



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

2014

Feedback Statement on CP 85 – Consultation on loan originating Qualifying Investor AIF



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Introduction

1. On 28 July 2014 the Central Bank of Ireland (the “Central Bank”) published Consultation Paper CP 85 *Consultation on loan origination Qualifying Investor AIF* (“CP 85”). The closing date for comments was 25 August 2014 and 13 responses were received.
2. CP 85 related to the publication of proposed rules to apply to loan originating Qualifying Investor AIF to be included in Chapter 2 of the AIF Rulebook.
3. CP 85 raised 10 specific questions for respondents to address. The section headed “Feedback on CP 85” briefly summarises the responses received to each question along with the Central Bank’s comments and decisions.
4. The AIF Rulebook has been revised to include final rules to apply to loan originating Qualifying Investor AIF. These incorporate changes resulting from the consultation process and other amendments necessary for consistency and drafting purposes. The revised AIF Rulebook is published today 18 September 2014.
5. Applications for loan originating Qualifying Investor AIF may be made from 1 October 2014 and application forms will be published on our website in advance of that date.
6. Nothing in this feedback statement should be read with, seen as a clarification of or a supplement to the AIF Rulebook. This feedback statement is published to promote understanding of the policy formation process within the Central Bank and is not relevant to assessing compliance with regulatory requirements.
7. The Central Bank is grateful to all parties who responded to the Consultation Paper and wishes to thank them for their time and effort. The responses are now available from our website.

**Markets Policy Division
Central Bank of Ireland
18 September 2014**

Feedback on questions posed in CP 85

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.

8. Most respondents agreed in general with the Central Bank's approach and five respondents considered that, for the most part, the draft requirements reflect best practice among asset managers.
9. One respondent argued that a risk appetite statement should not be specifically required as this matter was addressed under AIFMD while another considered that the Central Bank should not attempt to be prescriptive with respect to the substance of the requirements as this will depend on the characteristics of the loans.
10. Five respondents stated that the SME Code covers many of the same general principles which an AIFM must adhere to under AIFMD. Application of the SME Code would therefore need to take that into account and provide for a hierarchy of laws in the event of a conflict. An example of such a conflict was provided as AIFMD requires AIFM to act in the best interests of the AIF or its investors which may conflict with the obligation to act in the best interests of customers in the SME code.
11. One respondent stated that any tightening of the lending standards should only apply to future lending and not to loans already entered into.

Central Bank: The Central Bank welcomes the support for the draft requirements in this area and has not made any amendments. Risk appetite statements are now a widely accepted pillar of a risk management system.

With regard to the Code of Conduct for Business Lending to Small and Medium Enterprises, the Central Bank does not consider that there is any question of modifying the rules for one set of regulated financial service providers given the Central Bank has decided that these are the appropriate rules in relation to borrowers of that class when receiving credit from entities regulated by the Central Bank. Should a loan originating Qualifying Investor AIF choose to embark on lending that is subject to such rules it must be aware of and comply with these rules. The Central Bank does not accept that the best interests of investors in an AIF and those of consumers to whom such an AIF might lend money are mutually exclusive and it is noted for example that the similar obligation on the part of corporates generally to act in the interests of their shareholders does not exempt such corporates from their legal obligations to their customers. Again, it is a matter for the AIF itself and the AIFM to ensure that any conflicts or perceived conflicts are managed in an appropriate manner and in accordance with legal requirements.

Finally, with regard to any tightening of the lending standards and a concern that these should only apply to future lending, in the normal course this has to be correct.

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?

12. Seven respondents agreed that the proposed 25% of net assets diversification limit is a reasonable approach. However, three respondents disagreed with the notion of diversification limits and four respondents suggested specific exceptions should be permitted particularly in the context of lending to the real estate sector or lending to projects which are backed by government guarantees.
13. Certain clarifications were requested: (i) how to address situations where a loan originating Qualifying Investor AIF fails to continue to meet the minimum diversification limit; (ii) a request for clarification that diversification limits do not apply during the end of life phase of the AIF; and (iii) what level of approval will be required from unit holders.

Central Bank: The Central Bank acknowledges the support for the minimum diversification limit and this will remain as proposed in the Consultation Paper.

With regard to the clarifications requested, the Central Bank:

- notes that paragraph 13 of Section 1, Part 1 to Chapter 2 of the AIF Rulebook – Qualifying Investor AIF Requirements, addresses breaches of investment limits and this paragraph will apply to situations where the loan originating Qualifying Investor AIF has met with its target diversification level;
- confirms that diversification limits will not apply to a loan originating Qualifying Investor AIF which has reached its end of life phase and is closing out positions;
- confirms that the constitutional documents of loan originating Qualifying Investor AIF will establish the rules, processes and procedures for obtaining unit holder approval.

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.

14. The majority of respondents agreed that the proposed closed ended structure was the right approach although some of these considered that open funds should not be ruled out in their entirety or at least considered in the future.
15. Four respondents sought clarification of the term "closed-ended", which some submit has a variety of meanings under AIFMD and the Prospectus Directive. It was suggested that the term should be defined by reference to AIFMD.
16. Three respondents submitted that it should be possible for the loan originating Qualifying Investor AIF to add redemption dates to the schedule post-authorisation.
17. Most respondents disagreed with the proposal that distributions or redemptions during the life of the loan originating Qualifying Investor AIF would require approval of unitholders if assets were not valued by reference to prevailing market prices. It was pointed out that market values were unlikely to be available and that AIFMD has very detailed rules on how AIFMs are to value AIF assets. Distributions are made pro-rata to all unitholders and therefore if valuations are not correct the impact of the distribution hits all equally. Obtaining unitholder approval would be cumbersome and costly and may for example prohibit the AIF from distributing the regular coupon payments received on some types of loans.

Central Bank: For the purposes of AIFMD, closed-ended AIF are now defined by Commission Delegated Regulation (EU) No 694/2014 of 17 December 2013.

The Central Bank considers that the comments on pre-determined redemption dates have merit and has amended the rules to allow for "or *such other dates as may be approved by the board of the AIFM/investment company/management company/general partner*".

The Central Bank also considers that the comments on unitholder approval are valid in the case of distributions by a loan originating Qualifying Investor AIF. The rules have been amended therefore to apply the requirement for unitholder approval to redemptions only.

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.

18. While one respondent noted that the draft rules reflect procedures already in place with asset managers, three respondents found the proposals to be unnecessary and considered that the provisions in AIFMD were sufficient.
19. One respondent suggested that the intention by the Central Bank to allow for managerial discretion as to how to comply with this requirement should be explicitly referred to in the amended AIF Rulebook.
20. Seven respondents suggested that the AIF Rulebook clarify that information shall be made available to a unitholder upon request by that unitholder in order to avoid any implication that the AIFM has a positive obligation to pro-actively provide such information to all unitholders. Some of these respondents also suggested there may be instances in which preferential access rights to records/staff are appropriate but do not operate to disadvantage other investors.

Central Bank: The Central Bank is not persuaded that there is any legitimate reason why preferential access should be provided and therefore has not amended the rule.

However in light of the comments received some clarification on the operation of the rule may assist applicants. Once a loan originating Qualifying Investor AIF decides to provide access to its records or staff, this facility must be transparently available so that any unit holder will have been aware of the due diligence possibility. The onus is on the unitholders to pursue this opportunity. It may arise therefore that some unitholders will have put resources into due diligence processes while others have chosen not to.

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?

21. All respondents agreed with the Central Bank's approach and agreed that AIFMD rules are sufficient in relation to valuations.

Central Bank: The Central Bank acknowledges these comments.

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?

22. The majority of respondents fundamentally disagreed with this proposal and found it overly restrictive. Respondents expressed concern that the proposed limit would ultimately impact on the success of the loan originating Qualifying Investor AIF product and defeat the purpose behind its introduction.
23. These respondents considered that the proposed level of leverage will mean that many AIFMs will not be able to trade within the proposed limit and those who do are likely to exclude lower risk projects from their lending strategies including infrastructure projects. One respondent recommended that the regulatory focus should be on disclosure and considered that the risk associated with leverage varies considerably between the type of loan and quality of the borrower which a hard limit fails to recognise.
24. While acknowledging that the proposed limit is similar to the limit currently applied in the US to Business Development Companies (BDCs), respondents highlighted that there is a proposed amendment under consideration in the US to allow BDCs increase their leverage ratio. It was also submitted that the leverage restrictions in the banking sector typically permit much greater leverage than those contemplated by the draft rules, which could adversely affect the ability of loan originating Qualifying Investor AIFs to offer competitive products.
25. One respondent stated that the Central Bank's concern in relation to pro-cyclicality within the market is best addressed by rules and / or reporting requirements addressed to all participants in the market. One respondent suggested there should be a focus on ex ante monitoring rather than an upfront limit.
26. While one respondent agreed that the leverage limit set in the draft rules is reasonable they would have a preference to leave this matter to the discretion of the loan originating Qualifying Investor AIF. This respondent disagreed with the idea that the Central Bank

could tighten the limit and with the proposal for a formal plan to be submitted to the Central Bank if the leverage limit was breached.

27. Respondents suggested that if a limit is to apply it could be set at three times NAV as mentioned in the AIFMD Level 2 Regulation. Other respondents went further to suggest that an AIF with a higher minimum subscription of at least €500,000, or an AIF managed by an AIFM who was subject to heightened risk management and reporting requirements, could be permitted to operate without any regulatory imposed leverage restriction.
28. Different views were expressed regarding the most appropriate basis for calculation of leverage. While there was support for an asset coverage type of approach others preferred the commitment approach as set out in the AIFMD Level 2 Regulation.

Central Bank: We have considered these arguments carefully but on balance have decided not to increase permitted leverage. Other than arguments related to the perceived impact of the leverage limit, there were no overwhelming arguments in support of a higher limit and we are not convinced that this limit will prevent loan funds from establishing in Ireland. We accept that it may cause some managers to rule out setting up an Irish loan originating Qualifying Investor AIF, including some managers with relatively safer products and therefore we will keep this limit under review.

Due to the level of misunderstanding in relation to the rule itself we have restated it to apply the limit in terms of net asset value.

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 575/2013. 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?

29. While respondents had no issues with the majority of the disclosure related obligations, seven of them expressed concerns regarding the proposed obligation to provide information in periodic reports regarding each non-performing exposure or exposure subject to forbearance activities. These suggested that periodic reports could provide information on an aggregate basis with regard to these exposures as disclosure on a loan by loan basis could include confidential, proprietary or price sensitive information in respect of the underlying borrower. One respondent added that the scope to disclose information will be limited where the loan is part of a syndication.
30. Two respondents disagreed with the frequency of the proposed disclosure to investors and preferred to rely on AIFMD provisions in this regard.

Central Bank: The Central Bank agrees that disclosure in periodic reports could be provided on an aggregate basis provided that information on each relevant exposure is provided to the Central Bank on a loan by loan basis.

As indicated in the Consultation Paper we intend to introduce a reporting regime for loan originating Qualifying Investor AIF which will provide a template for loan by loan reporting.

Information provided by loan originating Qualifying Investor AIF on loans which are part of a syndication can only be provided on the basis of the information received from the syndicate.

Questions 8 and 9: 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.

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?

31. A number of comments were made in relation to the proposed rules in the consultation paper designed to address concerns regarding regulatory arbitrage. Many respondents profoundly disagreed with the retention requirements in paragraphs 13-14 on the grounds that they were disproportionate and were based on EU rules which apply only to securitisations. Respondents said that, as drafted, the rule would apply to syndicated loans and secondary market transactions which would not alone be impractical but would also put a loan originating Qualifying Investor AIF at a disadvantage to other types of AIF who could invest in loan participations without restriction and without application of a retention provision.
32. Five respondents believed that the regime in AIFMD and in the other draft rules on loan origination address the concerns in relation to regulatory arbitrage opportunities between the banking and non-banking lending sectors.
33. The same respondents acknowledged that the proposal to provide a list of undrawn credit lines would facilitate regulatory supervision and was reasonable but considered that such information should form part of the periodic regulatory reporting provided to the Central Bank rather than forming part of the periodic reports provided to investors.

Central Bank: Many of these comments are reasonable and we have modified the rule to apply it only where the loan acquired from a credit institution is a bilateral arrangement. Accordingly the retention rule does not apply if the loan purchased has been offered to multiple parties and is acquired on an arm's length open market basis.

We also find it reasonable to require that detail of undrawn credit lines be submitted to the Central Bank and not listed in periodic reports. An amendment along these lines has been made to the final rules.

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?

34. The majority of respondents were unhappy with the detailed requirements for stress testing set out in the Consultation Paper and argued that these were disproportionate and not realistic. It was suggested that the Central Bank should recognise the difference between a deposit taking bank and a closed-ended investment fund and allow the AIFM some discretion in its approach to stress tests based on the portfolio profile. Reference was made to US BDCs and the proposed European Long Term Investment Fund both of which can engage in loan origination but where such detailed provisions are not applicable. Respondents agreed that stress testing was a very necessary investor protection and prudential supervision related requirement but requested that reliance should be placed on the AIFMD stress testing requirements.

Central Bank: We have not made any changes to the requirements in relation to stress testing. The potential systemic risks arising from excessive credit growth and leverage are equally possible to arise from lending by investment funds as they are in the context of lending by banks.

Other issues raised by respondents:

Eligible assets:

35. CP85 proposed that loan originating Qualifying Investor AIFs must “limit operations solely to the business of issuing loans, participations in lending and to operations directly arising therefrom to the exclusion of all other commercial business”. Almost all respondents commented on this provision and considered it too restrictive. They considered that the category of eligible assets should be expanded to make it clear that loan originating Qualifying Investor AIFs can acquire loans on the secondary market or seek exposure to loans by way of sub-participations. Concerns were also expressed regarding the flexibility for loan originating Qualifying Investor AIFs to deal with collateral and to take possession of different types of collateral in the event of a default. Also, loan originating Qualifying Investor AIFs may need to use derivatives such as foreign exchange, credit and interest rate derivatives to manage applicable risks.
36. A number of the respondents argued that loan originating Qualifying Investor AIFs should be permitted to invest in debt securities and in equity positions particularly if these are equity positions related to the loans provided. Respondents also pointed to other fund structures such as ELTIF and US BDCs which can invest up to 30% in other investment funds.

Central Bank: It was not intended to prohibit investment by loan originating Qualifying Investor AIFs in syndications or in loan participations purchased on the secondary market and an amendment to the final rules has been made to provide this clarification. The rules also provide that the handling of assets which are realised security for loans is acceptable.

Treasury management and the use of derivatives for hedging purposes fall within “operations directly arising therefrom”.

The Central Bank does not believe that it is appropriate to allow loan originating Qualifying Investor AIFs invest in other investment funds as this could confuse the supervisory approach and investment in other funds could be used to circumvent the requirements applied to the loan originating AIF.

A loan originating Qualifying Investor AIF which also wishes to invest in other assets such as debt or equity securities could establish as an umbrella fund and establish a separate sub-fund for non-loan strategies.

AIFMD interpretative issues:

38. A number of respondents considered that certain of the proposed requirements should be imposed on AIFMs of loan originating Qualifying Investor AIF rather than on the AIF themselves. Some respondents also commented that certain of the proposed requirements overlapped with obligations imposed on AIFMs under AIFMD.
39. Two respondents wanted the Central Bank to clarify that the depositary will not have any additional responsibility in respect of loan originating Qualifying Investor AIFs.

Central Bank: The rules to apply to a loan originating Qualifying Investor AIF and included in Chapter 2 of the AIF Rulebook follow the structure of the existing Rulebook.

The Central Bank has the power to impose conditions on Irish AIFMs. However AIFs may have non-Irish AIFMs. If we placed the requirements on AIFMs instead of AIFs we would have a situation where additional requirements were imposed on Irish AIFMs but not on non-Irish AIFMs of Irish AIFs. To avoid creating this gap, we impose requirements on AIFs using our condition making power under investment fund legislation.

Loan originating Qualifying Investor AIFs will be required to have authorised AIFMs and so all of the AIFMD requirements will apply to the AIF via their AIFMs. We have not sought to repeat these in our AIF requirements. However, we identified additional requirements for loan originating Qualifying Investor AIF and some of these touch on areas which are also covered by AIFMD. We believe that these additional requirements mitigate risks specific to loan origination and do not specifically repeat obligations found in the AIFMD.

There are no additional rules applied to depositaries of loan originating Qualifying Investor AIFs.

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