



STATE STREET.

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Via e-mail: [fundspolicy@centralbank.ie](mailto:fundspolicy@centralbank.ie)

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

**Consultation Paper 85 - Consultation on loan originating Qualifying Investor AIF (“CP85”)**

Dear Sir/Madam:

State Street Corporation (“State Street”) appreciates the opportunity to comment on CP85 issued by the Central Bank of Ireland (“CBI”) regarding the proposed amendments to the AIF Rulebook to permit the establishment and operation of loan originating AIFs in Ireland.

Headquartered in Boston, Massachusetts, with branches and subsidiaries throughout the European Union (“EU”), State Street specialises in providing institutional investors with investment servicing, investment management and investment research and trading. With EUR 28.4 trillion in assets under custody and administration and EUR 2.48 trillion in assets under management, State Street operates in 29 countries and in more than 100 markets worldwide<sup>1</sup>. Our European workforce of 9,000 employees provides services to our clients from offices in ten EU Member States and includes 2,000 employees and 5 locations in Ireland.

As the CBI is no doubt aware from previous correspondence, State Street is supportive of the initiative to allow AIFMs to establish regulated loan origination AIFs in Ireland. We consider that allowing certain appropriately regulated investment funds to originate loans would be in the public good, and that risks resulting from this practice would be mitigated

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<sup>1</sup> As of June 30, 2014.

with the application of the prescribed governance, risk and liquidity obligations under AIFMD. We welcome the opportunity to respond to the CBI's consultation addressing additional safeguards that may be imposed on any Irish authorised AIF permitted to originate loans. We agree that loan originating funds should only be established as Qualifying Investor AIFs (QIAIFs), sold only to sophisticated investors, who are sufficiently experienced and knowledgeable to appreciate the risks involved in such products. Further, such loan originating QIAIFs would only be managed by highly specialised investment managers, who have the skills, processes and experience to operate within this market and we note that the CBI has identified the key requirements in its consultation. However, we would urge the CBI to ensure that the new rules strike a balance between the specific concerns around the need for additional safeguards for loan originating QIAIFs and creating an overly burdensome regime which would detract from its attractiveness as an Irish-domiciled investment product.

While we would encourage the CBI to proceed with creating a new section in the AIF Rulebook for loan originating QIAIFs, there are a number of areas where we believe the CBI should reconsider its proposals in order to make origination a usable strategy for Irish domiciled funds. Of primary concern would be the CBI's suggestions to mirror Capital Requirement Regulation obligations on banks to retain a net economic interest in securitisations. The imposition on the AIF or its AIFM to ensure that the bank originating or co-originating a loan warrants to retain a 5% interest in the loan as foreseen by paragraphs 13 and 14 of the proposed rules is not currently required anywhere in the loan syndication market and may well be so unworkable for managers operating within the loan markets as to make an Irish loan origination product a non-starter for many potential market participants.

Managers who are likely to establish loan origination QIAIFs are already very active within the syndicated loan market and many will already successfully run Irish domiciled funds which invest in loans on the secondary market. Though we appreciate that the CBI wishes to create a structure that focuses on the disciplines required specifically for loan origination, specialist managers in loans see origination as running in tandem with secondary market sub-participation or assignment, and will therefore wish to be able to build portfolios of originated loans along with loans acquired on the secondary market. For cash management purposes, these managers may also wish to hold a percentage of the portfolio in ancillary liquid assets or debt securities from time to time. We would ask the CBI to consider ensuring that the proposed rules do not prohibit such managers from engaging in this activity. We would add that the proposal for the European Long Term Investment Fund Regulation foresees a mixture of asset classes including direct lending.

Finally, while we appreciate the expressed concerns around cyclical vulnerability, and measures to promote stability, we would ask the CBI to consider a moderate relaxation of its proposed position on capping leverage for loan originating QIAIFs at a ratio of 1:1. This is naturally notwithstanding the fact that the CBI may act to limit or further restrict leverage in the event that it considers that there is a threat to financial stability.

Below please find our responses to the specific questions raised by the CBI in this consultation.

### **Question 1:**

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

*In addition it should be noted that*

*- Loan originating Qualifying Investor AIF will, in relation to relevant lending, be subject to the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises.*

*- The Central Bank has the ability to tighten the lending standards, including in cases where this is deemed necessary for financial stability and macro prudential purposes.*

In relation to the specific requirements outlined in paragraphs 5-9, we have spoken to potential loan origination managers and understand that the provisions essentially serve to formalise pre-existing manager best practice.

We expect that some loan origination QIAIFs may seek to lend to appropriate Irish SMEs, and note the applicability of the CBI's code of conduct as regards this lending. The Code covers many of the same general principles an AIFM must adhere to (e.g. in Article 12 of AIFMD) so we recommend its application should need to take that into account and provide for a hierarchy of laws in the event of a conflict, giving priority to AIFMD.

### **Question 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 believe the provisions as stated represent a workable proposal for meeting diversification requirements. In particular, allowing for disclosure in prospectus around diversification strategy, plus the flexibility in ramp up towards a diversified portfolio are welcome provisions.

We would note that funds may also be subject to concentration in the wind-down phase if some assets have been sold off or mature before others. As such, approval may be sought

to allow for these events. We feel that the provisions as stated afford loan origination QIAIF managers sufficient opportunity to do this in an orderly, transparent way.

### **Question 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.*

State Street agrees that managers will typically seek to structure funds over a finite lifespan, primarily focusing on matching buy-to-hold investors with a buy-to-hold pool of investment assets. As such, we do not anticipate that loan originating QIAIFs will typically seek open-ended vehicles as the norm.

Notwithstanding the above, we welcome the ability for loan originating QIAIFs to redeem investors or distribute on a non-prejudicial basis and we interpret the provision as stated in paragraph 17 to be more in keeping with a limited liquidity structure.

In our response to the July 2013 Discussion Paper on loan origination, we expressed the view that while closed-ended funds would be the most prevalent option for this asset class, loan managers with this expertise may nonetheless have an appetite to acquire allocations of loan origination positions in open-ended funds. While we recognise the concern held by the CBI in this regard, we feel the position does warrant continued review, particularly as the loan origination market evolves and a proven secondary market develops, similar to the secondary market in syndicated loans.

We think that the proposal to require unitholders to approve distributions or redemptions when no prevailing market prices are available is unnecessary, given the appropriate valuation and liquidity management provisions afforded by the AIFMD regime. Furthermore, in the syndicated loans market we have observed that illiquid loans pay coupons. It is uncertain what objective would be met by placing an embargo on onward distributions to loan origination QIAIF unit holders in these instances.

#### **Question 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.*

The commentary in CP85 points out that due diligence by investors is widespread in loan origination, and therefore the aim is to ensure that a non-discriminatory outcome is achieved for investors. The additional disclosure in 21 also seeks to make explicit the means by which information can be made available.

We welcome the distinction made here between unitholders verses potential unitholders. This corresponds to the provisions in AIFMD around ensuring that due diligence is being made available “on a non-discriminatory basis to all unitholders”. We further welcome that the Central Bank acknowledges a degree of “managerial discretion” around how to achieve the outcome.

Having discussed with potential loan origination managers, we believe that this rule is achievable provided expectation that unitholders carrying out the due diligence retain onus around what information requested.

#### **Question 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 note the AIFMD rules around valuation and agree sufficient provisions exist in the AIF Rulebook and the level 2 AIFM Regulation to deal with valuation. We believe the provisions are in place are robust to ensure that portfolios are valued in a fair, appropriate and transparent way.

As has happened in the syndicated loans market, we expect to see improved liquidity and wider price transparency across middle market / originated loans, resulting in deeper market for loans to be traded on secondary market.

For the reasons we outlined in question 3, we think it would be excessive and counterproductive to prohibit distributions / redemptions where market prices are not available.

#### **Question 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?*

The Paper has addressed concerns around cyclical vulnerability by proposing a maximum 1:1 ratio on leverage, followed by additional CBI discretion to mandate reduction in leverage.

The leverage rate proposed aligns the proposed loan origination QIAIF with the U.S. Business Development Corporation (BDC) leverage level. It is worth considering that BDCs are primarily targeted towards retail investors, whereas QIAIF are marketed solely to qualifying / sophisticated investors. Furthermore we understand that debate continues in the U.S. regarding potential extension of leverage ratio to 2:1 at a minimum.

We would also note that levels of leveraging in banks are not similarly restricted. While we accept that the CBI will seek to limit leverage as a means of mitigating risk, we believe that the current proposed level will result in a diminished usefulness in this product as it may inhibit managers from being able to achieve investment objectives and returns for investors. As we noted in our response to the CBI's Discussion Paper on loan originating funds from July 2013, State Street believes that it should not be necessary to put a strict limit on leverage on a loan originating QIAIF. The AIFM should have the flexibility to structure the fund according to the risk appetite and policy of the QIAIF and its investors. Investors in such funds will be sophisticated investors. An AIFM is already obliged to ensure that it has risk management processes in place appropriate to the activities it engages in and the leverage it employs. These funds will also be subject to the transparency requirements of AIFMD including both upfront investor disclosures and reporting to competent authorities. If the CBI nevertheless decides to impose a prescribed leverage limit, we would recommend an increase from the suggested leverage ratio of 1:1. The CBI should also consider whether it is more appropriate to assess the leverage limit on a commitment basis rather than by reference to NAV. Managers have argued that such approach may actually promote some stability in stressed market conditions, while still achieving the result prudent regulation around leverage restrictions.

We welcome the CBI's proposal in paragraph 20 around the process to be taken in event of breach of leverage.

**Question 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?*

State Street agrees that detailed disclosure of investment objectives, policies and strategies together with the risks associated with the investments and investment strategies of loan originating funds is the cornerstone for investors to be able to make an informed choice about investing in any product. As an extension of this, we agree that specific disclosures in the prospectus relating to the credit assessment and monitoring process employed by a loan originating QIAIF or its AIFM would be appropriate to assist investors making that informed decision.

However, for the periodic reports we would suggest that due to confidentiality reasons in relation to the underlying borrower, it may be desirable for loan originating QIAIFs to be permitted to provide the breakdown of underlying loans foreseen under the categories set out in the draft rules, paragraph 24 on an aggregate figure basis, without necessarily disclosing the specific names of the borrowers in each category. Depending on the strategies of the loan originating AIFs, it might also be more appropriate to allow the breakdown required under subparagraph (i) to be done by category or hierarchy of loan that makes the most sense for the QIAIF rather than trying to separate the loans into the types prescribed in the draft rules. This will still ensure that investors are in receipt of information pertinent to their being able to assess the make-up of a portfolio in terms of category, risk, etc. Most importantly, the QIAIF and its AIFM are bound to ensure that investors are in receipt of information that is “materially relevant, reliable, comparable and clear” as set out in Article 103 of the AIFM Regulation.

#### **Question 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.*

For the reasons stated by the CBI, we understand that the CBI may wish to receive information on undrawn committed credit lines and may consider it in the interests of the wider economy to share such information with other national competent authorities for the purposes of supervising this activity. This information should only be sought by and provided to the CBI.

**Question 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?*

All loan originating QIAIFs will be subject to the governance requirements imposed by AIFMD, the AIF Rulebook and the level 2 measures contained in the AIFM Regulation. The CBI also acknowledges the bespoke disciplines involved in loan origination and loan participation around the selection of potential investments including credit assessment of borrowers, on-going monitoring and risk and liquidity management and has reflected these requirements in the draft amendments to the AIF Rulebook.

The requirement for banks to retain a 5% economic interest in loans which it has originated or co-originated is not a current requirement in the syndicated loan market in any jurisdiction that we are aware of. The stipulation on AIFMs on purchasing securitisations contained in AIFMD to ensure that the credit institution originating the securitisation vehicle maintains a 5% economic interest in the asset is also imposed on the credit institution by the Credit Requirements Regulation and therefore avoids the AIF or AIFM from unilaterally requesting the credit institution to do so. However, the CBI proposals will place the onus on a loan originating AIF to demand the arranging bank to guarantee that it will maintain such an interest which it would not wish to do nor otherwise be required to do under any legislation directly regulating its own activities. We believe that imposing such a requirement only on Irish loan originating QIAIFs will create an overly burdensome and unattractive vehicle for managers and will disadvantage Ireland as a location in which to do such business.

**Question 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 agree with the proposal of the CBI to require that loan originating QIAIFs have sufficient reporting and stress testing capabilities to ensure that effective macro prudential supervision is achieved as is one of the key tenets of the AIFMD. It is important that national competent authorities are in receipt of information necessary for them to be able to identify areas where bubbles of risk may be developing. As noted in previous answers, there may be certain confidential information that could be disclosed to the CBI if required in more detail than would be necessary to investors. The CBI and macro prudential supervisors should bear in mind the differences between the activities and business nature of banks and collective investment schemes when monitoring developments for reporting in banking when assessing the application of such developments to loan originating AIFs.

The principles of AIFMD is important in this regard in so far as it obliges an AIFM to adopt and implement appropriate and proportionate liquidity and risk management processes for the types of AIFs it manages. We support additional reporting by loan originating QIAIFs but would suggest some of it could be done on an aggregate figure basis. We would also make the point that stress testing, scenario and risk testing under paragraph 16 should supplement AIFMD requirements rather than imposing overlapping requirements.

In conclusion, we agree that given the broader, financial stability implications of this type of lending, an appropriate macro-prudential regime is necessary. This regime should protect investors and should also mitigate against systemic risk. But it needs to be balanced to reflect the unique nature of this type of lending and also to support the development of this initiative.

Please feel free to contact me should you wish to discuss State Street's submission in greater detail.

Sincerely,

A handwritten signature in black ink, appearing to read 'SR', with a long, sweeping horizontal stroke extending to the right.

**Shane Ralph, Director**

State Street International (Ireland) Limited

