BLACKROCK

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Loan originating Qualifying Investor AIF
Markets Policy Division
Central Bank of Ireland
Block D
Iveagh Court
Harcourt Road
Dublin 2

Submitted via email to: fundspolicy@centralbank.ie

RE: CBI Consultation on loan originating Qualifying Investor AIF (Consultation Paper CP 85)

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to the Central Bank of Ireland's Consultation on loan originating Qualifying Investor AIF (**"QIAIF"**).

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 30 June 2014, the assets BlackRock manages on behalf of its clients totalled €3.37 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public and private sector pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.

BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy changes and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and we will continue to contribute to the thinking engaging with the Central Bank of Ireland ("**CBI**") on any specific issues that may assist in improving the final rules.

Key points

BlackRock welcomes this initiative from the CBI as we believe that it will facilitate investments in loans and that companies will benefit from access to more diversified sources of capital. Furthermore, the provision of loan capital by non-bank sources of capital should contribute to the liquidity and stability of financial markets. Initiatives such as permitting loan originating QIAIFs increase lending opportunities to specialised and diverse strategic market segments, such as infrastructure projects.

While we believe that certain aspects of the rules (particularly concerning credit granting, monitoring and management) are appropriate considerations for this type of investment, we have set out below two key areas we believe the CBI should review in producing the final rules for loan originating QIAIFs.

Leverage

The Consultation Paper provides that a loan originating QIAIF must manage leverage such that it has a total asset coverage of at least 200% and that this leverage limit needs to be managed in accordance with changing ongoing market conditions. It is BlackRock's view that this limit is overly restrictive and does not reflect the different strategies that may be offered by loan originating QIAIFs by focusing on credit products of differing quality.

It is our view that the rules already contained in the Alternative Investment Fund Managers Directive ("**AIFMD**"), which will apply to these QIAIFS, reflect an appropriate framework for both determining the appropriate level of leverage to be employed by the QIAIF and to ensure that potential investors are able to assess the risk associated with a particular product. AIFMD already requires that the Alternative Investment Fund Manager ("**AIFM**") of a QIAIF set a maximum level of leverage, disclose this to investors and demonstrate, on an ongoing basis, that the limit is reasonable and that the AIFM is complying with the limit.

If the CBI considers it necessary to impose a hard limit here, we consider that permitting loan originating QIAIFs to employ leverage with a total asset coverage of at least 300% will still ensure that the QIAIFs are appropriately managed and will broaden the type of loans the funds will seek to originate, allowing the market greater access to non-bank financing. Alternatively, we would welcome the ability for the AIFM to apply to the CBI for a derogation from the leverage limit setting out the reasons why the characteristics of the target credit products would justify a higher limit.

Scope

There is a requirement in paragraph 2 of Part II, Section 4 of the draft rules that the loan originating QIAIF "*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*". In our view this language is overly restrictive and inconsistent with other sections of the rules. The language appears to limit the ability for the QIAIF to acquire loans on the secondary market or to participate in loans as a sub-participant, which would unnecessarily restrict the activities of these QIAIFs. Such language also appears to exclude debt instruments qualifying as securities. We believe that it would be detrimental to investors if the investable universe would be limited to certain debt instruments (structured as loans) to the exclusion of others showing the same characteristics (structured as securities).

More broadly, it would also prevent the establishment of a QIAIF which would seek to originate loans as part of an overall private credit strategy which could seek to invest in loans in the secondary market as well as investment in other securities and investment products.

Responses to questions

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?***

We agree that the AIFM of the QIAIF must allocate adequate resources to credit and risk functions, with ongoing appropriate levels of control and governance. Intrinsic to this credit and risk function is a clear documented credit assessment and risk management process.

The structuring of loans depends on a number of characteristics such as borrower profile, ease of credit assessment, availability of security intermediation in the sector, lender's ranking on default and the ability to take effective security against the loan. To that end, we agree that it is appropriate that the AIFM develops its own procedures, policies and processes with respect to credit granting, monitoring and management, and that this should be a requirement of authorisations of any loan originating QIAIF. However, the CBI should not attempt to be prescriptive with respect to the substance of these requirements, which should reflect the particular characteristics of the loans the QIAIF will be originating.

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?***

While in general we understand the perceived benefits of including diversification requirements, we are of the view that this asset class does not require specific rules on diversification and indeed that diversification may defeat the purpose of some loan origination funds. For example, funds that are established to invest in significant infrastructure debt projects, many of which are backed by government guarantees, may be more concentrated than the rules currently contemplate for loan originating QIAIFs. In that instance, it is generally more important that the QIAIF have a diversity of investors, rather than being forced to diversify its investments. As such, BlackRock believes 'one-size-fits-all' rules on diversification are inappropriate – rather, the focus should be on the credit and risk assessment process operated by the AIFM.

If rules on diversification are to be included, it is important that any numerical or percentage diversification limit is applied at the time of acquisition rather than on an on-going basis as liquidating loan positions to rectify a passive breach caused by market movements is difficult. This is not just an issue for loan funds but also for many other funds investing in assets without a liquid secondary market. A mandatory termination might also be detrimental to investors – as a forced seller the loan originating QIAIFs might not be able to realise the optimal value. Furthermore, institutional investors investing for liability matching purposes expect their money to be invested for the entire term stated in the prospectus.

Finally, we also note that closed ended funds are designed to have a higher concentration of investments in the run-off phase.

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.

The decision to structure as a closed-ended vehicle will depend both on client demand and on the existence of a secondary market for the loans held in the portfolio and the time required to transfer them to a third party or to securitise and sell all the issued securities.

Given the wide variety of loans in the market, this does not necessarily mean that loan funds will have to be closed-ended. For example, a fund may decide to have a liquidity profile with staggered loan maturities that are aligned, at minimum, to its gating policy. In addition, closed-ended funds might have and should be allowed to have share buy-back facilities at the total discretion of the directors of the loan originating QIAIF, in the same way that UK investment trusts have in order to manage discounts to NAV. The loan originating QIAIF will also need to have this power to be able to repay surplus capital to investors.

Finally, we query whether it is appropriate to limit distribution payments to assets which have a market price. For example, this would require an AIFM which is seeking to distribute interest payments on an infrastructure debt loan which does not have a market valuation, to have to seek unitholder approval for each such distribution.

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.

BlackRock's view is that the rules in AIFMD provide an appropriate framework for rules in this area. The principle of fair access to information applies to all QIAIFs and loan originating QIAIFs would not require specific rules in that respect. This is coupled with the fact that only professional investors will be able to invest in the QIAIF. In our experience, such investors typically carry out an extensive level of due diligence on the types of loans that the fund will be seeking to originate or purchase. We believe that the current requirements are sufficient for potential investors to make an informed decision as to whether to invest into a particular fund.

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?

BlackRock's view is that the rules in AIFMD provide an appropriate framework for rules in this area.

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?

As stated in our key points above, we believe that the proposed limit on leverage would prevent a number of genuine strategies being offered by loan originating QIAIFs, such as loans for infrastructure projects. The risk associated with leverage varies considerably between the type of loan and quality of the borrower which such a hard limit fails to recognise.

Leverage can form an appropriate part of a strategy where the underlying assets bear low credit risk and leverage is needed in order to enhance returns for the loan originating QIAIF. An example of the type of loan that could meet this criterion is a commercial real estate loan backed by a building occupied by a government tenant and a long lease. In the absence of being able to leverage such loans, the loan originating QIAIFs are less likely to invest in such products.

Similarly, in the case of loans for infrastructure projects, leverage is not necessarily a cause for concern given that the investments are not pro cyclical and have low default correlation to the broad market.

From a regulatory perspective we would recommend focusing on the quality of the use of leverage disclosures made to investors and regulators under AIFMD. Specifically, the enhanced disclosures which can be required for any AIF that is more than three times leveraged should be used to determine which AIF strategies merit specific additional attention and monitoring.

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?

We note that there is already a requirement in the AIF Rulebook that a QIAIF "must provide investors with sufficient information to make an informed judgment on the investment proposed to them". While it is helpful for the CBI to set out specific information which it believes is required to meet this test in the context of a loan originating QIAIF, we believe the current requirement in the AIF Rulebook should provide the standard to be met in any disclosure.

In some instances, information about a loan may be confidential, particularly with regard to the borrower. For example, if the borrower is a listed company, it may be market sensitive information to disclose the terms on which it is able to access debt financing. The CBI's rules in this area need to be flexible enough for an AIFM to ensure it can meet its requirements under securities laws while still providing appropriate disclosure to investors.

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.***

We do not have any comments on the proposed rules in this area.

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?***

We do not have any comments on the proposed rules in this area.

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 do not have any comments on the proposed rules in this area.

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Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation Paper and will continue to contribute to the thinking of CBI on any specific issues which may assist in the development of loan origination funds in Ireland.

We would welcome any further discussion on any of the points that we have raised.

Yours faithfully,

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