

Submitted via email to:
fundspolicy@centralbank.ie

22 August 2014

Dear Sirs

Central Bank of Ireland consultation paper on loan originating Qualifying Investor AIF dated 28 July 2014 (the "Consultation Paper")

We refer you to our letter (the "2013 Response Letter") dated 18 September 2013 in response to the Central Bank of Ireland discussion paper of July 2013 (a copy of which is appended to this letter).

In the 2013 Response Letter we provided our general views in favour of loan origination by investment funds and we now welcome the publication of the Consultation Paper and continue to support the introduction of a framework enabling Irish funds to originate loans.

As a general comment we would agree with the Central Bank's statement in the Consultation Paper that many of the risks identified can be mitigated by the provisions of the Alternative Investment Fund Managers Directive ("AIFMD"). We believe that the AIFMD formalises what was generally accepted as best practice amongst asset managers and reflects the steps that are required by an asset manager to achieve a track-record and attract investors. Consequently, we do not believe that further extensive regulation of QIAIFs is required in this area.

We attach a schedule setting out our detailed responses to the "Questions for consideration" raised in the Consultation Paper which cross-refers to our mark-up of the draft Qualifying Investor AIF Requirements which is also attached. In each case we have addressed whether we believe the amended rules constitute a proportionate regulatory regime for a Qualifying Investor AIF with a primary objective of loan origination and how such rules might impact the structuring of a loan originating Qualifying Investor AIF.

If you would like to discuss this further, please do not hesitate to contact us by contacting Oliver Burgel or Caroline Mortimer (contact details below).

Yours faithfully

Oliver Burgel
Chief Operating Officer
Babson Capital Europe Limited
email: oburgel@babsoncapital.com
tel: +44 (0)20 3206 4586

Caroline Mortimer
Associate Director, Legal
Babson Capital Europe Limited
email: cmortimer@babsoncapital.com
tel: +44 (0)20 3206 4553



David Wilmot
Joint Head of Private Finance
Babson Capital Europe Limited

Attachments:

- Schedule of Babson responses
- Mark-up of draft Qualifying Investor AIF Requirements
- 2013 Response Letter

SCHEDULE

No.	Question for consideration	Babson response
	<p>Activities of loan originating Qualifying Investor AIF</p>	<ul style="list-style-type: none"> • In relation to paragraph 2, we have broadened the scope of activities to reflect the practice of loan originating funds. A loan originating QIAIF should still have the ability to purchase loans in the secondary market or to take a transfer of a loan from a syndicating bank as part of a primary syndication process without additional restrictions (as regular QIAIFs are already permitted to do). This flexibility is also required for the QIAIF to achieve diversification.
1	<p>Credit assessment granting and monitoring</p>	<ul style="list-style-type: none"> • We agree with the approach of the Central Bank in relation to credit assessment granting and monitoring and believe that, for the most part, the draft requirements reflect best practice amongst asset managers and are such that Babson funds would not have any difficulty in complying. • As reflected in the mark-up, we believe that the obligations should generally fall on the AIFM rather than the fund itself. • In relation to the criteria specified, we feel strongly that risk appetite should be part of the overall risk framework of our business and the risk relating to any credit should be proportionate – we do not think it is appropriate for an individual fund to include a risk appetite statement above and beyond the existing requirements under AIFMD for the AIFM to periodically disclose to investors the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.
2	<p>Diversification</p>	<ul style="list-style-type: none"> • We agree with the importance of a diversified portfolio of loans and believe that this is best addressed as a risk factor in the prospectus (as currently required by AIFMD). • It is worth noting that any fund (as opposed to a deposit taking bank) is required to satisfy potential investors through the provisions of the prospectus that adequate diversification is in place in order to attract investment. • Nevertheless, we believe that, for the most part, the draft requirements reflect best practice amongst asset managers and are such that Babson funds would not have any difficulty in complying. • Diversification may not be maintained in the late stages of a fund's life as the portfolio of loans shrinks due to prepayments/repayments etc and the proceeds are returned to investors as redemptions and distributions. We have marked up some suggested wording clarifying this

No.	Question for consideration	Babson response
		<p>would not constitute a breach of diversification requirements, but do not know if the intention was to in fact permit this outcome by remaining silent on the matter (which could equally work).</p> <ul style="list-style-type: none"> We have marked up paragraph 12(v) to ensure that this provision does not restrict us from entering into private equity backed transactions which constitute the majority of our loan origination activities. We believe that the revised drafting still reflects the intention of paragraph 12(v).
3	Liquidity	<ul style="list-style-type: none"> We agree with the comments of the Central Bank that most investment funds that engage in loan origination are closed-ended. We believe that the liquidity provisions of an investment fund should reflect the nature of the underlying assets and, as such, we do not currently envisage launching an open-ended fund focused on mid-market loan origination. However, as suggested in the 2013 Response Letter, we would caution against ruling out open-ended funds and suggest that this option should be open to asset managers and investors in the future should a more liquid mid-market develop. For the time being, we would not have any difficulty in complying with the draft requirements.
4	Due diligence by investors on the management of a loan originating Qualifying Investor AIF	<ul style="list-style-type: none"> We agree with the comments of the Central Bank that due diligence by investors in loan funds is a widespread practice, we also agree that AIFMD provides protection to investors in this regard. Subsequently, we believe that the draft requirements reflect procedures already in place with asset managers and are such that Babson funds would not have any difficulty in complying.
5	Valuation	<ul style="list-style-type: none"> We have a concern with the use of the term "market prices" as the assets within these funds may not always be traded on a market. Valuations may in some cases be provided by the AIFM using model based approaches (as provided for under AIFMD). Provided a distribution is being made to all unitholders pro-rata to their existing unitholdings, we believe it should not matter whether the assets are being marked at the date of the distribution based on market prices or model based prices. We have added suggested wording for this. We also agree that AIFMD contains extensive and adequate rules relating to valuation.

No.	Question for consideration	Babson response
6	Leverage	<ul style="list-style-type: none"> • As noted by the Central Bank, AIFMD requires asset managers to set a maximum level of leverage and to disclose this to investors. • We believe that setting an appropriate level of leverage is a decision best made by asset managers in response to investor appetite rather than being set by legislation. • Nevertheless, we agree that the level of leverage set in the draft regulations is appropriate but we would resist granting the Central Bank the flexibility for this to be tightened, especially for existing AIFs where this could trigger a liquidation spiral (as the only way to cure if unitholders were not able to make further subscriptions would be to try to sell loans to pay down leverage). • We disagree with the approach to correcting a breach of the leverage limit and believe that acquiring the approval of the Central Bank to a formal is disproportionate. As reflected in our mark-up, we believe it would be more proportionate to request that an AIFM reacts to a breach of the leverage requirements by submitting a formal plan that the AIFM considers most appropriate for the particular QIAIF in the relevant circumstances.
7	Disclosure	<ul style="list-style-type: none"> • We agree that detailed disclosure to investors (including in relation to non-performing assets) is a significant part of the AIFMD regime and reflects best practice amongst asset managers. Subsequently the requirements and are such that Babson funds would not have any difficulty in complying. • One further observation is that it was not fully clear to us from the drafting how/when such periodic reporting would be required to be submitted to the Central Bank (given the language in paragraph 25 on reservation of rights to pass the information on to other national competent authorities).
8	Interconnectedness with the banking sector	<ul style="list-style-type: none"> • When originating loans, we often sit alongside banks as part of an arranging "club". Loan originating by investment funds is complimentary to bank financing in that banks will be able to offer and provide ancillary facilities such as revolving credit facilities, overdrafts, hedging and letters of credit as well participating in term loan funding, potentially in a lower-risk tranche of debt. • Any risks associated with the acquisition of loans from banks are not unique to loan origination so query whether draft regulations in paras 13 and 14 are proportionate.

No.	Question for consideration	Babson response
10	Reporting and stress testing	<ul style="list-style-type: none"> • Provision of data on undrawn committed credit lines within periodic reports would not be a problem for Babson funds. • We have marked up some minor suggestions in paragraph 13 as there could be a risk that the use of the word "administration" could capture e.g. facility agent services, and paragraph 13 could then possibly capture a secondary purchase of part of a syndicated loan from a bank that continued to hold some of the loan and acted as the facility agent. From a logistical perspective, even with a narrower scope as we have drafted we feel that achieving 14(a)(i) is simply not practical, similarly (b)(i) is unlikely to be practical. • Reporting is a significant part of the AIFMD regime and we believe that the extensive requirements of AIFMD are adequate (which already require the AIFM to carry out periodic stress testing and scenario analysis for each AIF) and that further regulation is not required here. • We believe that the provisions of paragraph 16 are disproportionate and it is unrealistic to impose such specific risk mitigation techniques to an illiquid asset class. We believe that such obligations which currently apply to banks should not also apply to funds and that the Central Bank should recognise the differences between deposit taking banks and funds set up with the purpose of loan origination. • The AIFM of a loan originating QIAIF would stress-test an individual credit as part of the initial underwrite and the risk management team of the AIFM would carry out stress testing and scenario analysis as part of the periodic requirements under AIFMD. However, the approach to those stress tests should be set by the risk management team of the AIFM in a manner appropriate to the portfolio profile, the illiquidity of the asset class and liquidity profile of the AIF.

Amendment to Part I, Section 2: Supervisory requirements

- *Amend Subsection ii – paragraph 2*

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2. In the case of Qualifying Investor AIFs which are established as venture capital, development capital, private equity or real estate or loan originating Qualifying Investor AIFs, the initial offer period may extend up to two years and six months provided that the terms of the offer ensure that early unitholders are not prejudiced by the arrangements. Where these Qualifying Investor AIFs have multiple closings, this period must commence no later than the date of first closing.

PART II: SPECIFIC FUND-TYPE REQUIREMENTS

New

Section 4:

Loan originating Qualifying Investor AIF

1. The loan originating Qualifying Investor AIF is not subject to the prohibition on the granting of loans set out in paragraph 7. Section 1, sub-section I in part I of this Chapter.
2. The loan originating Qualifying Investor AIF shall limit its operations solely to the business of issuing loans or other debt instruments, participations in lending in the primary and secondary markets, investments in securities¹ and to operations directly arising therefrom, to the exclusion of all other commercial business.
3. The loan originating Qualifying Investor AIF is subject to the rules set out in this section in addition to the general rules for all Qualifying Investor AIF. The rules in this section also apply where a loan originating Qualifying Investor AIF engages in loan origination as part of syndication or club deal.
4. The loan originating Qualifying Investor AIF must have an authorised AIFM which may be the loan originating Qualifying Investor AIF.

Credit granting, monitoring and management

5. ~~The loan originating Qualifying Investor AIF~~ The AIFM shall establish and implement appropriate, documented and regularly updated procedures, policies and processes for each of the following:
 - ~~Risk appetite statement;~~
 - The assessment, pricing and granting of credit (including criteria, governance and decision making, committee structures);
 - Credit monitoring, renewal and refinancing (including criteria governance and decision making, committee structures);
 - Collateral management policy;

¹ BABSON NOTE: including investments in securities would allow us to use the QIAIF as a multi-strategy platform; direct lending in certain countries is also structured in bond or note format rather than loan format.

- Concentration risk management policy;
- Valuation, including collateral valuation and impairment;
- Credit monitoring;
- Identification of problem debt management;
- Forbearance;
- Delegated authority;
- Documentation and security.

6. ~~The loan-originating-Qualifying-Investor-AIF~~The AIFM shall ensure that:
- (i) credit-granting is based on sound and well-defined criteria and that the process for approving, amending, renewing and re-financing credits is clearly established;
 - (ii) subject to paragraph 7, the ~~loan-originating-Qualifying-Investor-AIF~~AIFM has internal methodologies that enable the ~~loan-originating-Qualifying-Investor-AIF~~AIFM to assess the credit risk of exposures to individual obligors, securities or securitisation positions and credit risk at the portfolio level;
 - (iii) the ongoing administration and monitoring of the various credit risk bearing portfolio positions and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, is operated through effective systems; and
 - (iv) diversification of credit positions is adequate having regards to the target markets and overall credit strategy of the loan originating Qualifying Investor AIF.
7. Internal methodologies referred to in paragraph 6(ii) above shall, in particular, not rely solely or mechanistically on external credit ratings.
8. ~~The loan-originating-Qualifying-Investor-AIF~~The AIFM shall address and control the risk that credit risk mitigation techniques used by them may prove less effective than expected.²
9. ~~The loan-originating-Qualifying-Investor-AIF~~The AIFM shall ensure that:
- (i) the concentration risk arising from exposures to each counterparty, including
 - (a) central counterparties;
 - (b) groups of connected counterparties; and
 - (c) counterparties in the same economic sector, geographic region or from the same activity or commodity;

² BABSON NOTE: Paragraph 5 requires the credit risk mitigation procedures, policies and processes to be regularly updated and any such techniques must effective in order to meet the requirements of this section. It is unclear what paragraph 8 adds to the drafting or what additional obligations are being imposed.

is addressed: and

- (ii) the application of credit risk mitigation techniques and, in particular risks associated with large indirect credit exposures such as single collateral issuer, is addressed and controlled including through the establishment and implementation of written policies and procedure.

Due diligence by investors

10. 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 has been made available on a non-discriminatory basis to all unitholders. Such access must not be structured so as to materially misrepresent the business of the loan originating Qualifying Investor AIF. The AIFM shall ensure that a single person within senior management is designated with responsibilities to ensure that the access given has been non-discriminatory. This person must be satisfied that a reasonable person relying on the access provided would not be influenced to invest in the loan originating Qualifying Investor AIF because of lack of access to information. 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.

Diversification / eligible investments

11. The loan originating Qualifying Investor AIF shall, in its prospectus, set out a risk diversification strategy which will seek to achieve a portfolio of loans which is diversified and which will limit exposure to any one issuer or group to 25% of net assets within a specified time-frame. The loan originating Qualifying Investor AIF shall not intentionally breach this risk diversification strategy. In the event that the loan originating Qualifying Investor AIF is not able to achieve its risk diversification strategy within the time-frame set out in its prospectus, for reasons beyond its control, the loan originating Qualifying Investor AIF must seek approval from the unitholders, in accordance with the procedures set out in the constitutional document, to continue to operate at the level of diversification which has been achieved. In the event that unitholders do not approve the proposal the loan originating Qualifying Investor AIF must terminate. The proposal to investors must be made within 30 days of the end of the time specified in the prospectus for meeting the risk diversification strategy. Once the maximum 25% exposure level or such other level of diversification approved by unitholders has been achieved, a subsequent reduction in the degree of diversification below such level resulting from repayments or prepayments on loans or sales of underperforming loans or market value movements shall not be viewed as a breach of diversification requirements.
12. The loan originating Qualifying Investor AIF shall not originate loans to any of the following:
 - (i) natural persons;

- (ii) the AIFM, management company, general partner, depositary, or to delegates or group companies of these;
- (iii) other collective investment undertakings;
- (iv) financial institutions or related companies of these, except in the case where (a) there is a bone fide treasury management purpose which is ancillary to the primary objective of the loan originating Qualifying Investor AIF or (b) such loans are to service companies operating within the financial sector that do not themselves originate or trade in loans;
- (v) persons intending to invest in equities or other traded investments or commodities, other than persons intending to use the proceeds of loans to acquire control of companies or issuers.

13. The loan originating Qualifying Investor AIF 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; and
- (ii) The provision of an administration, a credit assessment or credit monitoring service to the Qualifying Investor AIF 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.

For the purposes of this paragraph, "acquire a loan" means any of: to purchase; take transfer of; take credit risk or part of credit risk attaching to; take other exposures to; a loan.

14. Prior to acquiring a loan to which paragraph 13 applies, a loan originating Qualifying Investor AIF must:

- (a) have in place and implement policies and procedures to:
 - (i) [monitor the net economic interest³ of the vendor over the lifetime of the loan];
 - (ii) value the loan where the loan is not purchased at face value;
 - (iii) prudently monitor the performance of the loan; and
 - (iv) [stress test the loan independently of the vendor on a regular basis and at least annually, having regards to the changing risk profile of the exposure.⁴]
- (b) have received from the vendor warranties that:
 - (i) the vendor, or, where within scope of banking consolidated supervision, an entity within its group, will retain, on an on-going basis, a material net

³ "Net economic interest" has the same meaning as in Article 405 of Regulation (EU) No 575/2013 (Capital Requirements Regulation)

⁴ BABSON NOTE: Please see comments in Schedule relating to Question 10.

economic interest of at least 5% of the nominal value of the loan as measure at origination;

- (ii) the exposure will not be subject to any credit risk mitigation techniques; and
- (iii) the loan originating Qualifying Investor AIF will have readily available access to all materially relevant data on the credit quality and performance of the underlying exposures and on cash flows relating to and collateral supporting the exposures so as to be able to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the exposures.

15. Without prejudice to the generality of the requirements set out in section viii, Section I of part I of this Chapter⁵, any agent of, intermediary for or introducer to a loan originating Qualifying Investor AIF, or an entity which is a member of a group of which those entities are a part, shall be regarded as a connected party to whom section viii shall apply in the event that such an entity sells loans to a loan originating Qualifying Investor Fund or formulates the terms and conditions of a loan to be issued by a loan originating Qualifying Investor Fund.

Stress-testing

~~16. The loan originating Qualifying Investor AIF shall have a comprehensive stress testing programme which shall include the following:~~

- ~~(i) It shall identify possible events or future changes in economic conditions that could have unfavourable effects on the loan originating Qualifying Investor AIF's credit exposures and assess the loan originating Qualifying Investor AIF's ability to withstand such changes;~~
- ~~(ii) The stress measures under the programme shall be compared against internal risk limits;~~
- ~~(iii) The programme shall comprehensively capture transactions and aggregate exposures across all forms of counterparty credit risk at the level of specific counterparties in a sufficient time frame to conduct regular stress testing;~~
- ~~(iv) The programme shall provide for at least monthly exposure stress testing of principal market risk factors such as interest rates, FX and credit spreads for all counterparties of the loan originating Qualifying Investor AIF in order to identify and enable the loan originating Qualifying Investor AIF when necessary to reduce oversized concentrations in specific directional risks;~~

⁵ Dealings by management company, general partner, depositary, AIFM, investment manager or by delegates or group companies of these

~~(v) The programme shall apply at least quarterly multifactor stress testing scenarios and assess material non-directional risks including yield curve exposure and basis risks. Multiple factor stress tests shall, at a minimum, address the following scenarios in which the following occur:~~

~~(a) severe economic or market events have occurred;~~

~~(b) broad market liquidity has decreased significantly;~~

~~(c) a large financial intermediary is liquidating positions.~~

~~The results of the stress testing under the programme shall be reported regularly, at least on a quarterly basis, to senior management.~~

16. BABSON NOTE: Please see comments in Schedule relating to Question 10.

Liquidity and distributions

17. A loan originating Qualifying Investor AIF shall be closed-ended and shall be established for a finite period except that, the loan originating Qualifying Investor AIF 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.

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 or such distribution or redemption is being made to all unitholders pro rata to their unitholdings, a distribution or redemption of unitholder holdings cannot be made without the approval of the unitholders, in accordance with the procedures set out in the constitutional document, on each occasion.

Leverage

19. ~~The loan originating Qualifying Investor AIF~~The AIFM must ensure that any indebtedness by the loan originating Qualifying Investor Fund must have total asset coverage of at least 200%, or such other limit as may be set by the Central Bank from time to time for new loan originating ~~AIF/AIFs~~ or for one or more class of new loan originating ~~AIF/AIFs~~.

20. In the event that the loan originating Qualifying Investor AIF breaches the limit set out in paragraph 19, the AIFM on behalf of the loan originating Qualifying Investor AIF must, within 30 days or such longer period as the Central Bank may specify, ~~secure the approval of the~~

~~Central Bank~~ ~~for~~ ~~submit~~ a formal plan to bring the loan originating Qualifying Investor AIF into compliance with the leverage ratio to the Central Bank. The priority objective of such plan shall be the correction of the breach, taking into account the best interests of the unitholders.

Disclosure

21. The prospectus and all sales material issued or distributed by a loan originating Qualifying Investor AIF or parties appointed by it as distributors or placement agents must include a prominent risk warning which draws attention to the unique risks which arise from loan origination and how investment in a loan originating investment fund is not guaranteed and is subject to the possibility of investment losses and illiquidity. In addition, the prospectus must include:
 - (i) Information on the risk and reward profile to enable investors to identify the specific risks linked to a loan origination strategy;
 - (ii) Information on the extent to which the loan originating Qualifying Investor ~~Fund~~ AIF intends to be concentrated as regards individual entities, geographical locations and sectors and risk arising from the proposed concentrations;
 - (iii) Details of the credit assessment and monitoring process set out in paragraph 5 above;
 - (iv) Information on whether the AIFM will provide unitholders or potential unitholders with access to records and staff for the purpose of a due diligence process together with the terms and conditions under which such access will be made available.
22. The prospectus and all sales materials issued or distributed by a loan originating Qualifying Investor AIF or parties appointed by it as distributors or placement agents must include a risk warning drawing attention to the fact that leverage limits and lending standards may be tightened by the Central Bank which may impact on the ability of the loan originating Qualifying Investor AIF to follow the investment strategy set out in the prospectus.
23. The prospectus and all sales material issued or distributed by a loan originating Qualifying Investor AIF or parties appointed by it as distributors or placement agents must include a risk warning drawing attention to the potential implications arising from the application of the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises where loans are issued to SMEs operating within the State.
24. The periodic reports issued by the AIFM in respect of the loan originating Qualifying Investor AIF must include the following:
 - (i) A breakdown of the originated loans between senior secured debt, junior debt and mezzanine debt;

- (ii) A breakdown of the originated loans between loans made on a ~~fully amortised basis with an amortising repayment schedule~~ and loans made with bullet repayments;
- (iii) A breakdown of the loan to value ratio for each originated loan;
- (iv) Information in respect of each:
 - non-performing exposure, as defined in the Implementing Technical Standards adopted under Article 99 of Regulation EU No 575/2013, as amended from time to time; and
 - exposure subject to forbearance activities, as defined in the Implementing Technical Standards adopted under Article 99 of Regulation EU No 575/2013, as amended from time to time; and
- (v) Material changes to the credit assessment and monitoring process set out in paragraphs 5-9 above.

This information must also be provided to unitholders at each net asset value calculation point.

- 25. The periodic reports issued by the ~~loan originating Qualifying Investor AIF/AIFM~~ must include a list of any undrawn committed credit lines. The Central Bank reserves the right to pass this information to national competent authorities of the bank(s) in question, wherever located.

