loans. Furthermore, we propose that

[2] Final Rule of 3 April 2012 - 12 CFR Part 1310, See the Stage 1 Thresholds on page 23 of 93.

[3] See Article 24(4) of the AIFMD.

[4] The Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

derivatives instruments are to be held by the QIAIFs for hedging purposes, something we would suggest will decrease the actual leverage of the funds.

Eligible assets

Paragraph 2 of Section 4 of the draft amendments to the AIF Handbook requires a loan originating QIAIF to "limit its operations solely to the business of issuing loans, participations in lending and to operations directly arising therefrom, to the exclusion of all other commercial business". This limitation on the eligible assets of a QIAIF may prevent managers of loan originating QIAIFs from adequately managing their assets and creating an adequately diversified portfolio. We consider that the categories of eligible assets permissible for a loan originating QIAIF should be expanded in three ways.

First, we would posit that it may be better from the systemic risk perspective to expand the scope of eligible assets for these types of funds to include loans and loan participations purchased on the secondary market, bonds, convertible debt securities, equity instruments and derivatives (see discussion regarding derivatives below). The ability to invest in other types of instruments should help loan originating QIAIFs by dampening potential pro-cyclicality. For example, investments where conversion to equity is foreseen from the outset or is a distinct possibility during the time of the investment are investments that may not cause distress in times of defaults. As a minimum, it should be clarified that funds can therefore hold other types of instruments/assets if that is a result of a restructuring or default by the borrower on the loan (see the further discussion in this regard below).

We understand that the loan originating QIAIF is a new product and the limitations on the scope of investments available to this type of fund are meant to enhance the ability of the CBI to monitor exactly what these funds are doing and to maintain the ability to compare the activities of these funds against each other and understand the sector as a whole. However, we believe that there is a possible middle ground that should be considered. We would suggest that one way of achieving the aims of broad comparability and transparency while alleviating the down sides from the imposition of a ban on other types of holdings would be to adopt a similar approach to that which is taken in the proposed European Long-Term Investment Fund ('ELTIF') Regulation and to require that 70% of the assets of the fund must be held in loans and to permit the other 30% to be held in other assets. We would also suggest that there should be flexibility as well to exceed this 30% threshold in the event that assets are received as a result of a default, provided that no new investments may be made by the fund in anything other than loans as long as the fund remains over the 30% threshold (see further discussion below regarding the holding of assets received as a result of default).

With respect to acquisitions of loans originated by others, we note that the drafting of paragraph 2, which states that the loan originating QIAIF must "limit its operations solely to the business of issuing loans, participations in lending and to operations directly arising therefrom, to the exclusion of all other commercial business" may prohibit a loan originating QIAIF from acquiring a loan in a secondary transaction or acquiring interests in a loan securitization vehicle. Moreover, that provision seems contradictory to the types of arrangements contemplated by paragraphs 13 and 14.

Second, it is unclear from the proposal whether loan originating QIAIFs would be able to use derivative instruments to hedge against their risks. Paragraph 2 of the draft amendments (quoted above) seems to suggest that derivatives will not be permitted assets for loan originating QIAIFs as that provision limits the QIAIF's "operations solely to the business of issuing loans, participations in lending and to operations directly arising therefrom, to the exclusion of all other commercial business". However, paragraphs 6 and 9 refer to certain obligations of the loan originating QIAIF which would require the use of derivatives. In particular, paragraph 9(ii) states that:

> "the loan originating Qualifying Investor AIF shall ensure that:… (ii) the application of credit risk mitigation techniques and, in particular risks associated with large indirect credit exposures such as a single collateral issuer, is addressed and controlled including through the establishment and implementation of written policies and procedures."

Given the limitation set out in paragraph 2, it may be exceedingly difficult for loan originating QIAIFs to comply with paragraph 9(ii) without recourse to derivatives. The CBI should allow for the use of derivatives to manage risks associated with investments such as foreign exchange, credit and interest rate derivatives as well as other hedges that are relevant to the particular fund. For example, loans to commodity producers could be hedged by commodity derivatives.

Third, loan originating QIAIFs are very likely to be originating loans secured by collateral, although the nature of that collateral may vary widely depending on the nature of the loan and the borrower. If a borrower defaults on a loan originated by a QIAIF or otherwise acquired by a QIAIF or the relevant loan is restructured, it could easily be the case that the QIAIF would exercise its lien, in full or in part as relevant, on the collateral securing the loan and take possession/ownership of it. For example, if the loan is secured against a building and the borrower defaults, the loan originating QIAIF will need to have the ability to take possession of that building. If loan originating QIAIFs are only permitted to hold loans on their books, the building would have to be sold immediately. This may not be the best commercial outcome and could mean that in the event of a default by borrowers, assets are dumped on the market with potentially pro-cyclical effects. It is often the case that managers to loan funds will negotiate for collateral that they are able to manage and later sell at a time that makes the most sense for the fund thus mitigating the negative impact a default may otherwise have had on the fund's value.

Liquidity

The Consultation Paper envisages that a loan originating QIAIF may have discretion to invite, at dates determined at the authorisation date, without commitment and on a non-preferred basis, requests for redemption of holdings from unitholders. However, the redemption or distribution will not be able to be made unless the loan originating QIAIF has approval from the unitholders on each occasion if the assets of the QIAIF are valued other than by reference to prevailing market prices.

Conceptually this is fine. However, the way the provision is drafted, a QIAIF would be foreclosed from making distributions or redemptions at its own initiative (as distinct from doing so in response to requests from individual unitholders) subject to the same condition of a unitholder vote in the event that the assets of the QIAIF are valued other than by reference to prevailing market prices. Because a loan originating QIAIF is required to be closed ended and all investors are required to be treated fairly, distributions and redemptions at the initiative of the QIAIF are most likely to be made on a pro rata basis or for regulatory or other reasons set out in the QIAIF's rules or instrument of incorporation and/or its offering document (e.g. failure of the investor to provide information necessary for AML/KYC or FATCA reporting purposes). Requiring approval of the unitholders on each occasion would be overly cumbersome, costly and unnecessary where the redemption or distribution is made on a pro rata basis to all unitholders or is made in a situation clearly envisaged by the loan originating QIAIF's rules or instrument of incorporation and/or its offering document. The directors of the fund should therefore be given discretion to instigate distributions or redemptions on a pro rata basis or in circumstances clearly envisaged by the loan originating QIAIF's rules or instrument of incorporation and/or its offering document, regardless of the method of valuation to the extent that there is unencumbered cash or liquid assets available for the distribution or redemption and where such distributions or redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating QIAIF.

We would therefore suggest that Paragraph 18 of Section 4 of the draft amendments to the AIF Handbook should be amended as follows:

> "18. The loan originating Qualifying Investor AIF shall only make distributions or provide for redemptions of unitholders holdings during the life of the loan originating Qualifying Investor AIF to the extent that there is unencumbered cash or liquid assets available for distribution or redemption purposes and that such distributions or redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating Qualifying Investor AIF. Unless the assets of the loan originating Qualifying Investor AIF are valued by reference to prevailing market prices, a distribution or redemption of unitholder holdings, ***on an other than pro-rata basis or in circumstances clearly envisaged by the***

loan originating QIAIF's rules or instrument of incorporation and/or its offering document, cannot be made without the approval of the unitholders, in accordance with the procedures set out in the constitutional document, on each occasion."

Requirements with respect to certain loans acquired from a credit institution

Paragraphs 13 of Section 4 of the proposed amendments to the AIF rulebook provides that a loan originating QIAIF:

"shall not acquire a loan from a credit institution under arrangements which involve:

(i) The retention by the credit institution or a member of its group of an exposure correlated with the performance of the loan;

(ii) The provision of an administration, credit assessment or credit monitoring service in relation to the loan, whether on an individual or portfolio basis, by the credit institution or a member of its group

unless the loan originating Qualifying Investor AIF is satisfied that the requirements set out in paragraph 14 below have been fulfilled."

The paragraph also supplies a broad definition of what it means to "acquire a loan" for these purposes.

Because there is neither an "and" nor an "or" between subparagraphs (i) and (ii), it is not clear whether the subparagraphs are meant to be read conjunctively or disjunctively. The explanation at paragraphs 8 and 9 of the "Questions for Consideration" section of the Consultation Paper suggests that it is likely that the intended reading is for the provisions to be read conjunctively, such that if either element is not in play then the provision does not apply. If read as if there were an "or" there, then the requirements of paragraph 14 would apply to all purchases of loans from banks and not just to ones where a bank has partnered with a fund or where there is an ongoing connection between a credit institution and the particular loan originating QIAIF.

We would also welcome clarification that the requirements of paragraphs 13 and 14 are meant to apply only when there is an ongoing course of dealing between a bank and a loan originating QIAIF rather than with respect to the occasional acquisition of a single loan or a small number of loans from a bank. To this end, we recommend adding the word "ongoing" between "The provision of an" and "administration" in paragraph 13(ii). Where the relationship between the bank and the loan originating QIAIF is not ongoing or like that of a partnership between them, and a single loan or a small number of loans is being purchased on a one off basis, the application of requirements that more typically apply to pooled securitization arrangements seem overly onerous.

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