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British Private Equity and Venture Capital Association (BVCA) response to the Central Bank's consultation on loan originating Qualifying Investor AIF – Consultation paper CP 85

We are grateful to the Central Bank of Ireland for providing the opportunity to submit feedback on the draft amendments to the AIF Rulebook ("draft rulebook"). The BVCA represents the views of some of the largest investment firms in the world, alongside smaller mid-market and venture capital houses, to UK and European stakeholders. Drawing on the depth and breadth of their experience, we feel well placed to feed into this consultative process.

First, we fully support the objective of increasing the availability of non-bank credit intermediation, particularly at a time of widespread deleveraging in the banking industry. However, the regulatory approach proposed by the Central Bank, – i.e. an "Alternative Investment Fund Managers Directive (AIFMD) plus" framework – while sensible at face value, raises a number of concerns that could deter would-be loan originating Qualifying Investor Alternative Investment Funds (QIAIF) from seeking authorisation.

It is our view that on several aspects, the additional requirements to the AIFMD framework, as introduced by the Central Bank are unnecessary. We support an approach that mirrors the AIFMD as closely as feasibly possible.

The most prominent of these additional requirements is the notion of including a 1:1 leverage limit on loan originating QIAIF. In our view such a provision would disqualify a significant number of otherwise eligible funds from receiving the loan-originating QIAIF accreditation. We believe that the safeguards built into the AIFMD framework, particularly the additional compliance requirements for funds that are deemed to utilise leverage "on a substantial basis" (three times the fund's Net Asset Value (NAV) accounted under the "commitment method") are sufficient to ensure the safety and soundness of this nascent asset class. This point is explored in greater detail in our substantive response below.

We hope that the comments enclosed will prove useful and stand ready to answer any further questions you may have.

<u>**Annex A**</u>

Response to the questions posed in the consultation

1. Credit assessment granting and monitoring

We agree that loan originating QIAIF should have effective credit assessment and management processes in place, a proviso catered for by the AIFMD. Monitoring credit risk will of course be front and centre in the conduct of business for authorised funds and it is therefore logical that internal methodologies should be put in place, as opposed to the mechanistic reliance on external credit ratings. This is a policy trend clearly in evidence at EU-level[1] and one we fully support.

It would be appropriate to apply proportionality principles in this area, as asset managers cannot be expected to have comparable infrastructure in place to that which exists in the banking industry to monitor credit risk.

We are concerned however over the lack of clarity with regards to the Central Bank's approach to enforcement. Upon reading the draft rulebook a number of questions arise that we believe require clarification. For instance, will the loan originating QIAIF be required to have specific credit policies and procedures in place? Second, will the AIFM itself be brought into the scope of this? Finally, how will the regulatory regime accommodate loans that are provided to non-Irish entities? This is a non-exhaustive list but one that we feel is indicative of the lack of clarity found in the draft rulebook as it stands.

2. Diversification

At a general level we agree that exposures should be appropriately diversified, but do have some additional points to make.

First, the proposed wording of the draft rulebook states that a loan originating QIAIF "must aim to achieve a diverse portfolio of loans", and that exposure to any one issuer or group should not exceed 25 per cent of assets within a specified time-frame. We recognise the need for diversification but do not believe it necessary to include a strict numerical limit on the exposure a loan-originating QIAIF could have to any one particular issuer.

However, in the event of a loan-originating AIF failing to meet the diversification requirements as deemed fit by the regulator, it appears fair that approval must be sought from unit holders if the fund intends to continue operating at its current level of diversification. It would be helpful however to clarify exactly the representation of unit holders needed to constitute "approval"; we believe this should be a simple majority (>50%) of votes cast at a shareholder meeting. There must also be a degree of flexibility in the rules to cater for a sufficiently long ramp up period before the diversification levels must be achieved.

3. Liquidity

Mandating that all loan-originating QIAIF be structured as closed-ended funds appears a sensible approach. The definition of a closed-ended fund should be aligned with that contained in the AIFMD level 2 legislation (an AIF that does not offer redemption rights before winding up and therefore has its valuation linked solely to increases or decreases of its capital[2]).

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[1] Please see here for more information.

[2] European Securities and Markets Association (2013) Draft Regulatory Technical Standards on types of AIFMs under Article 4(4) of Directive 2011/61/EU - http://www.esma.europa.eu/system/files/2013-1119_opinion_on_draft_rts_on_types_of_aifms.pdf

We welcome the fact that the draft rulebook allows for redemptions at the discretion of the fund.

However, the requirement for shareholder approval in this regard along with the fact that redemption could only take place at times determined at the authorisation date of the loan-originating QIAIF could both prove difficult to implement in practice.

4. Due diligence

Although we believe the wording of the draft rulebook could ensure that unit-holders (current and future) are treated fairly, a more straightforward approach would be to apply the contents of the AIFMD surrounding the treatment of investors. This is also a well understood concept under the Markets in Financial Instruments Directive and conduct of business rules for investment firms.

5. Valuation

We agree with the approach to mirror the AIFMD framework in this regard (which does not require that the assets of AIFs be valued by reference to market prices, and recognises that for certain types of AIF this may not be possible), as the diversity found within the asset class when it comes to liquidity, maturity etc is very broad.

With regards to whether or not distributions should be prohibited unless market data is available, we do not consider this necessary. The maturity profiles of some of the instruments acquired by a loan-originating QIAIF may not be conducive to quick redemption, and under such circumstances market data may not be readily available. It would be counter-productive to the potential profitability of the fund to introduce an arbitrary requirement such as this.

6. Leverage

We fundamentally disagree with the proposal to introduce a leverage limit on loan originating QIAIF of 1:1 (i.e. an AIF with assets of 100 may borrow 100). No such limit applies to other types of QIAIF.

Authorised funds that are 3x leveraged or above would hit the threshold for additional reporting requirements under the AIFMD. This would give the central bank more market information, meaning that they would be better prepared to intervene in the extremely unlikely event that a loan-originating QIAIF found itself "in danger". The powers of intervention extend to tightening the leverage limit as designated by the AIFM where this is deemed desirable in order to manage credit growth or to address a threat to financial stability. It is under such circumstances that a leverage limit as identified by the regulator could be sanctioned, but certainly not in the first instance.

This close *ex ante* monitoring is surely an equally effective means with which to maintain the safety and soundness of the system, as opposed to a punitive, hard limit on leverage that could well serve to defeat the purpose of loan originating QIAIF as a means to diversify the Irish funding landscape.

Furthermore, the definition of leverage and the means of calculation must be brought in line with the extensive information contained in both level 1 and level 2 AIFMD legislation[3].

In any case, further clarity would certainly be required as to when any such limit on leverage would apply, i.e. at all times or at the point of borrowing?

7. Disclosure

We agree with the general approach outlined, as it remains consistent with material currently provided to investors periodically by the fund manager.

[3] European Securities and Markets Association (2014) Questions and Answers: Application of the AIFMD - http://www.esma.europa.eu/system/files/2014-esma-868___qa_on_aifmd_july_update.pdf

However, we are concerned that there may be confidentiality issues involved in the disclosure of details of specific loans to investors in the loan originating QIAIF.

The possible nefarious result being that prospective borrowers do not engage with the fund, as information would be available on a loan (with a potentially sub-par performance) - under the scenario as envisaged by the regulator - that would not be available during a typical arms-length transaction with say, a bank. The scope to disclose information will be even more limited when the activity of the loan-originating QIAIF is part of a syndicated loan arrangement.

8. Prohibited borrowers / borrowing arrangements

We assume that the list of prohibited borrowers has been designed with an eye to limiting conflicts of interest and potential threats to financial stability, but do not agree such restrictions achieve this end. The current set of macro-prudential regulation alongside the AIFMD that covers investment funds (UCITS), banks (CRD) and insurers (Solvency II) manage the risks these respective asset classes may pose to financial stability and matters surrounding conduct.

The fact that the list extends to *all* collective investment undertakings is particularly unwarranted. These funds (for example, private equity (PE) funds) contribute to the real economy, helping companies grow, restructure etc. For example, the BVCA's most recent annual survey of investee companies (conducted by Ernst & Young) shows that in 2012, under PE ownership, the sample of businesses reviewed enjoyed a 29 per cent increase in investment, 6.8 per cent revenue growth and 2.4 per cent productivity growth. All this while growing employment by 2 per cent[4].

By including such an extensive list of prohibited borrowers, the Central Bank again risks undermining the central premise of this consultative exercise: diversifying the Irish financial landscape.

As a bare minimum, non-levered investment funds should be excluded from this prohibition. We would also welcome clarification that a loan originating QIAIF could be a sub-fund of a QIAIF umbrella which has other non-loan originating sub-funds.

9. Reporting and stress testing

The consultation paper states that the loan originating QIAIF shall have a comprehensive stress testing programme, which 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 QIAIFs". We consider this requirement to be over and above what is necessary.

As mentioned above, the rationale behind opening up the practice of loan origination to investment funds centres on the objective of establishing a more diverse funding landscape. The process of stress testing entails considerable time and cost for the fund manager, which is why the delegated regulation of the AIFMD[5] uses the somewhat looser term "periodically" when referring to the frequency with which stress tests must be performed.

The regulatory requirements for loan originating QIAIF should be proportionate in the first instance to stimulate demand, particularly in a nascent asset class to such as this.

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[4] The EY BVCA Annual Report on the performance of Portfolio Companies VI covers 66 of the largest PE-backed portfolio companies that met defined criteria at the time of acquisition. The publication of relevant data is one of the steps adopted by the PE industry to improve transparency and disclosure, under the oversight of the Guidelines Monitoring Group. To read the full report please see here.

[5] European Commission (2012) Delegated regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operations conditions, depositaries, leverage, transparency and supervision - http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0231&from=EN

As such we would again recommend that the letter of the original AIFMD framework be followed as close as feasibly possible so as to cater for a known, stable regime. To do otherwise could lead to misinterpretations on the part of both investors and the regulator.

It is also not clear to whom the results of stress testing shall be reported to. The draft rulebook states senior management but does not differentiate between the AIF and AIFM. This is a point that requires clarification.