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Central Bank of Ireland
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Submitted via email to: fundspolicy@centralbank.ie

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Re: CP 85: Loan originating Qualifying Investor AIF

Maples and Calder is a leading international law firm advising financial, institutional and business clients around the world on the laws of the Cayman Islands, Ireland and the British Virgin Islands. We have worked with our clients and their international advisers on the establishment, structuring and distribution of funds with a wide-variety of loan and credit related strategies.

While Irish regulated funds have been able to make secondary market investment in loans for some time, the lack of a loan origination product has often been highlighted to us as a significant gap in the Irish offering. The implementation of the Alternative Investment Fund Managers Directive ("**AIFMD**") and the decision of many international and domestic AIFMs to use Irish AIFs as a key part of their AIFMD offering has increased the demand for a product of this type. The well-publicised lack of non-bank financing sources is also contributing to investor and borrower demand.

We therefore welcome the proposal by the Central Bank of Ireland (the "**CBI**") to introduce a new chapter to the AIF Rulebook to apply to loan originating Qualifying Investor AIFs ("**LQIAIFs**"). We note the work the CBI has carried out in this area including discussions with market participants, EU authorities and local industry members in putting forward a comprehensive proposal. We also support the proposal to add the LQIAIF to the internationally recognised qualifying investor fund regime in Ireland and to build the new rules into the AIF Rulebook which many AIFMs and their advisers will be familiar with.

In this regard, we think it is appropriate to recognise the harmonised and stringent regulatory and supervisory framework introduced for the activities within the EU of all AIFMs pursuant to AIFMD¹. This framework governs, inter alia, due diligence, risk management, liquidity management, valuation, reporting, disclosure (including disclosure on illiquid positions) and conflicts of interest. While AIFMD does not directly regulate the AIF and it is appropriate for the CBI to continue to set down rules for Irish AIFs, many of the proposals set out in CP85 will in practice be carried out by, or will indirectly apply to, the AIFM. It is in this context that we have flagged some areas where the overlapping AIFMD regime and proposed LQIAIF regimes might be further considered.

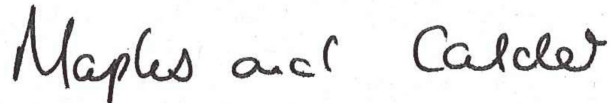
¹ Recital 4 of Directive 2011/61/EU.

Our thoughts and the feedback of our clients have mainly focused in the following areas (i) the ability to conduct activities or make investments in addition to loan origination in the same LQIAIF; (ii) the limitations on leverage; and (iii) the overlap of obligations under AIFMD with the proposed LQIAIF rules.

We have also contributed, as members, to the submissions by IFIA and AIMA. Where appropriate we have noted our support for the proposals put forward by these associations.

We would be happy to discuss any aspect of this submission with the CBI and look forward to the finalisation of the LQIAIF rules.

Yours sincerely,

A handwritten signature in black ink that reads "Maples and Calder". The signature is written in a cursive, slightly slanted style.

Maples and Calder

Response to CP85 Questions

(Questions from CP85 in bold type for ease of reference)

- 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 some disciplines and practices from the credit institution sector may be appropriate given the experience in that sector for loan origination. However, it is also necessary to recognise that AIFMs and their AIFs are structurally very different to credit institutions and in some cases subject to overlapping or conflicting requirements under AIFMD.

For example, AIFs will typically have no direct employees so active credit assessment and monitoring requirements will be largely applied by its delegates, agents, service providers and advisors, with continuing control and supervision by the board of directors in accordance with the AIF Rulebook, Corporate Governance Code for CIS and ManCos and other requirements in this area. In the vast majority of structures it will be the AIFM who will primarily apply such requirements.

We therefore suggest that:

- (a) references to "internal methodologies" (e.g. in Section 4, paragraph 6(ii)) and similar should be clarified to permit an AIFM or other delegate, agent or service provider of an LQAIF perform the obligation on its behalf;
- (b) the proposals in this area are amended to take into account AIFMD and in particular, Articles 15 (Risk Management) and Article 16 (Liquidity Management) and the corresponding Articles of the Level 2 AIFMD Regulations² (the "**L2 Regulations**"). For example, a new paragraph could be added in this section to read:

"Where the LQAIF has appointed an approved AIFM which has addressed credit granting, monitoring and management in its programme of activity, such procedures can be applied to fulfil the obligations of the LQAIF in paragraphs 5 to 9 of this Chapter."

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.

We have received responses from a number of clients who have noted that the Code may not be suitable for LQAIFs noting the differences in their structure compared to participants currently falling within the definition of "regulated entity" and lending to Irish SMEs.

We further note that the general principles in the Code overlap and in some cases conflict with the general principles applied to AIFMs under AIFMD. For example:

- (a) Article 12(1)(b) of AIFMD requires, inter alia, that an AIFM must act in the best interests of the LQAIF or the investors of the LQAIF it manages and the integrity of the market; but
- (b) the general principles section of the Code would impose a conflicting requirement on the LQAIF to ensure it acts honestly, fairly and professionally in the best interests of its

² Reference Article 44(2)(b).

customers [importantly defined as the borrowers not investors in this context] and the integrity of the market.

To avoid a conflict between the regimes we suggest the current text in CP85 is amended to state (new text underlined):

"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 except where the requirements of that Code are covered by AIFMD or inconsistent with an obligation the AIFM has under AIFMD".

It may also be appropriate to consider whether the application of the Code is appropriate to LQIAIFs or their AIFMs at all.

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 understand and support the need for the CBI to act in this manner.

However, to ensure that LQIAIFs and their investors are not prejudiced, tightening of the lending standards should be applied to future lending activity and not require retrospective action unless it is mandated by:

- (a) the principles currently applied to AIFMs by AIFMD, i.e. *"to act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market"*;
- (b) breaches to investment restrictions in which case the LQIAIF must record such matters and adopt as a priority objective the remedying of that situation, taking due account of the interests of its unitholders.

- 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 agree with this approach and also support the comments made by the IFIA with regard to proposed amendment to the termination options, i.e. formulating a plan to bring the LQIAIF into compliance with the revised diversification limit in lieu of termination.

Some clients have also noted that the counterparty restrictions in paragraph 12 (iv) should be amended to permit lending to financial institutions or related companies of CIS. The rationale provided is that some of these institutions and related companies will be large and diverse groups and the borrowing could be for purposes unrelated to their CIS activities. If the restriction in (iv) was unamended a valuable source of non-bank lending could be restricted for such groups. We suggest that paragraph (iv) could be amended by adding the following at the end of the current text *"or where the loan is to be used by these entities for purposes unrelated to their management of collective investment schemes"*.

- 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 believe that closed-ended structures will be suitable of the majority of LQAIF structures.

However, there may be occasions where greater liquidity is available (indeed we are aware of the growth in liquid loan portfolios) and the LQAIF or its AIFM see demand for more liquid strategies.

Noting that:

- (a) AIFMs will need to employ strict liquidity measures when managing an LQAIF in accordance with Article 16 of AIFMD (Liquidity Management) and the corresponding provisions of L2 Regulations; and
- (b) LQAIFs may impose redemptions gates and ultimately suspensions in the event of a run;

we believe it would be appropriate to permit LQAIFs also be established as limited liquidity funds and to continue to monitor the demand for open-ended LQAIFs and their suitability (if any) for authorisation via pre-submissions or derogation requests to the CBI.

We support the changes proposed by IFIA and AIMA in the context of paragraph 18 and distribution or redemptions by LQAIFs.

- 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.**

Articles 18 and 19 of the L2 Regulations impose detailed due diligence obligations on AIFMs (including in the context of investing in illiquid assets). AIFMD does not require the AIFM to make due diligence information available to investors. Rather, Article 12 of AIFMD requires that in carrying out due diligence (and its other obligations) AIFMs shall treat all investors fairly. Article 23(b) of the L2 Regulations expands on this further requiring that "*any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors.*"

We believe that these requirements, in addition to the disclosure rules on preferential treatment in Article 23, sufficiently address the due diligence obligations and suggest that paragraph 10 is amended as set out below. Further, as the only investors in an LQAIF will be

qualifying investors, it may be appropriate to consider that the due diligence requirements should be triggered by an investor request rather than imposing an additional obligation on AIFMs.

Suggested amendment to paragraph 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 request to all unitholders in accordance with the standards set out in AIFMD including, but not limited to, its obligation to treat all investors fairly in accordance with Articles 12 (1)(f)."

Finally, we note that AIFMD flags that further work in the area of due diligence may be undertaken by the European Commission (e.g. Recital 92 of AIFMD). While this is aimed at non-EU financial products, the majority of loan funds are currently non-EU and the principles established may be appropriate for consideration by the CBI so that Irish rules are harmonised with international standards.

- 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 support the IFIA submission in this context.

- 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?**

We support the IFIA submissions in this context.

- 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 support the IFIA submissions in this context.

We also note that the requirement to provide information to unitholders at each NAV calculation point would impose a greater burden on LQIAIFs than the timetables set down out for periodic and regular reporting by AIFMs to investors in Articles 108 and 109 of the L2 Regulations. In order to harmonise the reporting obligations of the LQIAIF and its AIFM (particularly owing to the overlap in information) we suggest that the LQIAIF disclosure timetable is aligned with AIFMD.

- 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 support the submission by the IFIA in this context.

- 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 support the submission by the IFIA in this context.

- 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 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.

AIFMD sets out a comprehensive framework for stress testing by AIFMs in the context of risk management and liquidity management. Article 24(2)(e) further provides that AIFMs of LQIAIFs shall provide the competent authorities of its home Member State with "*the results of the stress tests performed in accordance with point (b) of Article 15(3) and the second subparagraph of Article 16(1).*"

The general requirements in these paragraphs have also been expanded on by the L2 Regulations (Article 48 - Liquidity Management Limits and Stress Tests). We suggest the stress-testing requirements may benefit from alignment with these rules as the AIFM will be conducting these tests.

Other Matters in CP85

Additions to the Definitions Section of the AIF Rulebook and paragraph 2 of Section 4 of the proposed rules

We believe that the permitted activities of LQIAIFs should be expanded beyond loan origination activity. We have contributed to the detailed submissions made by the IFIA and AIMA and this context and would support their arguments.

We further add that EU and international fund structures which are available to retail investors permit greater diversity of activity/investment in other assets. These include UCITS (10%), ELTIFs (30%) and US BDCs (30%). As the LQIAIF will be limited to marketing to qualifying investors it would seem appropriate to permit other activities and investment in other assets to at least the limits permitted by retail funds.