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25 August 2014

Re: CP 85 - loan originating Qualifying Investor AIFs

We welcome the publication by the Central Bank of CP85 and the proposal to introduce a regime for loan originating Qualifying Investor AIFs ("LO-QIAIFs").

We attach our response to the consultation paper. We have received feedback from a number of our clients that are managers with significant loan investment expertise. This feedback is reflected in the attached.

We are happy to discuss these issues further.

Yours sincerely,

ARTHUR COX

Donogh Crowley, John S Walsh, Michael Meghen, William Johnston, Eugene McCague, Nicholas G Moore, David O'Donohoe, Colm Duggan, Isabel Foley, John Meade, Conor McDonnell, Patrick McGovern, Grainne Hennessy, Séamus Given, Colin Byrne, Caroline Devlin, Ciarán Bolger (Chairman), Gregory Glynn, Stephen Hegarty, Declan Drislane, Sarah Cunniff, Kathleen Garrett, Pádraig Ó Ríordáin, Elizabeth Bothwell, William Day, Andrew Lenny, John Menton, Patrick O'Brien, Orla O'Connor, Brian O'Gorman (Managing Partner), Mark Saunders, Mark Barr, John Matson, Deborah Spence, Kevin Murphy, Cormac Kissane, Raymond Hurley, Kevin Langford, Eve Mulconry, Philip Smith, Kenneth Egan, Bryan J Strahan, Conor Hurley, Alex McLean, Glenn Butt, Niav O'Higgins, Fintan Clancy, Rob Corbet, Rachel Niall, Siobhán Hayes, Pearse Ryan, Ultan Shannon, Dr Thomas B Courtney, Orla Keane, Aaron Boyle, Rachel Hussey, Colin Kavanagh, Kevin Lynch, Garrett Monaghan, Geoff Moore, Fiona McKeever, Chris McLaughlin, Maura McLaughlin, Joanelle O'Cleirigh, Paul Robinson, Richard Willis, Tim Kinney, Deirdre Barrett, Cían Beecher, Ailish Finnerty, Robert Cain, Connor Manning, Gary McSharry, Keith Smith, John Donald, Dara Harrington, David Molloy, Stephen Ranalow, Jonathan Sheehan, Gavin Woods, Simon Hannigan, Claire McGrade, Colin Monaghan, Susan O'Reilly, Niamh Quinn, Colin Rooney, Catherine Austin, Hilary Callanan, Aiden Small

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Annex I: Permitted activities of loan originating QIAIFs

CP 85 refers to the proposed new regulatory regime which would apply to a type of fund whose *"sole strategy is loan origination"*. However, the proposed new draft section 4, paragraph 2 of Chapter 2 of the AIF Rulebook provides as follows:

"*The loan originating Qualifying Investor AIF shall 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"*.

The ability for LO-QIAIFs to pursue a combined strategy of loan origination, acquisition of loans on the secondary market and the acquisition of debt securities is of fundamental importance to the success of this product. Without this ability, we have a real concern that the LO-QIAIF will not be of sufficient interest to managers or indeed investors.

Given the reference in CP 85 that the *"sole strategy"* of the LO-QIAIF should be loan origination, it would be helpful if the revised AIF Rulebook clearly provided for the ability of LO-QIAIFs to (i) acquire interests in loans by way of assignment or sub-participation; (ii) acquire debt securities; (iii) hold cash and other liquid assets; (iv) use financial derivative instruments; and (v) acquire any collateral pledged as security under the terms of the loans originated or otherwise acquired by the LO-QIAIF.

We also suggest that it be clarified that an umbrella QIAIF can be comprised of both (i) LO-QIAIF sub-funds; and (ii) sub-funds investing in non-LO-QIAIF strategies.

Annex II: Arthur Cox responses to individual questions within CP 85

1\.

Credit assessment granting and monitoring: *The draft rules require that the loan originating Qualifying Investor AIF must have an effective credit assessment and management process with established policies in a number of key areas in line with the requirements for credit institutions. Do you agree with this approach?*

In addition it should be noted that

- *Loan originating Qualifying Investor AIF will, in relation to relevant lending, be subject to the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises.*
- *The Central Bank has the ability to tighten the lending standards, including in cases where this is deemed necessary for financial stability and macro prudential purposes.*

We welcome the proposals in relation to credit assessment granting and monitoring, which we recognise are aligned with CRD and practices in the banking sector. However, we think the AIF Rulebook should expressly apply the principle of proportionality to these requirements. This reflects the fact that the infrastructure of managers will differ from that of a bank.

We note that the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises ("SME Code") would apply only where loans are issued to SMEs operating within the Irish state. However, it should be noted that the SME Code covers many of the same general principles that an AIFM must adhere to under Article 12 of AIFMD. Application of the SME Code would therefore need to take that into account and provide for a hierarchy of laws in the event of a conflict. This could be addressed by providing that the Central Bank's SME Code applies in relation to relevant lending *"except where the requirements of that Code are covered by AIFMD or inconsistent with an obligation the AIFM has under AIFMD*." We note that the SME Code was written at the time when investment funds were not within its scope and is written from the perspective of a bank acting as the lender.

2. ***Diversification:*** *While, unlike other Qualifying Investor AIF, we propose that a loan originating Qualifying Investor AIF must aim to achieve a diversified portfolio of loans, we also propose that the period of time necessary to achieve the minimum diversification can be established by the AIF in the prospectus. We believe this is a proportionate control because of the particular dangers of an overly concentrated strategy. We also recognise that because of the nature of this asset class it may subsequently, for reasons beyond the control of the AIF, be impossible to reach the target diversification. Accordingly, we have devised a solution which would require the AIF to seek approval from unit holders to either continue with a revised diversification strategy or terminate. Do you think this is the right approach?*

We note the proposal that there be a limit on exposure to any one issuer or group to 25%. While we agree with the principle that exposures should be appropriately diversified to avoid overly concentrated strategies, we disagree with the proposal that a limit be prescribed by the AIF Rulebook. QIAIFs in other asset classes are not subject to this diversification requirement. LO-QIAIFs established as investment companies under Part XIII of the Companies Act 1990 are subject to a statutory obligation to diversify risk. The Central Bank has sensibly avoided being prescriptive about how risk diversification is to be achieved in the case of other investment strategies and it seems inconsistent to apply a specific limit to LO-QIAIFs where no such limit is imposed on other, potentially riskier, strategies. It should be for the AIFM to determine what the appropriate risk limits should be in the context of the proposed strategy for the individual LO-QIAIF and it should be for the investor to determine on the basis of the disclosures on risk limits in the prospectus as to whether it is comfortable assuming the level of risk disclosed. If the Central Bank feels that there needs to be prominent risk disclosure in this regard, which most AIFMs would insist on in any event as a matter of prudent disclosure, we suggest that the AIF Rulebook specifies that the prospectus of a LO-QIAIF with diversification limits per issuer higher than 25% include a prominent risk disclosure on its cover page to this effect.

If the LO-QIAIF is not sufficiently diversified by the deadline specified in the prospectus, shareholder approval is needed so that the LO-QIAIF can continue to operate at the current level of diversification. Otherwise, the LO-QIAIF must terminate. It would be important to allow for a sufficiently long ramp-up period before the diversification levels must be achieved. The shareholder approval threshold to continue the LO-QIAIF should be clarified to be an ordinary resolution of shareholders in accordance with the LO-QIAIF's constitutional documents.

We think it would also be helpful if the AIF Rulebook expressly referred to a similar "grace period" where the LO-QIAIF is winding down positions, has received early pre-payments on existing loans or in other circumstances referred to in the prospectus.

Separately, we note the list of prohibited borrowers set out in the draft section 4, paragraph 11 of Chapter 2 of the AIF Rulebook includes "other collective investment undertakings". We would query the rationale for this prohibition. Investment funds are a vital part of the "real" economy, engaging in activities such as investing in the growth and restructuring of companies. We believe it would be unhelpful to economic growth to exclude LO-QIAIFs as a potential source of funding to such investment funds.

3.

Liquidity: *We propose to require that a loan originating Qualifying Investor AIF must be closed ended. This is to avoid the situation which may arise in an open ended fund where sudden losses of investor confidence lead to investor runs which in turn leads to a situation where loans may have to be recalled or sold on. Our research indicates that investment funds which engage in loan origination elsewhere tend to establish as closed funds in any event.*

We also recognise that the requirement for a closed fund should not prevent an AIF following the maturity of certain of the assets, to distribute the return from the realised assets to unit-holders. Accordingly we have developed an approach which will allow redemptions or distributions at the discretion of the loan originating Qualifying Investor AIF. This discretion must be exercised on a non-prejudicial basis. Moreover, if assets of the AIF are not valued by reference to market prices, each redemption or distribution can only be made with the approval of unitholders.

We would recommend that the term "closed-ended" is not used as this has a variety of different meanings under, for example, AIFMD and the Prospectus Directive. However, we have no issue with the LO-QIAIF having the discretion to refuse redemption requests at all times so as to avoid any potential “run” on the assets of the LO-QIAIF.

We suggest that the section is reworded to state that the LO-QIAIF must be a closed-ended or limited liquidity QIAIF. The limited liquidity QIAIF can provide that any redemption requests are satisfied entirely at the discretion of the QIAIF or the AIFM provided that, if redemption requests are processed, they are satisfied on a non-preferred basis.

We would also note that, due to the illiquid nature of the assets of a particular LO-QIAIF strategy, it may not be possible for a close-ended QIAIF to specify at the date of authorisation of the QIAIF those pre-determined dates at which redemption events may occur. In addition, there may be early pre-payments on the loans. Therefore, it should be possible for the closed-ended AIF to add redemption events to the schedule post-authorisation where it is determined that there is available cash to distribute by way of redemption payments.

We believe that shareholder approval for a distribution or redemption in the event that the assets are not valued by a reference to prevailing market prices is unnecessary. The AIFM will be subject to the AIMFD valuation rules. Any distribution payments will be made on a pro rata basis to all investors in the relevant class. All redemption opportunities must be offered on a non-preferred basis. Accordingly, even where model pricing is being used in a LO-QIAIF, all investors will participate in a distribution and will have the opportunity to participate in a redemption event. Any such distribution or redemption would have to be met out of unencumbered cash or liquid assets. Finally, we do not believe it is appropriate that shareholders holding a majority of the shares could block a distribution or redemption approved by the LO-QIAIF and the AIFM that could otherwise be made available to all shareholders. This would put minority shareholders at a distinct commercial disadvantage as they would be relying on the votes of other shareholders rather than the judgement of an AIFM and the LO-QIAIF that they have selected to invest in.

4.

Due diligence by investors on the management of a loan originating Qualifying Investor AIF: *In our consultations and research we found that detailed due diligence by investors in loan funds is a widespread practice. In effect this due diligence by investors appears to us to supplement reliance on prospectus disclosure to a unique degree. While it is likely that this is currently working well, simply as a consequence of market discipline in this small market sector, we need to ensure that due diligence continues to be done in an orderly way if the sector expands. The envisaged rule does not require due diligence access to be provided by all such funds. It merely requires that where provided, a non-discriminatory outcome for all investors is achieved.*

It is true that AIFMD already sets out specific rules which require an AIFM to "treat all investors fairly". Additionally, Article 23 of the AIFMD Level 2 Regulation states that "any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors". Nevertheless it may be useful for the

Central Bank to have a more specific rule with regard to due diligence in the context of this type of AIF. The proposed rule requires that there will have been non-discriminatory access for investors - it does not require that all potential investors who approach the AIF expressing an interest in investing will be given the same access. We intend to leave managerial discretion as to how to achieve this outcome. It would not necessarily require that all potential investors get equivalent initial access. Do you think that we should include this rule? We welcome feedback on this matter particularly from investors on whether they consider it is a useful protection measure.

We note the proposal that where the AIFM intends to provide access to its records/staff to any investor for the purposes of a due diligence process, it must ensure that such access is being made available on a "*non-discriminatory basis to all unitholders*" (Part II, section 4, paragraph 10 of the draft amended AIF Rulebook).

We agree that the use of the term "*unitholders*" in the draft amendments to the AIF Rulebook is the correct one and understand that the Central Bank does not intend that all potential investors who approach the AIF expressing an interest in investing will be given the same access. CP85 states that the Central Bank will leave "*managerial discretion as to how to achieve this outcome*". We suggest that this element of discretion be explicitly referred to in the amended AIF Rulebook. In addition, we suggest that the AIF Rulebook clarify that "*such information shall be made available to a unitholder upon request by that unitholder*". This should avoid any implication that the AIFM has a positive obligation to pro-actively provide such information to all unitholders and that the onus is on the unitholder to request such access.

We believe that it is important to ensure consistency in the terminology used in the AIF Rulebook and the regime implementing AIFMD (Directive 2011/61/EU) generally. We note the principle referred to at Article 23 of the AIFMD Level 2 Regulation that "*any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors*". For the avoidance of doubt, the AIF Rulebook should state that "*preferential treatment accorded by an AIFM to one or more unitholders in the loan originating Qualifying Investor AIF in terms of access to its records/staff shall not be considered to be discriminatory where the granting of such access rights is determined by the AIFM not to result in an overall material disadvantage to other unitholders and an appropriate description of such access rights shall be made available to*

all unitholders". We think this is an important clarification as there may be instances in which preferential access rights are appropriate but do not operate to disadvantage other investors.

It would be very important that the managerial discretion referred to above is explicitly stated in the AIF Rulebook so that the AIFM can make the determination that, for the reasons set out in the bullets above or otherwise, the provision of access rights to some but not unitholders does not operate to the overall material disadvantage of other unitholders.

We suggest that paragraph 10 in the draft amended AIF Rulebook be amended as follows: The penultimate sentence should be deleted. The final sentence should be reworded to state that "*The AIFM shall not intentionally or negligently conceal or fail to disclose information that a reasonable investor in the loan originating qualifying investor AIF would be likely to have considered* ***material*** *in considering an investment in the loan originating Qualifying Investor AIF"* [amendment in bold]. As a general principle, investors should be provided with all information that would be material to an investment decision by a reasonable investor and that the prospectus or other document does not omit any such material information. This materiality test should be referred to in paragraph 10. The penultimate sentence in paragraph 10 seems to be addressing the same issue although we would have a concern that the concepts referred to - "*would not be influenced to invest…because of a lack of access to information*" - adds unnecessary complexity and untested terminology. We would strongly urge the Central Bank to rely on the concept of materiality as suggested for the last sentence of paragraph 10.

5.

Valuation: *AIFMD contains detailed rules, particularly in the Level 2 Regulation on valuation and imposes a number of obligations on AIFM which apply notwithstanding that they may not carry out the valuation function. For example, an AIFM must ensure that for each AIF, there are fair, appropriate and transparent valuation methodologies. These must be disclosed to investors. AIFMD does not require that the assets of AIFs are valued by reference to market prices and recognises that for certain types of AIF this may not be possible. Accordingly there are a number of mitigants to address risks arising where market prices are not available and for example, valuation procedures must include a review process particularly where a material risk of an inappropriate valuation exists. We are not proposing to include any additional rules in relation to the valuation of the assets of a loan originating Qualifying Investor AIF. In the light of our proposal, set out in number 3 above regarding redemptions and distributions, do you consider that this is the correct approach or should any distributions be prohibited unless market pricing is available?*

We agree that AIFMD rules are sufficient in relation to valuations. Please see our response above to question 3 in relation to redemptions and distributions.

6.

Leverage: *We believe that leverage is a key potential source of cyclical vulnerability. The ESRB has advised us of the importance of mitigating pro-cyclical vulnerabilities in funds which originate loans. In our view, there should be a leverage limit in such funds for this reason. However, we also recognise that AIFs operate without any statutorily specified leverage limit. Neither AIFMD nor our AIF Rulebook apply a leverage limit to Qualifying Investor AIFs. Under AIFMD, AIFMs are required to set a maximum level of leverage for each AIF and disclose this to investors. They are required to be able to demonstrate that the limit set for each AIF is reasonable and that they are complying with it at all times. Nevertheless, in light of the specific risks attached to loan origination, we propose to impose a leverage limit on loan originating Qualifying Investor AIFs and we have set this at a ratio of 1:1. For example, an AIF with assets of 100 may borrow 100. The requirement for total asset coverage of at least 200% means that should the value of the assets decline, the leverage level must also be reduced and, accordingly, leverage must be managed to ensure compliance with the leverage limit in changing market conditions. Do you agree that this is an appropriate level of leverage?*

The Central Bank has the ability to tighten the leverage limit including in cases where this is deemed desirable in order to manage credit growth or to address a threat to financial stability.

In recognition of difficult market conditions which may result in a breach of the limit and that these market conditions may prevent the AIFM from immediate deleveraging, an additional rule sets out the process which must be followed in the event of a breach. Do you consider that there is sufficient detail around that process?

AIFMD imposes detailed requirements in relation to the use of leverage by AIFMs and their AIFs. However, no specific leverage limits are imposed by AIFMD. Instead, AIFMD requires that AIFMs provide to investors upfront and ongoing disclosure on the level of

leverage that may be and is employed. AIFMD also imposes comprehensive regulatory reporting obligations. To impose requirements additional to those requirements under AIFMD would be a significant departure from the approach applied to all other QIAIFs. We don't believe that this departure is necessary.

Imposing a leverage limit of 1:1 would constitute a material constraint for a significant number of managers who have indicated that they would not be able to trade within these limits. This limit runs the risk that LO-QIAIFs will be pushed to the riskier end of the loan investments spectrum such as mezzanine type loans or to lower grade borrowers. The very robust feedback we have received from global investment managers with a proven track record in loan investments is that, if the regime involves an absolute leverage limit of 1:1, it will simply not be workable.

This leverage limit is also out of step with the limit applicable to banks (10 times). We also note that while Business Development Corporations ("BDCs") in the US currently have a similar 1:1 leverage ratio, they are not available to retail investors in the US and it is expected that this leverage limit will in any event increase to 2:1 in 2015. It should also be noted that the methodologies to calculate leverage for BDCs are not the same as those used to calculate leverage under AIFMD (see below). Therefore, a comparison with BDCs is not necessarily a like-for-like comparison. Finally, other QIAIFs are not subject to a prescribed leverage limit.

We would therefore ask that the Central Bank reconsider this proposal and suggest instead the following:

- the limit should be raised to be consistent with AIFMD's concept of leverage on a substantial basis which is three times NAV (using the "commitment" approach);

- the method of calculating any limits, whether self-imposed or imposed by the AIF Rulebook, should be consistent with the "gross" and "commitment" methods prescribed by AIFMD;

- the limit of three times NAV may be disapplied if the LO-QIAIF has a minimum subscription limit of €500,000 or its equivalent in other currencies. The aggregate of an investor's investments in the sub-funds of an umbrella Qualifying Investor AIF cannot be taken into account for the purposes of determining this requirement. The amounts of subsequent subscriptions from unitholders who have already subscribed the minimum subscription of €500,000 are unrestricted. Institutions may not group amounts of less than €500,000 for individual investors;

- if these limits are subsequently exceeded for reasons beyond the control of the LO-QIAIF or as a result of investment in FDI or the exercise of subscription rights, the LO-QIAIF must record such matters and adopt as a priority objective the remedying of that situation, taking due account of the interests of its unitholders; and that

- any subsequent reduction in the leverage limits can only be applied to new lending.

7. ***Disclosure:*** *Detailed disclosure to investors of an AIF's investment objectives, policies/ strategies and the risks attached to these, is a significant part of the AIFMD regulatory regime. Given the nature of this asset class however we are proposing to impose supplementary disclosure requirements, both in the prospectus and periodic reports of a loan originating Qualifying Investor AIF. These include specific risk warnings and detail on the credit assessment and monitoring process and any amendments to that process.*

We are also proposing to require itemised disclosure to investors of each loan in periodic reports under prescribed categories and, in particular, propose to require that loans which are either non-performing or have been subject to forbearance activities are identified. These are matters which are prescribed in the final draft Implementing Technical Standard to be adopted under Article 99 of Regulation EU No 575/20131. Our approach is that loan originating Qualifying Investor AIFs apply the same criteria as banks to distressed loans and investors can have some assurances that appropriate categorisation is applied. Do you consider that this is the correct approach?

For the most part, we have no issues with the proposals in relation to the disclosure requirements outlined in CP85.

However, it should be noted that the disclosures required in the periodic reporting may include some confidential, proprietary or price sensitive information particularly in respect of the underlying borrower which may not be appropriate to release in a periodic report under paragraph 24. Points 24 (iii) and (iv) in particular, require periodic disclosure of loan to value information on each loan and information in respect to non-performing exposure and exposure subject to forebearance activities. This information could be seen as confidential or price sensitive to the loan parties involved. In order to address this concern, we propose that the LO-QIAIF could provide details by way of percentage of loans made that are non-performing, without identifying the specific loans in question.

Also, paragraph 10 of the draft Rulebook contains a provision that *"The AIFM shall not intentionally or negligently conceal or fail to disclose information that a reasonable person would be likely to have considered important in considering an investment in the loan originating Qualifying Investor AIF"*. There is already a general requirement in the AIF Rulebook that a QIAIF's prospectus must contain *"sufficient information for investors to make an informed judgment of the investment proposed to them"*.[1] We would suggest that the standard wording in relation to the obligation to provide relevant information should be consistent with that for other QIAIFs.

Under paragraph 20 of the draft AIF Rulebook amendments, we suggest that the term *"all sales material"* is clarified. Much of the sales material will come from the AIFM and will relate to its team rather than specifically any AIF in question. We would therefore recommend changing "by a loan originating QIAIF" to *"in respect of a loan originating*

[1] Paragraph 2 of the general prospectus requirements under Section 3, Part I, Chapter 2 of the AIF Rulebook

QIAIF" to exclude general sales material regarding the AIFM itself that does not reference the fund.

Under paragraph 24(i) the terms *"senior secured debt, junior debt and mezzanine debt"* are used but not defined. In order to provide the AIFM with a clear frame of reference we suggest inserting *"as defined in the governing documentation of the Qualifying investor AIF"* at the end of this sentence.

8. ***Interconnectedness with the banking sector:*** *The ESRB has advised us that loan origination by investment funds could increase regulatory arbitrage opportunities between the banking and non-banking lending sectors. They advise us to monitor and mitigate such risks. Identification of suitable lending opportunities is a central business challenge for loan origination funds. It is likely that AIFMs of loan originating AIFs will seek partnerships with banks particularly to leverage off their expertise with regard to credit analysis, risk management and the structuring and servicing of loans and to access their client base. Such arrangements may also be desirable for banks. Banks may find it beneficial to use the balance sheets of AIFs for risk sharing purposes as well as meeting demand from clients which a bank is not in a position to take on its own balance sheet.*

While there can be benefits in such partnerships, this may also introduce systemic risks arising from arbitrage and we are proposing to address this risk by a requirement for each loan originating Qualifying Investor AIF to include detail of any undrawn committed credit lines in periodic reports. When aggregated by bank and looked at in conjunction with data on drawn facilities, this should provide useful information to regulators on the relationships between the banking and non-banking sectors.

Please see the response to question 9 below.

9. *In addition to requirements in AIFMD regarding investment in securitisations and rules in our AIF Rulebook on transactions with connected parties, we are requiring that specific rules apply where there is any on-going connection between a credit institution and a loan originating Qualifying Investor AIF. Do you think that this is sufficient?*

As questions 8 and 9 both outline proposals relating to interconnectedness with the banking sector, we have considered these items together.

Any LO-QIAIF will:

i. be an internally-managed AIF or have an external AIFM, in either case subject to the provisions of AIFMD;
ii. be regulated by the Central Bank as a collective investment scheme under the relevant Irish statutory provisions; and

iii. comply with the specific regime set out in the consultation and to be inserted in Chapter 2, Part II, Section 4 of the AIF Rulebook (the "Draft Amendments").

As noted elsewhere in this response, the approach of placing LO-QIAIFs firmly within the AIFMD regime imposes a high standard of prudential regulation and regulatory reporting obligations upon the structure. In addition, the Central Bank has invested significant effort and resources, through the July 2013 Discussion Paper and its subsequent discussions with industry participants and international colleagues, in developing additional prudential rules to address concerns around regulatory arbitrage, contagion risk, liquidity risk and pro-cyclicality, which are set out in the Draft Amendments. For example, the detailed provisions in relation to credit granting, monitoring and management in paragraphs 5-9 of the Draft Amendments create a tailored set of rules to supplement the existing general provisions of AIFMD and the AIF Rulebook. We believe that this rigorous regime addresses the concerns by the ESRB in relation to regulatory arbitrage opportunities between the banking and non-banking lending sectors.

We note the proposals in paragraph 25 of the Draft Amendments to require the loan originating QIAIF to include a *"list of any undrawn committed credit lines"* in its periodic reports. We recognise that such information may be useful for regulators in determining the relationships between banking and non-banking sectors, but believe that any regulatory measures should be proportionate to the risks posed to the regulatory system. In addition, we believe that loan originating QIAIFs may view such information as sensitive and, as such, be reluctant to disclose it publically via its periodic reports. Given that the intention behind this proposal is to facilitate regulatory supervision, rather than serve any investor disclosure purpose, and in light of the above concern around confidentiality, we would propose that such information be provided directly to the Central Bank as part of ongoing reporting, rather than form part of the periodic reports.

We note also the series of rules in paragraph 14 which will apply in certain circumstances where a LO-QIAIF acquires a loan from a credit institution. While we have no fundamental objection to most of these, we believe that many of the provisions of paragraph 14(a) of the Draft Amendments, including for example the requirements to be able to value the loan, monitor performance of the loan and to stress test the loan are addressed in other sections of the Draft Amendments. For example, paragraph 16 includes detailed stress testing obligations on the loan originating QIAIF, regardless of whether it originates directly or acquires from a credit institution.

We are also aware of concerns raised by market participants as to the ability or willingness of arranging banks in the existing syndicated loan market (which would be the vendor for the purposes of these provisions) to provide a warranty to the QIAIF that it will retain 5% of the nominal value of the loan as measured at origination (as contemplated by paragraph 14(b)(i) of the Draft Amendments).

In this regard, it is worth recalling the review of the existing syndicated loan market for secondary loans conducted by the Central Bank in the context of the July 2013 Discussion Paper. As part of that review the Central Bank had noted that it "*is a highly structured market, with specialised teams operating in banks and asset managers to review loan participations which are circulated by other financial institutions which structure a deal on the basis of their own detailed credit assessment and on the basis of bespoke structured documentation, fees and interest rates particular to that deal*". It goes on to note that "*the syndicated loan market has an inherent discipline around the credit assessment and*

monitoring because loans must be structured and priced to be credible to a range of potential lenders".

There are no existing 'skin in the game' or retention requirements at the point of loan origination in the Irish syndicated loan market and we are not aware of similar provision in loan markets in other jurisdictions. We have been advised that arrangers may prove unwilling to accept this additional requirement as a cost of dealing with Irish LO-QIAIFs, thereby limiting the ability of the new QIAIF product to access this market. The purpose of a retention requirement is generally to ensure alignment of interests between the originator and any purchasers in the secondary market. However, as the Central Bank has noted above, the syndicated loan market is a sophisticated market with loan arrangers subject to the inherent discipline around credit assessment and monitoring in order to ensure that loans are structured and priced in a way that is credible to a range of potential investors.

We have been advised by managers in this market that the introduction of this requirement on a unilateral basis would place Irish LO-QIAIFs at a significant disadvantage in the purchase of debt from banks in the secondary market. Effectively, the banks would be unwilling to sell to an Irish LO-QIAIF if the cost was the imposition of a 5% 'skin in the game' requirement. This would result in a smaller pool of potential investment for Irish funds and increased costs in respect of those transactions in which they do engage. To introduce this requirement on a unilateral basis would discourage banks from selling to Irish LO-QIAIFs in the secondary market, thereby reducing investment opportunities and increasing costs for Irish LO-QIAIFs.

Accordingly, if a 'skin in the game' requirement is to be applied to loan arrangers in this manner, it should be imposed on a harmonised level (whether as an EU or global initiative) in regulation aimed at loan arrangers and credit institutions rather than through the back-door as a local Irish restriction which will not be able to achieve the intended aim and will only damage the interests of Irish LO-QIAIFs and their investors.

10.

Reporting and stress testing: *Macro prudential supervisors need information on the activities of loan originating AIFs in order to address systemic risks associated with excessive credit growth and leverage. AIFMD imposes substantial reporting requirements on AIFMs who must, inter alia, provide periodic information on the ten principal exposures of each AIF; the five most important portfolio concentrations; borrowings of cash or securities; and borrowing embedded in financial instruments. In addition we intend to put in place similar reporting on individual loans as is provided by the banking sector. It is also intended that our requirements in this regard will evolve with developments in banking. The rules also provide for periodic stress testing. Do you agree with our approach?*

We would urge the Central Bank to re-consider the merits of imposing additional reporting obligations over and above the onerous reporting obligations prescribed by AIFMD. In particular, we would ask that the Central Bank consider whether the reporting on individual positions already required by AIFMD addresses the concern that sufficient data is given to the Central Bank on individual loans.

The draft AIF Rulebook refers to the results of stress testing being reported to "senior management". We assume that this refers to the senior management of the AIFM and would ask that this be clarified in the AIF Rulebook.