Alternative Investment Management Association

Funds Policy Division
Central Bank of Ireland
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Sent by email to: fundspolicy@centralbank.ie

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Dear Sirs,

AIMA's response to the Central Bank's Discussion Paper regarding Loan Origination by Investment Funds

The Alternative Investment Management Association Limited[1] (AIMA) appreciates the opportunity to comment on the Central Bank of Ireland's (Central Bank) discussion paper regarding loan origination by investment funds (the Discussion Paper). We welcome the Central Banks' indication that they will consider higher risk profile investment strategies, such as loan origination, for Irish authorised qualifying investor alternative investment funds (QIAIFs).

As a result of the recent financial crisis, banks have been encouraged to deleverage their balance sheets and increase their capital. This has put pressure on the amounts of funding that banks are able and willing to lend. Consequently, there has been a dearth of available financing for business for long-term as well as short-term projects. We consider that there may be real advantages in permitting QIAIFs to originate loans, as this may help to channel finance to where it is needed. Furthermore, we consider that loans constitute an asset class which will attract institutional investors.

We do not consider that the balance of the public interest is best served by the current rule which prohibits loan origination by investment funds, and consider that relaxing the rule could be beneficial to both the economy and investors. We believe that risks associated with loan origination by investment funds can be adequately monitored and mitigated by the regulatory framework of the Alternative Investment Fund Managers Directive (AIFMD), as implemented in Ireland by the Alternative Investment Fund Rulebook (the AIF Rulebook) under which QIAIFs are regulated.

The AIF Rulebook requires managers of QIAIFs to manage and monitor their liquidity, to provide extensive disclosures to both investors and regulators (in particular, in relation to the use of leverage) and to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each QIAIF investment strategy and to which each QIAIF is or may be exposed. We consider that the regulatory framework set out in the AIF Rulebook is therefore already adequate and that further regulatory measures should not be necessary to mitigate any shadow banking concerns which may be raised by QIAIFs originating loans.

We set out our response to the questions raised in the Discussion Paper in the Annex. Our main concerns with the proposals relate to the following issues:

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

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- **Loan origination by QIAIFs should be permitted** – The AIFMD as implemented in Ireland by the AIF Rulebook already provides an extensive regulatory framework under which managers of QIAIFs are regulated. We do not consider that additional requirements above and beyond those contained in the AIF Rulebook would be necessary in order to mitigate shadow banking concerns which may be presented by QIAIFs being permitted to originate loans. We consider that some of the Central Bank's proposed rules are unnecessary considering the nature of the investors who will be investing in QIAIFs and the requirements already imposed on managers of QIAIFs under the AIF Rulebook;

- **Loan origination investment funds should be able to be open-ended** – In the Discussion Paper, the Central Bank states that loan origination is likely to be more appropriate within closed-ended investment funds. We are unclear as to how the Central Bank is defining "closed-ended" in this context. However, we believe that QIAIFs which originate loans should be able to be open-ended and to offer periodic liquidity. The QIAIF's ability to offer liquidity will very much depend on the liquidity of the underlying loans, many of which are capable of being sold on secondary markets. We note that the policy principles recently published by the Financial Stability Board (FSB) do not require that funds which may be susceptible to runs must be closed-ended, instead offering a policy tool kit with a variety of potential mitigating factors. We consider that tools which may be used by fund managers in periods of stress, such as gates and side pockets, would be more appropriate than mandating that all QIAIFs that originate loans have to be closed-ended; and

- **"Loan origination investment funds"** – We consider that the Central Bank should clarify the definition of "loan origination investment funds". This is important as some hedge funds have historically structured an investment as a loan that was originated through a wholly-owned special purpose vehicle (SPV). Ideally, an Irish fund should be able to originate loans directly or indirectly through an SPV.

We hope you find our comments useful and would be more than happy to answer any questions you have in relation to this submission.

Yours faithfully,

Jiří Król
Deputy Chief Executive Officer
Head of Government & Regulatory Affairs

Annex A

AIMA's response to the questions posed in the Discussion Paper

1. *Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?*

We consider that allowing pooled investment funds to originate loans would serve a public good. The recent financial crisis has led to the banks withdrawing the provision of finance to many companies, in particular small businesses and start-up companies. Allowing pooled investment funds to originate loans may provide a way for these companies to gain access to the finance that they need.

Allowing pooled investment funds to originate loans will also broaden the possible asset classes open to investors, which allows them to broaden their portfolios and hence further diversify their risk. We consider that loans constitute an asset class which will attract institutional investors, as the credit market has an attractive risk/return profile compared to other asset classes, allowing funds which originate loans to develop by:

- Providing finance to borrowers and/or reducing costs to borrowers through increased competition;
- Diversifying funding away from the banking system;
- Responding to current liquidity requirements/needs;
- Channelling resources towards specific needs more efficiently as a result of increased specialisation; and
- Taking advantage of the illiquidity premium.

The pooled investment fund structure allows investors who have an appetite to invest in loans to be matched up with those entities which are seeking to gain access to credit.

2. *What are the 'shadow banking' risks raised by the relaxation of the current policy?*

The Central Bank suggests that QIAIFs which originate loans may be considered to fit within the FSB's economic functions which may create shadow banking risks of:

- Management of client cash pools with features that make them susceptible to runs;
- Loan provision that is dependent on short-term funding; and
- Securitisation and funding of financial entities.

Whilst we agree that loan origination by investment funds could be captured by the FSB's definition of shadow banking, we do not consider that permitting QIAIFs to originate loans will raise shadow banking concerns. As set out below, we consider that managers of QIAIFs will already be adequately regulated under the AIF Rulebook.

3. *In what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?*

We consider that the AIF Rulebook already adequately mitigates any risks which may be posed by loan origination by QIAIFs.

<u>Risk management</u>

The AIF Rulebook requires managers of QIAIFs to have in place a risk management function that is functionally and hierarchically separated from the portfolio management function and other operating units so to avoid conflicts of interest. The risk management function must implement adequate risk management systems in order to identify, measure, manage and monitor

appropriately all risks relevant to each QIAIF investment strategy and to which each QIAIF is or may be exposed.

Liquidity

In relation to liquidity, the AIF Rulebook permits funds to be established as open-ended, open-ended with limited liquidity or closed-ended and there are a number of different liquidity management techniques which funds are permitted to use, such as redemption gates, the use of in specie redemptions, side pockets, redemption charges and soft closings. Managers of QIAIFs are also required to employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the QIAIF and to ensure that the liquidity profile of the investments of the QIAIF complies with its underlying obligations. The AIF Rulebook requires asset managers to ensure that, for each QIAIF that they manage, the investment strategy, the liquidity profile and the redemption policy are consistent. This requirement will mean that potential liquidity mismatches are mitigated and managed.

Leverage

Managers of QIAIFs will be required to set a maximum level of leverage which they may employ on behalf of each QIAIF they manage as well as the extent to which the right to reuse collateral or a guarantee could be granted under the leveraging arrangement. Managers of QIAIFs are required to report to investors the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage and any collateral and asset reuse arrangements, and the maximum level of leverage which the AIFM are entitled to employ on behalf of the AIF.

Reporting and disclosure

Managers of QIAIFs are also required to report to competent authorities on a regular basis regarding all the positions their QIAIFs hold and in the case of QIAIFs employing substantial leverage, competent authorities will be provided with more detailed information about the strategy and risk controls used by the QIAIF.

Possible further mitigants

However, if the Central Bank considers that it is necessary to introduce additional measures to reduce the risk that QIAIFs which originate loans may be susceptible to runs, the Central Bank could add a requirement the QIAIF's redemption provisions are outlined in advance to the Central Bank before the QIAIF embarks on any formal application for authorisation in order to ensure that the redemption terms are appropriate to strategies that may include loan origination.

The Central Bank could also consider requiring managers of QIAIFs that originate loans to provide the Central Bank with details of their (or their personnel's) experience in the area of loan origination and any experience in the area of liquidity risk management.

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?***

Chapter 2, Part 1, Section 1 of the AIF Rulebook sets out the type of investor which will be permitted to invest in a QIAIF. These types of investors will be able to understand the risks which are involved in originating loans and will be able to adequately asses their appetite to invest in different types of assets. We consider that the AIF Rulebook provides sufficient protections for investors in the case where investment funds are allowed to originate loans and consider that imposing additional criteria would be unnecessary (see answers to Questions 2and 3 in this regard as well). In particular, the AIF Rulebook requires asset managers to ensure that, for each QIAIF that they manage, the investment strategy, the liquidity profile and the redemption policy are

consistent. This requirement will mean that potential liquidity mismatches are mitigated and managed.

5. Respondents are asked with they agree with the analysis of the funding gap?

We agree with the Central Bank's analysis of the funding gap. We consider that allowing QIAIFs to originate loans would be a good way to bridge this funding gap and could help to benefit the wider economy.

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?

We do not consider that QIAIFs which originate loans will "fall squarely" into any of the FSB's defined economic functions simply by being a QIAIF which originates loans. However, even if QIAIFs which originate loans fall within any of the FSB's defined economic functions, as outlined above, we consider that any shadow banking risks that these funds may pose can be adequately monitored and mitigated under the AIF Rulebook.

7. Respondents are asked whether they agree with the main risks with loan origination identified in Section 5 and whether there are other risks?

Section 5 identifies a number of possible risks which may be associated with loan origination: concentration risk, illiquidity risk, risk of investor runs, leverage, money creation, dominant lenders, misalignment with investor risk appetite or investor capability and mispricing of credit. We agree that these are the main risk factors but note that out of these risks, only one is not faced by QIAIFs which do not originate loans (i.e. money creation). However, with respect to money creation, fractional reserve lending, if any, may be provided by banks or other credit institutions which are regulated for this purpose. Although a QIAIF may borrow funds and recycle such funding by originating loans, creation of money and leverage is performed by the credit institution that may provide financing to the QIAIF, not the QIAIF itself.

Furthermore, we note that the AIFMD already contains provisions which would mitigate these risks, for example, in relation to illiquidity risk the AIF Rulebook requires managers to consider a wide number of strategies to manage liquidity and make clear disclosure to investors of how they intend using these tools. Moreover, in Ireland the AIF Rulebook already provides that a QIAIF:

> "may establish side pocket share classes into which assets which are illiquid when purchased may be placed, provided that the ability to establish these share classes has been provided for in the QIAIF's constitutional document and has been disclosed to unitholders in advance."[2]

If a QIAIF intends to originate loans which will be highly illiquid in nature it will therefore be able to manage its liquidity and will have to disclosure to investors how they intend use measures which aim to do so.

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?

We agree that there are differences between loan participation and loan origination but we do not consider these differences mean that loan origination is necessarily more risky or should be prohibited. As mentioned above, the AIF Rulebook provides adequate protection against the possible risks posed by loan origination and we therefore consider that it should be permitted for QIAIFs. The AIFMD does not mandate any investment restrictions and under the AIF Rulebook QIAIFs are permitted to engage in bilateral transactions in a wide range of assets which are not regularly

[2] See Chapter 2, Part 1, Section 1 (v.)(9) of the AIF Rulebook.

traded or valued without the need for any additional regulatory constraints. We therefore consider that the prohibition on the origination of loans by QIAIFs is unnecessary.

Furthermore, we consider that where loan origination leads to particular concerns similar to those raised in the Discussion Paper, those risks could be negated by the Central Bank during the application for approval for authorisation of the manager of the QIAIF.

We agree with the Central Bank that the requirement for a syndicated loan to have commercial appeal to multiple lenders imposes a market discipline by dictating that such loans must have credible terms and prices. However, simply because a bilateral loan does not need to have such broad appeal it does not automatically follow that further regulatory overlay is justified for QIAIFs which originate loans. The manager of the QIAIF will still be required to act in the best interests of investors and to perform a high level of due diligence in the selection and on-going monitoring of its investments. Furthermore, the provision of funds by investors will be dependent on the perceived performance of the manager.

We also agree with the Central Bank that the most successful practitioners in the loan origination market have specialist skills and engage in a very detailed investment process. The Central Bank could screen potential managers of QIAIFs which will originate loans during the investment process in order to assess whether they can demonstrate that it has sufficient expertise, experience and resources to operate effectively in this asset class.

9. How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund?

Given the various different types of loans which exist, it will be extremely difficult to structure a loan diversification requirement which will come into force over the life-time of QIAIFs which originate loans. We consider that such a requirement would be unnecessary, as investors in the fund as well as regulators will be given adequate information about how the fund will be diversified.

10. How is a geographic diversification requirement best addressed within the requirements?

The AIF Rulebook does not contain a geographical diversification requirement and we do not consider that it would be necessary to introduce such a requirement for QIAIFs which originate loans. Managers of QIAIFs will already be required to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each QIAIF they manage. The risk management process requires significant amounts of disclosure to the Central Bank regulator and to investors before a fund is approved and those disclosure requirements and the duty to act in the best interests of investors apply regardless of the complexity of the underlying investments being made by a fund.

In addition, managers of QIAIFs which originate loans are already required to have appropriate knowledge and expertise in relation to the instruments in which their QIAIFs invest and will need to employ staff members who are able to ensure that this requirement can be met. Imposing a mandatory geographical diversification requirement would appear to impose a disproportionate burden in terms of cost on managers as it may force them to increase staff to meet this requirement.

11. Respondents are asked for their views on the types of loans originated and their term?

QIAIFs will already be required to manage their risk profiles which will limit the types of risks assumed by them. Managers of QIAIFs will have to carefully select the loans which they will choose to originate and investors will be made aware of these risks. We do not consider therefore than imposing a blanket restriction of certain types of loans would therefore be appropriate.

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?

We disagree. Whilst we are aware that the Central Bank is concerned that open-ended funds may be more susceptible to runs, hence a potentially greater risk in terms of the shadow banking activity, the AIF Rulebook already imposes liquidity requirements which will mean that the fund manager will have to match the liquidity of the fund to the redemption policy of the QIAIF.

Some of the tools suggested by the FSB for mitigating shadow banking risks, such as imposing gates or side pockets, would be more appropriate to manage the liquidity of the QIAIF than imposing a blanket restriction on having open-ended funds originating loans.

The necessity for a fund to be closed-ended will depend very much on the precise details of what the fund is actually investing in. Loans are an extremely diverse asset class and whilst some types of loans are illiquid in nature and are not easily traded in the secondary market, other loans, such as consumer loans, may have a highly liquid secondary market. Furthermore, some QIAIFs which choose to originate loans may also invest in other asset classes which are more liquid in nature and may therefore be able to offer periodic liquidity to investors.

We consider that the fund manager of a QIAIF which originates loans should be able to match the liquidity of the QIAIF to the investment strategy and the QIAIF should be able to permit periodic redemption. This is likely to make these funds more attractive to investors who do not want to subscribe to a closed-ended vehicle even if they do have relatively long-term investment horizons.

13. There may be other legitimate purposes, outside of the investment strategy, for which limited leverage might be usefully allowed. What would these be?

We consider that AIFM should be allowed to use derivatives for efficient portfolio management purposes, for example to hedge interest rate, credit and currency risks even though technically these may contribute to leverage within the QIAIF. Other legitimate non-investment related purposes for which leverage should also be permitted include the funding of redemption requests, funding the purchase of assets pending the drawdown of capital commitments and meeting necessary fees, costs and expenses of the QIAIF.

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

We do not believe there should be leverage limits imposed on QIAIFs that originate loans. The AIF Rulebook permits the managers of QIAIFs to set their own leverage limits but requires managers of QIAIFs to demonstrate that the leverage limits for each QIAIF it manages are reasonable and that it complies with those limits at all times. Where the stability and integrity of the financial system may be threatened, the Central Bank has the ability to impose limits to the level of leverage that the manager can employ in QIAIFs under its management. Moreover, special requirements apply to managers of QIAIFs which employ leverage on a substantial basis at the level of the QIAIF. Such managers are required to disclose information regarding the overall level of leverage employed, the leverage arising from borrowing of cash or securities and the leverage arising from positions held in derivatives, the reuse of assets and the main sources of leverage in their AIFs. We consider that the level of leverage employed by QIAIFs is therefore already adequately regulated. Finally, we would like to point out that the inability to employ reasonable amounts of leverage may, in a low interest rate environment, lead managers to focus only on the higher yielding spectrum of the market, thus potentially working against the broader policy aim of increasing the availability of finance to the real economy.

15. Respondents are invited to offer views as to the appropriateness of a capital/co-investment requirement?

We do not believe that there should be any capital/co-investment requirement for managers of QIAIFs that originate loans. The Volker rule will prevent co-investment by many managers and this will therefore not be a viable option for managers who are affect by that rule.

We agree that it is desirable to align the interests of the fund manager with the interests of the investors as far as possible, but we consider that this is more appropriately achieved through other methods. For example, the remuneration provisions of the AIFMD were designed specifically to better align the interests of the staff of the asset manager with the funds it manages. Managers of QIAIFs also have to have in place conflict of interest policies which mitigate any potential misalignment of the interests of investors and manager.

16. Views are invited on what the appropriate hard-wired constraints might be?

We do not consider that introducing hard-wired constraints for QIAIFs which originate loans is appropriate.

17. Respondents are asked whether they agree with the analysis of the main risks and mitigants for loan origination investment funds? Are there others?

We agree with the analysis of the main risks and mitigants for loan origination investment funds. However, as noted above, the majority of the main risks are the types of risks which are cited as being those which alternative funds generally present. We consider that the AIF Rulebook already provides sufficient protection against the risks which may be presented by originating loans.

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

As stated above, we do not agree that QIAIFs which can originate loans would need to be closed-ended funds. Whilst mandating that funds be closed-ended would mitigate concerns that they would be susceptible to runs, this is not the only way of achieving this. Tools could be used by fund managers to limit redemptions in stressed periods which would be disclosed to investors at the outset. Investors in QIAIFs are able to understand that funds may have limited liquidity and are able to factor this into their decision to invest in a fund. Mandating that funds be closed-ended may, however, not be as attractive a proposition from the investor perspective as it will require that their capital is locked up for a longer period of time.

As stated above, we also do not agree that leverage restrictions should be placed on QIAIFs which originate loans as the AIF Rulebook imposes requirements on the use of leverage which are designed to mitigate the risks which the use of leverage may present.