Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2013

Loan Origination by Investment Funds

Discussion Paper

July 2013

This Discussion Paper sets out a range of issues which must be considered if investment funds are allowed to source assets by directly originating loans. This paper contains specific questions on areas where the Central Bank would particularly welcome views. The Central Bank invites written replies to the paper. These should be forwarded by email to fundspolicy@centralbank.ie by 13th September 2013.

Contents

Preface

At present, Irish non-UCITS investment funds are prohibited from originating loans as part of their strategy to source assets for investment purposes. The Central Bank is currently reviewing this policy. This review raises a broad number of issues concerning (i) investor protection, (ii) the provision of credit to the real economy, (iii) the regulation of different channels of credit intermediation, (iv) the stability of these channels and (v) monetary policy. Therefore, the Central Bank considers it appropriate to set out the issues in the form of a discussion paper and to seek the views of interested public and private sector stakeholders.

In recent months, the Central Bank has had discussions with regulatory colleagues, industry representative bodies, funds service providers and a number of investment managers who are engaged in both loan origination and participation in loan syndicates. The Central Bank is publishing this discussion paper to offer all interested parties an opportunity to consider the wide range of relevant issues presented in the paper and to offer their views.

A number of key questions are posed in this discussion paper. These questions are:

1. **is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?**
2. **what are the 'shadow banking' risks raised by the relaxation of the current policy?**
3. **in what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?**
4. **does the current Alternative Investment Fund Rulebook ('AIF Rulebook') provide sufficient protections for investors in the case where investment funds are allowed to originate loans?**

We ask anyone considering responding to this discussion paper to do so by 13th September, 2013 by emailing a response in Word format to fundspolicy@centralbank.ie clearly labelled 'Loan Origination Discussion'. Our intention is to publish written contributions submitted. We will not necessarily publish a feedback statement, as would be normal for a consultation. We will consider how best to take the matter forward in light of the further development of the debate which this discussion document is intended to stimulate.

1. Introduction

Loan origination investment funds are those which undertake to source loan assets for their investment portfolio by directly originating loans rather than confining themselves to investing via loan assignments or loan participations. In such instances the investment fund is the original lender of record and lending is (or is part of) the investment strategy of the fund. The responsibilities of the fund's investment manager include credit assessment, selection, pricing, documentation, monitoring, servicing and provisioning.

Undertakings for Collective Investment in Transferable Securities (UCITS) have been prohibited from engaging in loan origination as an investment strategy since the first UCITS Directive in 1985. This position is reflected in Regulation 111 of the European Communities (UCITS Regulations) 2011. There has never been any serious consideration of lifting this constraint, which in any case, can only be changed by an amendment to EU law.

Up until now, the same approach has been adopted in the Central Bank Non-UCITS Notices[1]. The Alternative Investment Fund Manager Directive (AIFMD)[2] goes live on 22 July 2013. Under the Central Bank's new AIF Rulebook[3], prepared as a response to the introduction of the AIFMD, alternative investment funds (AIFs) continue to be prohibited from originating loans, though they may take loan exposure through the assignment of or participation in existing loans which have been originated by another party (hereafter ‘loan participation’).

There is nothing in the AIFMD itself prohibiting an AIF marketed by an AIFMD-compliant AIFM from engaging in loan origination. The AIFMD regulates investment fund management rather than investment fund constitution, so it is not surprising that the AIFMD does not seek to regulate the investment strategies and activities of the AIFs themselves and does not therefore consider the merits or otherwise of loan origination. Irish authorised AIFs continue to be prohibited from engaging in loan origination because the Central Bank has used its discretionary powers under domestic law to prohibit them from doing so. However, the Central Bank has also indicated its willingness to consider higher risk profile options for Irish authorised AIFs than are allowed for UCITS. Loan origination may be one such investment strategy.

Section 4 considers why this regulatory constraint has been in place and why it does not extend to loan participation. Two key questions are considered: whether the balance of the public interest is best served by the current rule which prohibits loan origination by investment funds and to what

---

1 Non UCITS Notice 8.8, paragraph 10
2 Directive 2011/61/EU
3 http://www.centralbank.ie/regulation/industry-sectors/funds/Pages/AIFMD.aspx

extent such activity could raise 'shadow banking' concerns. Respondents are asked to consider whether these are the correct preliminary questions and whether all aspects of these questions have been explored?

The first question concerns the balance of the public interest. There is a body of empirical evidence which suggests that the development of non-bank sources of credit may assist the evolution of the European economy at this juncture. In addition, a number of recent studies have examined alternative funding options for long-term financing.[4] Moreover, in recent months, several specialised fund promoters have made direct approaches to European regulators, including the Central Bank, seeking a relaxation of certain national rules prohibiting funds from originating loans. These matters are reviewed in Section 2.

The Central Bank has responsibility for all Irish financial regulation and it is therefore necessary and appropriate that financial stability concerns are taken into account in the regulation of non-bank lending activity. Following the lead of the Financial Stability Board (FSB)[5] various financial authorities have started to re-evaluate the consequences of entities which provide credit and fund this activity primarily outside the banking system through the so-called 'shadow banking' system. Where loan origination by such entities is, in addition, partly funded by bank credit, these entities are creating money as they are recycling financial claims within the fractional reserve banking system. Section 3 considers the international thinking in this area, which is itself evolving.

In summary, therefore, this discussion paper seeks views from stakeholders regarding:

- the merits of allowing investment funds to originate loans;
- the financial stability, investor protection and monetary stability issues associated with such activity; and
- the mitigants which, if adopted, could address risks which arise therefrom.

Respondents are also asked to identify other questions which are relevant to the review of the Central Bank's current policy on loan origination by investment funds.

---

4 For example, the Breedon Review examines funding options in the UK while a recent EU Commission Green Paper explores options to foster the supply of long-term financing in the European economy. Furthermore, the European Commission and the European Investment Bank (EIB) released a joint report which summarises various measures introduced to support funding for SMEs. In 2012 the World Economic Forum produced a report on how to improve long term investing which overlaps with these issues. In 2013 the OECD produced draft High-level Principles of Long-Term Investment Financing by Institutional Investors.

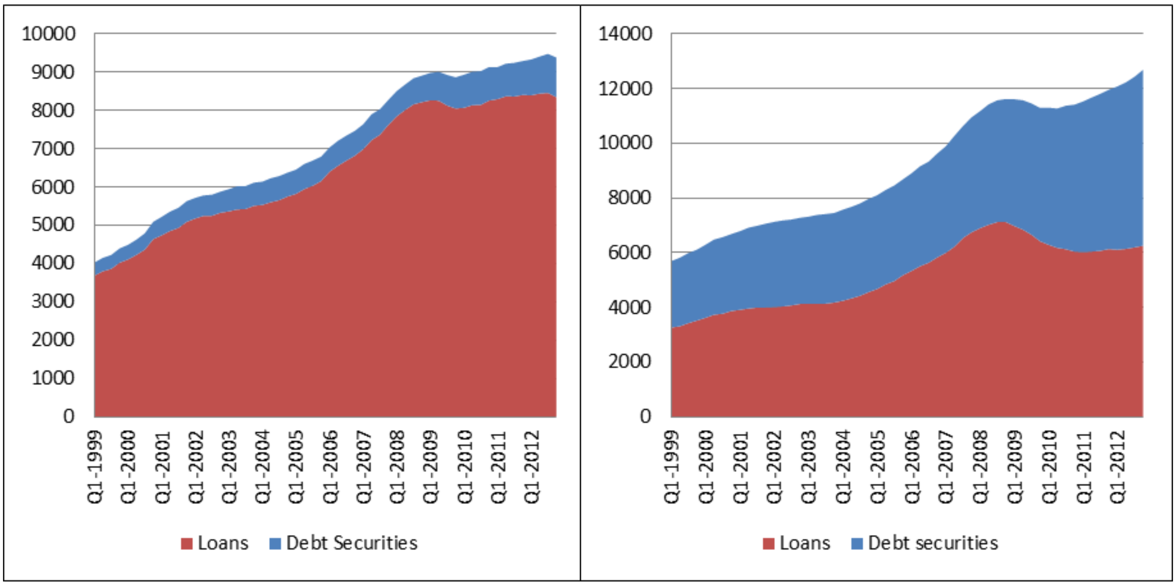
5 At the summit in Seoul in November 2010, G20 requested that the FSB (a) define what is meant by shadow banking, (b) consider how this activity could be monitored and (c) recommend regulatory measures which may mitigate financial stability risks, see http://www.financialstabilityboard.org/press/pr_110412a.pdf

2. The ‘Funding Gap’ and non-bank financing options.

The supply of credit in Europe is primarily bank-based, and there has been little change in this trend during the last decade. In comparison, the US non-bank lending sector is much more developed as a source of funding (Figure 1).[6] According to ECB President Mario Draghi “*in the United States 80% of credit intermediation goes via the capital markets. In the European situation it is the other way round. 80% of financial intermediation goes through the banking system*.”[7] Given the prominent role of bank-credit in the European economy, there are concerns about banks deleveraging in response to the cyclical downturn and current and impending regulatory requirements.[8] [9]

Figure 1: Debt liabilities of non-financial corporations, 1991Q1 – 2012Q4

Euro Area (€ billions) **United States ($ billions)**



Source: OECD ‘Non-consolidated financial balance sheets by economic sector’.

Note: quarterly balance sheet data. Debt securities correspond to ‘Securities other than shares, excluding financial derivatives’.

---

6 A comparison of the euro area and US banking sectors highlights the dependence on bank-based credit in the euro area. Bank lending in the euro area is significantly more than in the US both in value terms (€18.5 trillion euro versus €7.3 trillion euro) and as a percentage of GDP (196 per cent versus 67 per cent).). Source: European Banking Federation International Comparison of Banking Sectors.

7 http://www.ecb.int/press/pressconf/2013/html/is130502.en.html

8 There has been some comment recently that insurance companies may fill the gap left by the reluctance of banks to continue previous patterns of corporate lending. However, concerns have also been raised over the impact of Solvency II on corporates financing activities by insurance companies. A paper “The Impact of Solvency II on Bond Management” by the French Business School, EDHEC, suggests that these regulatory changes will sharply reduce the appetite of insurance firms for non-investment grade credit once it comes into force. This reflects a new requirement in Solvency II which obliges insurers to account for the risk of their investments as a cost. The size of this cost, as calculated using the standard Solvency II formula, could be greater than the yields investors would earn on the bonds.

9 A report by McKinsey and Company (2013) highlights European banks’ funding gap. It states “from a pure volume perspective, European banks’ funding gap is in excess of €1 trillion, resulting from the need to fund a loan business of approximately €12.3 trillion with deposits in the range of €11.3 trillion. Taking into account the newly proposed regulatory requirements under Basel III, a similar funding gap of €1.2 trillion exists for European banks’ collective balance sheets from the net stable funding ratio (NSFR).”

The financial crisis has had detrimental consequences for banks' balance sheets, cost of funds and profitability, and growing empirical literature suggests that this has weighed negatively on their ability to supply credit to the real economy. The adverse effects of the resulting relative credit shortages on real economic activity have been examined by a number of studies.[10] [11] More recently, empirical studies have examined the factors that led to the impairment of the bank-credit channel following the global financial crisis.

The main findings of this literature suggest that:

- loan supply shocks have a significant effect on economic activity and explain about half of the decline in annual real GDP growth during 2008 and 2009 in the euro area and the US;[12]
- strains on banks' liquidity positions and their access to market financing contributed significantly to the slowdown in corporate lending during the financial crisis of 2007-2009;[13]
- banks cut lending when economic conditions are poor or when raising new capital is costly;[14]
- capital constrained banks are more reluctant to advance new lending in an attempt to maintain minimum capital adequacy ratios;[15]
- banks affected by a crisis are more likely to decrease their lending and increase loan interest in the post-crisis period compared to unaffected banks;[16]
- firms that can only access capital through banks are most vulnerable to banking crises and tend to suffer larger valuation losses along with bigger declines in their capital expenditure and profitability compared to firms with alternative sources of capital;[17]
- firms were unable to substitute the decline in credit advanced by banks with credit from foreign banks and therefore this led to a significant aggregate effect on credit supply.[18]

In summary, a number of empirical studies have assessed the impairment of the bank-credit channel and find evidence which suggests that significant segments of the EU economy appear to have severely restricted access to financial credit as a result of the financial crisis, bank deleveraging and the lack of alternative financing channels. The deleveraging of European banks has led them to reduce their exposures to longer-term investment projects in particular, such as the financing of infrastructure or the purchases of aircraft or ships.[19]

---

[10] See for example, Amiti and Weinstein (2009), Ciccarelli et al. (2010), Mach and Wolken (2011), and Gambetti and Musso (2012).

11 In contrast, Takáts and Upper (2013) find evidence which suggests that declining bank credit to the private sector does not necessarily constrain the economic recovery after output has bottomed out following a financial crisis.

[12] Gambetti and Musso (2012).

[13] Hempell and Sorensen (2010)

[14] Hyun and Rhee (2011)

[15] Hyun and Rhee (2011)

[16] Allen et al. (2012)

[17] Chava and Purnanandam (2011)

[18] Bofondi et al. (2013)

[19] Véron (2013)

It is reasonable to conclude that the banking crisis has highlighted a weakness in the structure of the lending market in the European economy. Michel Barnier, European Commissioner for Internal Markets and Services, has previously noted "*I do not think that financial intermediation should be left entirely and solely in the hands of the banks. And I am aware of the role that alternative sources of financing have to play in these difficult times for the European economy, where the banks have to adhere to more stringent prudential ratios. Alternative financing is therefore necessary, but it is important that it is carried out in a solid and transparent framework*." [20]

The European Commission has recently produced a package of measures comprised of the EU Long-term Investment Funds ("ELTIF") proposal, the European Venture Capital Funds ("EuVECA") regime and the European Social Entrepreneurship Funds ("EuSEF") regime, designed to address the funding gap. While each of the measures is slightly different in focus, together, they contribute to the European Commission's overall approach to addressing the funding needs of the European economy.[21]

Overall, the academic studies, including empirical analyses, support the feedback from our dialogue with the investment management industry. Their perspective, in summary, is that large SME and intermediate sized companies which are too small to access the corporate bond market, even where they have very strong borrowing proposals, are it finding increasing difficulty in getting access to lending, particularly in amounts, ranging between €25 million to €100 million and particularly in relation to leveraged buy-outs, infrastructure lending and commercial real estate borrowing proposals. It is difficult to assess, but this positive impact could occur both across Europe and domestically.

---

[20] http://europa.eu/rapid/press-release_SPEECH-12-310_en.htm

[21] The EU Long-term Investment Funds ("ELTIF") proposal issued in June 2013 is broadly similar to the European Venture Capital Funds ("EuVECA") and European Social Entrepreneurship Funds ("EuSEF") regimes which will apply from July 2013, in so far as each is framed under an EU Regulation, not requiring national transposition, requiring funds to invest 70% of assets in specified eligible investment with the definition of assets designed to encourage investment in the areas targeted. However some of the key differences between the ELTIF proposal and EuVECA and EuSEF Regulations exist. These include the fact that the ELTIF can be open to retail investors, with no minimum subscription amount proposed. An ELTIF Manager has to be a fully authorised AIFM under the AIFMD whereas EuVECA / EUSEF managers only need to be registered under the AIFMD. The ELTIF and their managers are subject to the full AIFMD requirements whereas the EuVECA and EuSEF Regulations do not set out any such requirements. The eligible assets of ELTIFs differ slightly to EuVECA or EuSEF, as do the types of undertakings they can invest in. ELTIF can borrow cash, subject to a 30% of capital limit. EuVECA/EuSEF can only borrow when the amount is covered by capital committed. While ELTIF set out in the legislation that investors have no right of redemption until the end of the ELTIF's life EuVECA and EuSEF, which would be expected to be long term investment with very limited or no redemption rights, are silent in that regard.

It would appear on the basis of this analysis, that if there is scope to moderate the current prohibition on loan origination by investment funds without other adverse consequences (eg related to investor protection, financial stability or monetary stability concerns) then it is something worth pursuing in the public interest.

Respondents are asked if they agree with this analysis?

3. Shadow Banking Entities and Financial Stability

Following the G20 meeting in Seoul in November 2010, the FSB has been pursuing a mandate to develop proposals for developing the regulation of the shadow banking activities. The FSB established a task force with three objectives:

- clarify what is meant by the "shadow banking system", and its role and risks in the wider financial system;
- set out approaches for effective monitoring of the shadow banking system;
- prepare, where necessary, additional regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

In October 2011, a series of recommendations on strengthening oversight and regulation in the shadow banking system was published. These outlined five workstreams to assess in more detail the case for further regulatory action covering the following areas:

1. The regulation of banks' interaction with shadow banking entities (indirect regulation) – The Basel Committee on Banking Supervision (BCBS) examination of enhanced consolidation for prudential regulatory purposes, concentration limits/ large exposure rules, risk weights for banks' exposures to shadow banking entities, and treatment of implicit support;
2. The regulatory reform of money market funds (MMFs) – The International Organisation of Securities Commissions (IOSCO) examination of regulatory action related to MMFs;
3. The regulation of other shadow banking entities – A new workstream set up under the FSB Task Force examination of shadow banking entities other than MMFs;
4. The regulation of securitisation – IOSCO, in coordination with the BCBS, examination of retention requirements and transparency; and
5. The regulation of securities lending and repos – A new workstream set up under the FSB Task Force examination of securities lending and repos (repurchase agreements) including possible measures on margins and haircuts.

The (third) workstream on examination of the regulation of shadow banking entities (other than Money Market Funds (MMFs)) issued a consultation paper in November 2012 that outlined a policy framework for the regulators of these entities. This framework consists of three elements:

(a) A list of five economic functions which regulators should refer to in determining whether non-bank financial activities other than MMFs are involved in non-bank credit intermediation that may pose systemic risks or in regulatory arbitrage.

(b) A framework of policy toolkits which consists of overarching principles that regulators should apply for all economic functions and a toolkit for each economic function to mitigate systemic risks associated with that function.

(c) Information sharing among regulators to ensure implementation of the policy framework is consistent and to minimise any opportunities for regulatory arbitrage.

Economic Functions

According to the FSB, the five economic functions which may exist when non-bank credit intermediation takes place are:

1. *Management of client cash pools with features that make them susceptible to runs.*

   Pooling of investor funds into a single product could create "run risk" which can be intensified if leverage is allowed in the product. (e.g. unregulated liquidity funds, short-duration ETFs, short-term investment funds, credit hedge funds that leverage using short-term bank funding);

2. *Loan provision that is dependent on short-term funding.*

   Entities outside the banking system that engage in provision of loans may concentrate lending in certain sectors depending on their expertise, which may create risks if growth in those sectors is cyclical (e.g. construction). Risks may be increased if the entities are using short-term or wholesale funding as their supply. (e.g. deposit taking finance companies not subject to bank regulation, finance company arms of car companies, other finance companies funded by banks and used as a vehicle to circumvent regulations);

3. *Intermediation of market activities that is dependent on short-term funding or on secured funding of client assets.*

   Non-banking entities that provide market intermediation such as securities broking or prime brokerage services could be exposed to liquidity risks depending on their funding model.

4. *Facilitation of credit creation.*

   Non-banking entities that provide credit enhancements such as guarantees may create excessive leverage by facilitating credit creation which may not be suitable for the risk profile of the borrower. (e.g. issuers of CDS)

5. *Securitisation and funding of financial entities.*

   The provision of funding by entities to related-banks or non-bank financial entities may aid in the creation of excessive maturity and liquidity transformation, leverage or regulatory arbitrage in the system. This practice was also used by entities to avoid banking regulations.

It seems likely that loan origination funds would fall into the first and second of these economic functions if open-ended and even if they were structured so as not to do so, could still be argued to fall under function five? Respondents are asked if they agree?

Policy Toolkits

The FSB identifies a policy toolkit that aims to mitigate against the risks that each of the five economic functions pose. In their current consultation document (due to be replaced by a final view in September), they leave it to regulators to design specific regulatory regimes to deal with any specific market structure or practice devised to exercise these economic functions. They argue that the combination of these policy tools should be guided by:

- ***Focus:*** Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates;
- ***Proportionality:*** Regulatory measures should be proportionate to the risks shadow banking poses to the regulatory system;
- ***Forward-looking and adaptable:*** Regulatory measures should be forward-looking and adaptable to emerging risks;
- ***Effectiveness:*** Regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions;
- ***Assessment and review:*** Regulators should regularly access the effectiveness of their regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.

The policy framework should enable authorities to:

- define the regulatory perimeter;
- collect information needed to assess the extent of risks posed by shadow banking;
- enhance disclosure by other shadow banking entities as necessary so as to help market participants understand the extent of shadow banking risks posed by such entities;
- assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from the policy toolkit.

The development of a regulatory regime for loan origination with investment funds needs to take account of all of these principles.

While the FSB refers to five economic functions (or activities) which authorities should refer to in determining whether non-bank entities in their jurisdictions are involved in credit intermediation which may pose systemic risks or in regulatory arbitrage, we have suggested above that two are of primary relevance when considering loan origination by investment funds:

- Management of cash pools with features that make them susceptible to runs
- Loan provision that is dependent on short-term funding

Listed below are the tools the FSB recommends to mitigate the risks posed by both of these economic functions. The tools primarily address the risks which arise as a result of the short term nature of the funding supporting these activities. For a loan origination fund product which is closed-ended with only very limited leverage many of the tools recommended may be deemed unnecessary.

Tools recommended by the FSB

- Restrictions on maturity of portfolio assets
- Limits on leverage
- Tools to manage liquidity risk including liquidity buffers, limits on asset concentration and illiquid assets
- Tools for managing redemption pressures in stressed market conditions including side pockets, gates, redemption fees, suspension of redemptions
- Impose bank prudential regulatory regimes on deposit-taking non-bank loan providers
- Capital requirements
- Restrictions on types of liabilities
- Monitoring of the extent of maturity mismatch between assets and liabilities
- Monitoring of links (e.g. ownership) with banks and other groups

Various regulatory authorities, especially the Financial Stability Board, have looked at the activities and entities that could loosely be described as being in engaged in ‘shadow banking’. Lane (2013) explains that “shadow banking comprises activities involving some element of maturity and liquidity transformation, credit extension, and risk transfer, conducted partly or wholly outside the “traditional” banking system. It covers a wide range of activities, including securitisation, repos, and money market funds (MMFs) as well as some activities of non-bank financial institutions such as finance companies and credit hedge funds.”[22]

There is little doubt that loan origination by investment funds would be captured by the FSB definition of shadow banking. The FSB recognises that non-bank credit intermediation, appropriately conducted, provides a valuable alternative to bank funding, one that supports real economic activity. The focus should therefore be on identifying the risks that may arise and ensuring, where necessary, that such risks are appropriately mitigated.

Given the current work amongst international policy makers, led by the FSB, it is appropriate to use the FSB toolkit to aid the review of the current policy. Combining the analysis in Section 2, with the framework in Section 3, leads to the overall conclusion that with appropriate risk mitigants in place,

[22] Speech by Timothy Lane, Deputy Governor, Bank of Canada “Shedding light on shadow banking”, 26 June 2013 http://www.bis.org/review/r130628g.pdf

the balance of public interest might be served by allowing investment funds to originate loans in certain circumstances. Respondents are asked if they agree?

4. Loan Origination by Investment Funds

Current rules and their background

Securities regulation differs from the regulation of banks, insurers and investment firms as it tends to focus less on the strength of the service providers that facilitate the creation and trading of the securities and more on (a) appropriateness of assets, (b) liquidity of units and share classes, (c) valuation, (d) custody, (e) disclosure, (f) incentives of key risk takers and (g) reporting to financial authorities. For consumer (or investor) protection, distribution rules are usually relied on.[23] In essence, the security or product is designed to be inherently safe in key respects and to ensure the investor is protected irrespective of the financial health of the promoter or the behavioural standards of the distributor.

In UCITS regulations one of the key protections is the definition of so-called ‘eligible assets’. With some defined exceptions relating to portfolio management, UCITS may only invest in listed securities and money market instruments, deposits, financial derivative instruments and other eligible investment funds. The general concept for investment funds being sold to retail investors, most notably UCITS, is that the eligible assets should be capable of being widely bought or sold. This has many advantages in terms of safely holding the assets, managing the liquidity of the fund, valuing the assets and allowing the retail investor the full advantage of the discipline of the open market on those investments.

However, it also has some significant disadvantages. In particular, it reduces the range of assets in which those funds can invest to those which are sold through structured, liquid markets. To deal with this problem, regulators have been involved over the years in the challenging task of extending the classes of eligible assets so as to maximise the investment opportunities open to retail investors without negating the protections inherent in the original concept of confining funds to liquid, marketable assets.

Non-UCITS are not subject to any domestic legislative provisions on eligible assets. Instead the domestic investment fund legislation empowers the Central Bank to impose rules including those regarding permitted investment policies. The rules which the Central Bank imposes on authorised funds are set out in the AIF Rulebook (and previously the NU Series of Notices). One of the asset types that Qualifying Investor Alternative Investment Funds (QIAIF) have been permitted to invest in are syndicated loans, which they do by what is called ‘loan participation’. The syndicated loan market is a highly structured market, with specialised teams operating in banks and asset managers

---

[23] Conduct of business regulation cuts across the regulation of both firms and securities markets. See UK Retail Distribution Review (RDR) or EU proposals on Packaged Retail Investment Products (PRIPS).

to review loan participation proposals which are circulated by other financial institutions which structure a deal on the basis of their own detailed credit assessment and on the basis of bespoke structured documentation, fees and interest rates particular to that deal. Further, the originator of the loan usually administers the loan on behalf of all the participants in the syndicated loan facility, distributing interest and principal payments and managing the relationship with the borrower, thereby avoiding the need for each of the individual participants to have the required systems and controls in place. This market has features which (a) support credit assessment, (b) mitigate information asymmetries and (c) may offer secondary market liquidity. For that reason, investment funds are allowed to participate in syndicated proposals.

Loan origination vs Loan participation

Certain stakeholders have argued that because it is possible to take a position in a loan by way of loan participation immediately after another party has originated a loan, we should allow loan origination and we should do so merely to be consistent with what we already allow.

Having reviewed the matter in depth and consulted with a range of market participants, the Central Bank is not persuaded with this argument:

- The syndicated loan market has an inherent discipline around the credit assessment and monitoring because loans must be structured and priced to be credible to a range of potential lenders. In the absence of specific regulatory requirements, it is not clear that such a discipline exists in direct debt-financing or bilateral loan origination activity. A number of the key risks with loan origination arise because of that difference;
- The best practice which the Central Bank has encountered amongst loan originators suggestsa highly involved selection process requiring specialist skills, for identifying projects, undertaking due diligence, negotiating loan terms, extending credit and monitoring progress once loans are on the books. Measured in terms of time-input, alone, from pre-screening to loan origination, this may take over six months. It contrasts with investment via loan participation which may take a number of days but no more than a few weeks. It is clear from the Central Bank’s engagements with investment managers, that loan participation is viewed as being fundamentally different to loan origination[24];
- It is important that the credit assessment and monitoring which underpins any loan origination process is thorough and credible. If investment funds were effectively originating loans by making arrangements for another party to originate a loan and then participating in the loan just after it was originated, this would not be an acceptable practise as it would constitute a form of avoidance of the responsibility to conduct thorough credit assessment and monitoring

[24] One firm which undertakes loan origination described how it may only select 12 projects for investment after having filtered 200 loan finance applications through various levels of due diligence and internal committees in a year.

and it would run the risk that the supply of credit is mis-priced and by mis-managed. Just because there is the potential for certain requirements to be avoided does not mean that they should not exist.

Boundary anomalies are inherent in all regulatory frameworks which include hard-wired boundary rules. The evidence suggests that there is a substantive difference between loan origination and loan participation. As mentioned earlier, the end-effect of having economic exposure to a loan belies the different processes by which the loan was originated. Therefore separate analyses should be conducted on the regulatory risks arising in each case. The read-across from loan participation to loan origination misses some of these regulatory risks.[25]

Bilateral loan arrangements may not benefit from third party information regarding pricing or credit assessment. There may be operational risks for fund investment managers and their third party administrators because of the need to have the necessary systems to record, administer, account and manage the risk associated with bi-lateral loan arrangements. There is a risk that these tasks may be taken on by fund service providers who may not have the appropriate systems or resources to conduct this processing.

Respondents are asked if they agree?

---

[25] There are a significant number of anomalies in investment funds regulation. UCITS can invest in transferable securities provided they are listed and liquid. They are also required to spread risk and diversification rules apply in respect of issuers/counterparties/credit institutions to ensure that UCITS are not concentrated in one or a small number of entities. However a UCITS could still invest in 16 issuers all providing exposure to the same asset class. For example, a technology fund. This is not deemed to be inconsistent with the general principle of risk spreading which forms part of a UCITS sole objective. Other types of anomalies arise – UCITS can invest up to 100% in government issues but if they take collateral in the form of government debt it must be diversified. UCITS can invest up to 35% in any government debt – including the most lowly rated issue.

Investment in structured instruments is also permitted and therefore UCITS can have exposure to commodities, gold, oil, real estate but cannot invest directly in any of these The fact that these are anomalies is not, in our current view, fatal to any of the compromises which led to these anomalies for various reasons which can be set out on a case by case basis.

European Long Term Investment Fund (ELTIF)

On 26 June 2013, the European Commission issued its proposal for a European Long Term Investment Fund (ELTIF). In launching the proposal Commissioner Barnier commented "we need to secure long-term financing for Europe's real economy. Currently, financing is scarce and where it exists, too focussed on short-term goals." While the European Commission's Green Paper on the Long-Term Financing of the European Economy considers, in a broad context, the need to revive funding of the real economy by improving the mixture and overall resilience of different funding sources, it confirmed the need for measures on investment funds. Moreover, the Commission believes the ELTIF can contribute to increasing non-bank finance to businesses.

Due to the complexities of the EU legislative process together with European Parliament elections in May 2014 and a change in Commission in Autumn 2014, there is a realistic possibility that the final text for the Regulation may not be agreed until 2015.

The ELTIF designation is reserved for those EU AIFs who comply with the Regulation so there is the implication that a manager who wants to manage or market funds focussed on long term assets without the designation is not obliged to comply with the proposed regulation.

Eligible investment assets include participations such as equity or quasi-equity instruments, debt instruments in qualifying portfolio undertakings and loans provided to them

'Qualifying portfolio undertakings' are the main permitted exposures for ELTIFs and are non-financial undertakings which are not admitted to trading on regulated market or MTF and are considered to include infrastructure projects, investment in unlisted companies seeking growth and investment in real estate or other real assets such as ships, aircraft and rolling stock

While the Regulation does not require long-term holding periods for the ELTIF manager, eligible investment assets are generally illiquid, require commitments for a certain period of time and have an economic profile of a long term nature.

While borrowing of up to 30 per cent is permitted it must not result in assets of the ELTIF being encumbered.

Co-investment is prohibited and is deemed to represent a conflict of interest.

The Regulation includes diversification limits, prohibits short selling, exposure to commodities, securities lending and repos and only allows exposure to derivatives for the purpose of exchange rate and duration hedging.

The Regulation makes no distinction between equity investment, purchase of debt instruments and lending as techniques for investment and does not consider that the governance framework in place needs to reflect the means by which investment is achieved.

The overall assessment is that if loan origination funds were allowed at this time it will pave the way for the ELTIF option. At the very least, providing a jurisdiction with a well-considered regulatory framework for loan origination funds would provide the industry with a framework within which they could prove the concept of loan origination funds for investors reluctant to go down this road without such a regulatory framework. In addition, consideration could be given as to how to align the two by considering whether fund promoters would be allowed to design loan origination funds which would operate out of Ireland initially as AIFs but with an option to opt into the ELTIF regime, with investor consent when it becomes available. This idea needs further careful consideration as it may not be viable.

In that sense, the ELTIF proposal does not cut across the further consideration of this issue by the Central Bank of Ireland as it relates to Irish funds regulation. However, it does not foreclose the careful consideration of risk mitigants which do not appear in the ELTIF proposal. This is because analogous mitigants may be added to the ELTIF proposal as part of the legislative process and also because we are not considering an ‘opt-in’ proposal but rather a set of rules which would apply either to all AIFs or to all QIAIFs which originate loans.

5. Regulatory risks associated with funds that originate loans and their potential mitigants

Outline Risk Analysis

Securities regulation seeks to protect investors, maintain market integrity and mitigate systemic risk. European funds regulation provides detailed rules seeking to mitigate these risks. In this section, the specific issues which might arise in the context of an investment fund which originates loans are considered. These are as follows:

1. **Concentration Risk**

   Direct lending portfolios may build up concentrations for three reasons: (i) exposure to a certain sector or collection of borrowers with similar economic characteristics, (ii) the fact that the loan book takes time to build up and in the initial stages is dominated by the initial positions and (iii) a loan book containing few loans. Apart from the third point, it is possible that risk concentrations may arise for natural reasons, for example, the sector expertise of the lending team (in the case of (i)) and the natural evolution of the loan book it its early stages (in the case of (ii)).

2. **Illiquidity risk**

   Private lending is intrinsically illiquid. Whereas the secondary loan market facilitates the trading in loans which conform to more standardised legal terms and recognised monitoring and servicing arrangements, this may not be the case for private loans.[26] Two issues arise here. First, it is important that the valuation and servicing of the loan portfolio allows investors to understand the quality of the performance of the portfolio, this is especially true when cash flows are only remitted to investors a number of years after the launch of the fund. Second, it is important that the structure of the investment fund vehicle does not permit redemptions which could force fire sales of loan assets which would adversely affect other investors in the fund.

3. **Risk of investor runs**

---

[26] The Loan Market Association (LMA) is the European organisation and has as its key objective improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa (EMEA). By establishing sound, widely accepted market practice, the LMA seeks to promote the syndicated loan as one of the key debt products available to borrowers across the region. See the following link to standard documents and term sheets: http://www.lma.eu.com/documents.aspx#c46.
The Loan Syndication and Trading Association (LSTA) is the US equivalent organisation, see the following link to standard documents: http://www.lsta.org/hub_stddoc.aspx?id=110

Funds, including funds which originate loans, manage client cash pools and are therefore vulnerable to client “runs”. There is a risk that funds may be structured so that there is a mismatch between the liquidity and/ or maturity of their assets and liabilities. This creates a credit channel which is subject to swings in investor confidence and may heighten the pro-cyclicality of credit supply. For example, during surges in investor confidence, this alternative credit channel may accelerate credit supply. However, in turn, sudden losses of investor confidence may lead to credit supply disruptions (e.g. an open-ended investment fund may be subject to investor runs leading to a situation where loans may be recalled and credit is withdrawn). A run could also have broader systemic consequences if the investment fund holds a concentrated position in a particular segment of the credit market.

4. **Leverage**

Where investment funds use leverage to increase the potential returns for the portfolio, they are introducing additional risks. First, in many cases, the leverage may lead to encumbrance of the loan portfolio thereby reducing the claim of the investors on the fund in the event of a liquidation or bankruptcy of the fund. Second, the leverage may confer on the lenders to the fund, rights or covenants which allow them to direct the operation of the fund, including the sale of assets, in certain instances.

5. **Money Creation**

By allowing investment funds to use leverage as a source of funding for the loan portfolio, a channel is being opened which allows for the creation of new money as this credit is recycled as new deposits within the fractional reserve banking system. In Europe, owing to the dominance of credit intermediation by banks, this is not a significant channel. Were loan origination by investment funds to develop further, the monetary transmission mechanism would change and monetary authorities would need to be vigilent to the significance of this effect.

6. **Dominant lenders**

Certain originators may be dominant lenders to specific real economy sectors. This may arise because there are barriers to entry into this lending market due to the scarcity of experienced loan originators and analysts in the sector. There is the risk that such a lender may set less stringent pricing or loan documentation terms and thereby deter entrants into this market but ultimately, create an unsustainable lending channel. (This argument works the other way as well, if barriers to entry are weak, certain lenders may compete for market share and drive down pricing or loan documentation terms and make the overall market unsustainable).

7. **Misalignment with investor risk appetite or investor capability**

Loan funds will typically (i) hold assets which are not traded on secondary markets and are illiquid, (ii) not be open to regular redemption requests, (iii) invest in sectors which are not closely or intensively analysed by investment advisors and (iv) not pay cash flows on a regular basis during the early life of the fund. There is the risk of significant information asymmetry and the investor may have to passively own the investment fund for long periods in the absence of specific new information on the performance of the fund.

8. **Mispricing of credit**

Owing to the nature of investment funds and, in particular, the specific roles performed by the investment fund and the investment fund manager, the risk remains that there may be a mispricing of credit owing to a lack of incentive alignment. This risk arises as the loan issuance and loan pricing decision will be driven, to a large degree, by either an investment manager, or in the case of some products, the credit assessment process may be outsourced to an external specialist, both of whom receive a transactional fee which may not be affected by the performance of the loans. In addition, when there is an apparent excess of investor capital seeking loan-pool exposure via investment funds, there is the risk that the quality of the loan origination process may be influenced, adversely, by the challenges of meeting that demand. As a result, loan documentation may be weaker (e.g. lighter covenants), the nature of the borrowers may be more risky or the collateral taken against the loans may be poorer.

Respondents are asked whether they agree that these are the main risks with loan origination investment funds? Are there other risks?

In advance of permitting such investment funds, are there features of loan origination investment funds which means that the Central Bank would need to have additional powers to appoint an administrator to insolvent loan origination investment funds?

Potential measures to mitigate these risks

The Central Bank has identified a list of possible measures to mitigate these risks. It is worth recognising that some of these mitigants address more than one of the risks identified above. Furthermore, AIFMD introduces a range of measures in relation to (a) remuneration, (b) liquidity management, (c) capital of the AIFM, (d) reporting, (e) conflicts of interest, which are relevant to the analysis of the risks of loan origination funds.

1. Diversification requirements

Diversification provides an important risk mitigant tool for investment funds, as it does for banks. It is commonly accepted as an effective means of reducing investor risk within an investment fund and has been one of the key investor protection pillars within UCITS.

Diversification seems particularly important for loan funds as we believe there will be a strong inherent tendency for sectoral concentration and large exposures in order to control investment management costs.

While one approach to diversification would be to require a minimum number of loans to be held, such an approach does not eliminate the possibility of a single significant exposure, comprising the majority of the assets and therefore, in this instance, does not seem to us to be the best approach to diversification.

A requirement for diversification across sectors, while meaningful, needs to be balanced against the benefit of lending expertise which is often sector specific. We believe the benefit of sector knowledge and expertise may well outweigh the benefit of diversification across sectors in some cases and therefore a sector diversification requirement may not be appropriate in this instance.

Therefore, the best approach to diversification for a loan origination fund may be a maximum percentage of assets exposure to a single borrower, perhaps set a level of circa 10 per cent. This approach does not, however, address geographic diversification. How is this best addressed within the requirements?

There may be practical problems where an investment fund is starting up and makes its first loan, at which point it has no loan diversification. How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund?

2. Other Product Features

While a number of the product features have been considered in this section and emerge as risk mitigants, namely leverage, diversification and investor type there are a number of important features of the loans themselves which require consideration, namely:

- Types of loans
- Loan term

2a. Types of loans

In order to mitigate as much as possible the risk of default and therefore investor losses it may be proposed to limit the types of loans an investment fund can originate to senior secured debt, however, any regulatory framework developed needs to take account of the commercial demands for the product. Based on our engagement with investment managers there would appear to be some merit and demand for allowing an element of second charge/mezzanine/unsecured lending where the risk mitigants are deemed to be sufficiently robust to support this. Our discussions with investment managers did not identify the commercial need for an investment fund wholly engaged in mezzanine/unsecured lending and on that basis we do not propose, at this juncture, to consider an investment fund engaged in an unlimited level of mezzanine / unsecured lending. The level at which second charge and / or unsecured / mezzanine lending may be undertaken needs careful consideration with the possibility of imposing a minimum level senior secured lending or a maximum level of second charge and / or unsecured / mezzanine lending, which could be further broken down between second charge and / or unsecured / mezzanine lending. The straight forward approach is to allow only (first charge) secured term lending.

2b. Loan Term

Banks, traditionally the long term lenders, are restricted in their ability to provide long term financing under Basel III. It is appropriate to consider in the context of a loan origination fund whether there should be a restriction imposed on the lending term. To avoid any maturity / liquidity mismatch, the term of the loan should be no more than the term for which the investment fund is closed. However, in order to be a valuable source of funding to the real economy on terms which make it viable to those commercial entities seeking the funding, is there any case for allowing a lending term which extends beyond the term of the fund, albeit with a requirements concerning maximum lending terms and investors disclosure of the potential liquidity / maturity mismatch?

3. Measures to address liquidity and maturity mismatches

In order to avoid mismatches between the maturity or liquidity of assets and liabilities, loan origination is likely to be more appropriate within closed-ended investment funds.[27] By this mechanism, investment funds will not be vulnerable to redemption demands which could lead to a credit squeeze on the fund. One of the issues to be considered is whether there are treasury management techniques which would allow a loan origination fund to manage its liquidity effectively without being closed ended? Our sense is that the level of reassurance such techniques will provide will not be robust in stressed market conditions. Do you agree?

---

[27] Article 16 of AIFMD requires that AIFs have liquidity management policies which are appropriate to the assets and to the liquidity of the fund units. ESMA will shortly issue a regulatory technical standard defining open-ended and closed-ended funds for this specific purpose. Certain funds which are generally illiquid will be deemed to be open according to this definition as the liquidity management policies will need to cater for the possibility of redemptions, however limited or restricted. However, investors generally understand that funds which are distributed as open-ended funds facilitate regular redemptions so there is a risk of investor misperception.

Redemption gates and redemption fees can also be used for the management of redemption pressures in stressed market conditions. By using gates, investment funds constrain the redemption amount to a specific proportion on any one redemption day. Thus, gates are a measure for investment funds to manage maturity mismatches (or maturity transformation) by prolonging the term of a fund's liability. They can ease redemption pressures and thus prevent or dilute a "run" or other "herding" behaviour. Likewise, redemption fees may discourage investor redemptions requests. The question is whether there is a robust enough gating mechanism which would allow a loan origination fund to provide a limited redemption capacity? Is it not the case that any such gating would be a temporary measure and over a matter of weeks or months we would, nevertheless see investor pressure on a loan origination fund leading to a contraction in credit?

The 'limited liquidity' investment fund option does not seem to be a viable solution in this instance. Under this option, an investment fund would, for example, only allow redemptions every six months. But given the inherent illiquidity of loan assets over a number of years, this does not seem to offer a comprehensive solution. It therefore appears difficult to make a case for anything other than such investment funds being closed-ended. Respondents are asked if they agree?

4. **Constraints on Leverage**

The use of leverage is one key element which must be considered when assessing the potential adverse impact of loan origination by investment funds. To mitigate potential financial stability issues associated with loan origination by investment funds and to protect investors, leverage limits may be imposed. This would help curtail pro-cyclicality and such constraints could be calibrated to suit the specificities of the investment fund. For example, the appropriate level of leverage may differ depending on the market it is involved in and its significance within the financial system (e.g. size, interconnectedness). The imposition of leverage restrictions would also limit the impact of loan origination by investment funds on money creation.

Yet permitting some use of leverage as a temporary measure to facilitate treasury management seems appropriate – for example to allow an investment fund to issue a loan as subscriptions which have been committed are being gathered in. There may also be other legitimate purposes outside the investment strategy for which limited leverage might usefully be allowed.

Respondents are invited to offer views as to what the appropriate leverage restrictions would be?

5. Financial Commitment by Investment Manager

While it is generally accepted that there is necessity for capital in the context of bank credit intermediation, its appropriateness in the context of an investment fund originating loans needs more careful consideration. Whereas banks have access to central bank support and depositors have some form of deposit protection insurance, investors in investment funds take explicit risk knowing that they may make a profit or a loss. As such, loss absorption buffers similar to bank prudential capital requirements are not necessary. However, an argument could be made (similar to that which arises in securitisation[28]) that the Investment Manager should have 'skin in the game' so that incentives between the investment managers and the investors are aligned. It may be that some type of co-investment requirement may represent a more suitable and commercially viable mechanism for ensuring appropriate lending and therefore investor protection.

Respondents are invited to offer views as to appropriateness of a capital and / or co-investment requirement?

6. Investment manager competence, remuneration and expertise

The expertise, experience and track record of the investment manager and those personnel responsible for the lending decisions are key factors in ensuring that the lending decisions are made appropriately and accurately priced. We believe it is of paramount importance that the investment manager can demonstrate they have undertaken successful lending on an on-going basis over a medium term time horizon. In the application for authorisation of an AIF, the investment manager must be able to demonstrate proven expertise and capability and track record in the area of loan origination including credit assessment, review, provisioning and monitoring / control of large exposures.

ESMA has produced guidelines for the remuneration of certain staff within an AIFM.[29] Are there particular issues in relation to investment funds which originate loans which might merit further constraints on the remuneration of investment managers?

Do the list of control functions (CFs) and pre-approved control functions (PCFs) in the Statutory Code for Fitness and Probity[30] cover those key credit functions in an investment manager of a loan origination fund?

---

28 See Article 122a of 2009/111/EC.

29 See Guidelines on sound remuneration policies under the AIFMD http://www.esma.europa.eu/system/files/2013-201.pdf

30 http://www.centralbank.ie/regulation/processes/fandp/Documents/Fitness%20and%20Probity%20Standards%20(final)%2030%20November%202011.pdf

7. Constraints on the type of investor

It is important that only investors who are sufficiently sophisticated and in a position to assume the risks presented by an investment fund originating loans are permitted to make such investments.

A unit-holder in a QIAIF must be an investor who:

(a) is a professional client within the meaning of Annex II of Directive 2004/39/EC (Markets in Financial Instruments Directive); or

(b) receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the QIAIF; or

(c) certifies that they are an informed investor by providing the following:

- Confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or
- Confirmation (in writing) that the investor's business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the QIAIF.

Entities which are required to be authorised or regulated to operate in the financial markets, large undertakings meeting a combination of minimum balance sheet, turnover, own funds requirements, national and regional governments, other institutional investors whose main activity is to invest in financial instruments, should all be regarded as professional clients for the purposes of MiFID. Furthermore additional investors may be considered professional clients for the purposes of MiFID provided at a minimum, two of the following criteria should be satisfied:

- the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters,
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,
- the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

In addition, the QIAIF must ensure that prospective unit-holders certify in writing to it that they meet the minimum criteria listed above and that they are aware of the risk involved in the proposed investment and of the fact that inherent in such investments is the potential to lose the entire sum invested.

Whilst the Central Bank views these requirements as the minimum required, the Central Bank considers that they are sufficiently stringent and does not see a necessity to restrict further the permissible investors for a loan origination fund.

Respondents are asked if they agree?

8. Credit assessment requirements

The banking system is intensively regulated through the Basel framework and CRD IV. How the banking regulatory system treats credit risk is of significant relevance to non-bank credit intermediation.[31] [32] A bank's systems, including the credit rating process, policies and historical data are also key elements. The Bank of International Settlements (BIS) has set out principles for sound credit risk assessment: Sound credit risk assessment and valuation for loans[33] include:

- Responsibility of the board of directors and senior management;
- Reliable classification system;
- On-going validation of any internal credit risk assessment models;
- Adoption and documentation of a sound loan loss methodology with policies, procedures and controls for identifying problem loans and determining loan loss provisions in a timely manner;
- Loan loss provisions should absorb estimated credit losses in the loan portfolio;
- Experienced credit judgement is essential to recognise and measure loan losses;

It also recognises that credit risk is a complex issue and one which is highly correlated with interest rates and macro-economic trends. Similarly for all types of household and corporate lending, income gearing – a measure of the ease with which households and firms can cover debt-servicing obligations – is found to be an important driver of the probability of default.

Based on the Central Bank's engagement with investment managers who undertake loan origination, it is evident that many have sound credit assessment and monitoring policies in place, together with a well-developed expertise in the pricing of credit. While the details of how these practices are executed will differ across the investment funds, the principles would

---

31 Bank of International Settlements, International Convergence of Capital Measurement and Capital standards (2006): http://www.bis.org/publ/bcbs128.pdf

32 Title II of Regulation (EU) No 575/2013.

33 Bank of International Settlements, Sound credit risk assessment and valuation for loans (2006): http://www.bis.org/publ/bcbs126.pdf

seem to be consistent and provide the basis for the development of a defined set of requirements in this area which, at a high level, should include the following:

- Risk appetite statement;
- Credit policy to include governance of credit risk, portfolio management, credit assessment, credit pricing, committee structures, credit monitoring and stress testing;
- Collateral valuation policy;
- Concentration risk policy;
- Impairment provisioning policy;
- Problem debt management and forbearance policies;
- Delegated authority policy;
- Policy addressing documentation and security;
- Credit management information.

These practices, incorporated into a product regime, together with product key features could frame a regulatory approach for loan origination by investment funds.

The introduction of comprehensive credit assessment frameworks can also help mitigate the risks of credit mis-pricing by ensuring that appropriate documentation and collateral are used to support the credit decision.

The Central Banks does, however, recognise that there are problems with this, particularly for entities which are setting up outside the traditional practices of banks. Even within banking, despite long established practices and known best practices, credit assessment can be weak, particularly where the bank is not well diversified or under cyclical or competitive pressures. The banking rules on credit assessment described above are focused on process with few hard-wired requirements of the kind that would provide strong reassurance in the very different investment fund environment, which seems to us even more susceptible to such pressures and to others particular to the unusual structure of investment funds.

There seems to be a strong case for some hard-wired limits as these would exclude the most extreme practices. These could include, for example not allowing lending:

– to any connected party of any investment fund, its manager or its service providers under any circumstances;
– to other investment funds;
– to financial institutions or related entities;
– to persons intending to invest in equities or other quoted investments or commodities;
– other than on a secured basis with an LTV of, approximately 70 per cent at origination based on at least two independent valuations;
– other than on a fully amortised basis;

– as part of a complex investment strategy[34]
– to natural persons

Views are invited on what the appropriate hard-wired constraints might be which would be most likely aim to exclude the most egregious misbehaviour while facilitating normal, prudent lending.

9. **Monitoring of loan book**

When considering whether and how to assess the quality of the lending on a post-authorisation basis it is necessary to note that the Basel framework on credit risk assessment recommends, conducting the evaluation of credit risk assessment for loans, controls and capital adequacy by:

- periodically evaluating the effectiveness of an investment fund's credit risk policies and practices for assessing loan quality;
- being satisfied that the methods employed to calculate loan loss provisions produce a reasonable and prudent measurement of estimated credit losses in the loan portfolio that are recognised in a timely manner.

Some element of post authorisation supervision of lending practices would seem to be appropriate but the intensity and scale of such supervision needs further consideration and is something which may need to be determined on the basis of the outcome of some initial review work, based on a random selection of entities engaged in loan origination.

A second element to be considered is the most appropriate and effective manner to execute such review work. The options available include:

- The AIF submits an annual report to the Central Bank on their loan positions, including independent validation of provisioning, loan valuation, collateral value and asset quality breakdown;
- As part of their annual audit the auditors are required to prepare a report, for inclusion in the financial statements, on the loan positions addressing provisioning, loan valuation, collateral value and asset quality breakdown;
- Similar to the approach undertaken for banks the Central Bank itself undertakes, on a sample basis, a review of loan positions held by AIFs provisioning, valuation and collateral.

[34] There may be a particular problem here because of the desirability of structuring funds to have some pay-out in the early years. A pure loan fund will not have that. A loan fund which combines lending with another form of investment can create that profile. But allowing this more complex strategy opens up risks that are very difficult to place within a regulatory framework.

The application of the FSB framework to loan origination by investment funds

The foregoing analysis seems to suggest that a regulatory framework could be designed which mitigates the risk to (i) investors, (ii) market integrity, (ii) financial stability and (iv) monetary stability. In some cases, the aforementioned risk mitigants are aligned or are strongly over-lapping. The FSB suggests a wide range of mitigant tools. For a loan origination investment fund which is closed-ended with only very limited leverage, many of the tools recommended may be deemed unnecessary however it is worthwhile to consider each tool individually.

Recommended Tools

- Restrictions on maturity of portfolio assets
  The need for such a tool is negated in the context of a closed-ended structure.
- Limits on Leverage
  The proposed structure takes account of this tool.
- Tools to manage liquidity risk including liquidity buffers, limits on asset concentration and illiquid assets
  The need for such a tool is negated in the context of a closed-ended structure.
- Tools for managing redemption pressures in stressed market conditions including side pockets, gates, redemption fees, suspension of redemptions
  The need for such a tool is negated in the context of a closed-ended structure.
- Impose bank prudential regulatory regimes on deposit-taking non-bank loan providers
  The proposed structure is non-deposit-taking.
- Capital requirements
  In a structure with no deposits and no or very limited leverage the requirement for capital is negated.
- Restrictions on types of liabilities
  Given the other detailed regulatory requirements and limits proposed for the product a restriction on the types of liabilities has not been considered necessary.
- Monitoring of the extent of maturity mismatch between assets and liabilities
  The need for such a tool is negated in the context of a closed-ended structure.
- Monitoring of links (e.g. ownership) with banks and other groups
  It is proposed to prohibit lending to any connected party of any fund, its manager or its service providers under any circumstances.

Respondents are asked if they agree that closed-ended investment funds with limited leverage mitigate many of the financial stability risks?

List of Key Questions

1. **Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?**
2. **What are the 'shadow banking' risks raised by the relaxation of the current policy?**
3. **In what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?**
4. **Does the current Alternative Investment Fund Rulebook ('AIF Rulebook') provide sufficient protections for investors in the case where investment funds are allowed to originate loans?**
5. **Respondents are asked with they agree with the analysis of the funding gap?**
6. **Do respondents agree loan origination funds would fall squarely into the first and second of the FSB defined economic functions if open-ended and even if structured so as not to do so, could still be argued to fall under function five?**
7. **Respondents are asked whether they agree with the main risks with loan origination identified in Section 5 and whether there are other risks?**
8. **Respondents are asked for their views on the analysis of the differences between loan origination and loan participation and the resulting risks which arise?**
9. **How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund?**
10. **How is a geographic diversification requirement best addressed within the requirements?**
11. **Respondents are asked for their views on the types of loans originated and their term?**
12. **Respondents are asked whether they agree that it appears difficult to make a case for anything other than such investment funds being closed-ended?**
13. **There may be other legitimate purposes, outside of the investment strategy, for which limited leverage might be usefully allowed. What would these be?**
14. **Respondents are invited to offer views as to what the appropriate leverage restrictions would be?**
15. **Respondents are invited to offer views as to the appropriateness of a capital / co-investment requirement**
16. **Views are invited on what the appropriate hard-wired constraints might be.**
17. **Respondents are asked whether they agree with the analysis of the main risks and mitigants for loan origination investment funds? Are there others?**
18. **Respondents are asked if they agree that closed-ended investment funds with limited leverage mitigate many of the financial stability risks?**

References

Allen, F., Carletti, E., Qian, J., and Valenzuela, P. (2012): "Financial intermediation, markets, and alternative financial sectors," Economic Working Papers (ECO2012/11).

Amiti, M., and D. E. Weinstein (2009): "Exports and Financial Shocks," NBER Working Paper N. 15556, December 2009.

Bank of International Settlements (2006): "International Convergence of Capital Measurement and Capital Standards," http://www.bis.org/publ/bcbs128.pdf

Bank of International Settlements (2006): "Sound credit risk assessment and valuation for loans," http://www.bis.org/publ/bcbs126.pdf

Bofondi, M., Carpinelli, L. and E. Sette (2013): "Credit Supply during a sovereign debt crisis," Working Paper N. 909, Bank of Italy.

Breedon Review (2012): "Boosting Finance Options for Business," Report of industry-led working group on alternative debt markets, March 2012.

Chava, S., and A. Purnanandam (2011): "The Effect of Banking Crisis on Bank-Dependent Borrowers," *Journal of Financial Economics* 99, 116-135.

Ciccarell, M., Maddaloin, A and J. L. Peydro (2010): "Trusting the Bankers. A New Look at the Credit Channel of Monetary Policy," Working Paper N. 1228, European Central Bank.

EDHEC Business School (2012): "The Impact of Solvency II on Bond Management," An EDHEC Financial Analysis and Accounting Research Centre Publication, July 2012.

European Banking Federation (2012): "International Comparison of Banking Sectors," Update of the EBF Facts and Figures Report 2011.

European Commission (2012): "Proposal for a Regulation of the European Parliament and the Council on key information documents for investment products," July 2012.

European Commission (2013): "Long-Term Financing of the European Economy," European Commission Green Paper, March 2013.

European Commission (2013): “Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European Venture Capital Funds,” Official Journal of the European Union, April 2013.

European Commission (2013): “Regulation No 346/2013 of the European No 346/ 2013 of the European Parliament and of the Council of 17 April 2013 on European Social Entrepreneurship Funds,” Official Journal of the European Union, April 2013.

European Commission and European Investment Bank Group (2013): “Supporting small and medium-sized enterprises in 2012,” A Joint Report of the European Commission and the European Investment Bank Group, May 2013.

European Commission (2013): “Proposal for a Regulation of the European Parliament and the Council on European Long-Term Investment Funds,” June 2013.

Financial Stability Board (2011): “Shadow Banking: Scoping the Issues,” A Background Note of the Financial Stability Board, April 2011.

Gambetti, L., and A. Musso (2012): “Loan Supply Shocks and the Business Cycle,” Working Paper N. 1469, European Central Bank.

Hempell, H. S., and C. Kok Sorensen (2010): “The Impact of Supply Constraints on Bank Lending in the Euro Area Crisis Induced Crunching?,” Working Paper N. 1262, European Central Bank.

Hyun, J. S., and B. K. Rhee (2011): "Bank capital regulation and credit supply," *Journal of Banking & Finance*, vol. 35(2), pages 323-330.

Lane, T. (2013): “Shedding light on shadow banking,” Speech delivered at the CFA Society Toronto, Canada, 26 June 2013 http://www.bis.org/review/r130628g.pdf

Mach, T. L., and J. D. Wolken (2011): “Examining the impact of credit access on small firm survivability,” Finance and Economics Discussion Series 2011-35, Board of Governors of the Federal Reserve System (U.S.).

McKinsey and Company (2013): “Between deluge and drought: The divided future of bank-funding markets,” McKinsey Working Papers on Risk, N.41.

OECD (2013): “Draft High-Level Principles of Long-Term Investment Financing by Institutional Investors,” Report of OECD Task Force on Institutional Investors and Long-Term Financing, May 2013.

Takáts, E., and C. Upper (2013): “Credit and growth after financial crises,” BIS Working Paper N. 416, July 2013.

UK Retail Distribution Review: http://www.fsa.gov.uk/rdr

Véron, N. (2013): “Bank versus Non-Bank Credit,” *Policy Contribution* 2013/6 Bruegel.

World Economic Forum (2012): “Measurement, Governance and Long-Term Investing,” WEF Report, March 2012.

www.centralbank.ie fundspolicy@centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Bosca PO 559, Sráid an Dáma, Baile Átha Cliath 2, Éire
PO. Box No 559, Dame Street, Dublin 2, Ireland