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By Email fundspolicy@centralbank.ie

Central Bank of Ireland
Policy Section



Response to Discussion Paper - "Loan Origination by Investment Funds"

Dear Sir/Madam

We welcome the publication of the Discussion Paper relating to "Loan Origination by Investment Funds". We act for a number of parties which would like to explore the possibility of undertaking loan origination in regulated fund structures. In addition, we believe that there are a number of benefits for the wider community in allowing regulated funds to originate loans and, accordingly, to provide an alternative source of funding for businesses.

We have set out our responses to your queries below. In addition, our Investment Funds Unit has been involved in the production of the Irish Funds Industry Association's response to the Discussion Paper.

Please do not hesitate to contact Michael Barr (mbarr@algoodbody.com or 01-649 2327) if you have any questions or would like further detail in respect of any of our responses.

Yours faithfully,

A&L Goodbody

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

Yes. In Ireland, and in Europe more generally, there is significant deleveraging by banks which is making it significantly harder for businesses to borrow from the traditional banking sector. In addition, there are efforts by all European governments to encourage economic growth but this is hampered by the lack of credit available. Allowing investment funds to originate loans will assist in some way in redressing the balance.

In addition, allowing for loan origination in a regulated investment fund structure ensures that there is the appropriate degree of regulatory oversight and, if necessary, control at the level of the fund itself.

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

It is questionable if any new shadow banking risks are raised by allowing investment funds to originate loans. A lot of the risks identified in the Discussion Paper would equally apply to the current system where the regulated funds are permitted to acquire loans on the secondary market, particularly from bank lenders that originate loans and sell on a significant amount of the exposure after originating the loans in question.

In addition, insofar as there are shadow banking risks, the regulatory obligations under which investment funds would originate loans would operate¹ to address the apparent risks to the extent that there is no new layer of risk being added to the financial system by allowing regulated funds to originate loans. In particular, the significant level of liquidity management and general risk management obligations that will apply to such investment funds (or their AIFMs) deal with a number of the issues, as set out below.

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

In our view the main three shadow banking risks that may be of relevance to loan origination (but could equally apply to acquisition of loans on the secondary market or, in certain cases, acquisition of debt securities) are:

- susceptibility to runs;
- dependency on short term funding; and
- avoiding bank regulation.

To deal with these in turn:

"Susceptibility to runs"

¹ or will operate once subject to the full requirements of AIFMD

In all likelihood investment funds that could originate loans (were that to be permitted) would have a fully authorised AIFM (or be a fully authorised internally managed AIF)² and, therefore, directly or indirectly would be subject to the full rigours of the AIFMD and related regulatory provisions. This would include, in particular, significant liquidity management obligations which should address the concern that such funds would be susceptible to runs. In all likelihood, an investment fund, the primary investment policy of which was to originate loans, would be a limited liquidity or closed ended fund rather than an open ended fund (but please note our comments later on this point).

The Central Bank could require that a pre-authorisation submission is made relating to the redemption provisions that would be offered by an investment fund that proposed to hold a majority of its assets in loans that the fund originated. This would be similar to the requirement to make a pre-authorisation submission that applies in respect of life settlement funds currently.

It is important to note that funds that originate loans are not any more likely to be susceptible to runs than funds that acquire loans on the secondary market or which acquire other specialist assets. Run risk arises when there is a mismatch between the redemption provisions offered to investors and the liquidity of the fund's underlying assets and the mere fact that a fund originates a loan does not heighten such a risk. As noted above, it would be incumbent on the manager of such a fund to ensure that appropriate limited redemption provisions were offered to investors where loan origination was a predominant part of the fund's investment policy.

In addition, the Central Bank could require that investment managers of such proposed investment funds are required to detail their expertise in, and capability for, loan origination and related liquidity risk management.

Dependency on short term funding

We do not believe that there should be any special restrictions on leverage that may be undertaken by QIAIF investment funds that can originate loans. Under AIFMD, the fund or its AIFM will be subject to obligations to set leverage limits, report leverage and may also be subject to the imposition of leverage limits. This should deal with any short term funding concerns.

Avoiding bank regulation

The Financial Stability Board, which identified this risk, was looking at the full spectrum of non-bank financial entities which would have included a large number of unregulated entities, that are not the subject of this Discussion Paper. Conversely, Irish regulated investment funds that are permitted to engage in loan origination will be regulated as collective investment schemes under the relevant Irish statutory provisions, will be subject to the AIF Rulebook and, in addition, will be, directly or indirectly, subject to the provisions of the AIFMD either as an internally managed AIF or by virtue of having an externally authorised AIFM. Accordingly, for the Central Bank to allow loan origination in Irish regulated funds, it should not have any concern that the fund sponsor is setting up such a fund so as to avoid regulation.

² It is unlikely that such a fund would have assets of less than €100m

4. Does the current Alternative Investment Fund Rulebook (AIF Rulebook) provide sufficient protection for investors in the case where investment funds are allowed to originate loans?

Yes, we believe that it does. Irish regulated investment funds, particularly constituted as QIAIFs, have been allowed to invest in specialised and potentially illiquid asset classes to date. Investment funds that can originate loans would be in no different a position, in general terms, from investment funds that can invest in a variety of other specialised asset classes. The expertise required to manage such funds may be different but is not necessarily any more onerous than those required to manage, for example, property funds, private equity funds, loan funds that acquire loans in the secondary market, life settlement funds and a variety of other special type funds which have for a long time been catered for within the QIAIF/QIF regime. We do not believe that changes are required for this particular asset class.

The key for funds that can originate loans will be to ensure that investors are provided with sufficient information to make an informed judgement of the investment proposed to them and that those managers operating them can demonstrate their experience of the asset class. This is no different than what is required of a variety of other asset classes.

In addition to the requirements of the AIF Rulebook, funds that can originate loans will be subject, directly or indirectly, to the AIFMD and related regulatory provisions which will provide a significant amount of protection for investors and an added level of obligations on the fund or, if applicable, its AIFM. We note a number of these added obligations are set out in the Irish Fund Industry Association's (IFIA) response to the Discussion Paper and we have not repeated them here.

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

We have no reason to disagree with this analysis.

6. Do respondents agree loan origination funds 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 5?

Yes, but for reasons set out above (see response to Question 3) we believe the three areas of concern would be dealt with under a combination of the existing AIF Rulebook and the provisions of the AIFMD and related regulatory provisions that would apply to investment funds that could originate loans.

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

We note that a number of these risks are already borne by regulated investment funds that can invest in certain classes of assets, particularly funds that can acquire loans on the secondary market and, hence, are not new risks being introduced to the market.

We have received a number of other comments in respect of the risks identified including:

- Misalignment with investor appetite or investor capability – We understand it is not correct to say that loan funds do not pay cashflows on a regular basis during the early life of the fund, particularly where the loans originated are senior secured loans.
- Mispricing of credit – This could also arise with bank originated loans, particularly where the bank in question has other commercial relationships with the borrower.

You have asked whether the Central Bank needs additional powers to appoint administrators to insolvent loan origination funds. We do not see why the Bank would need additional powers in respect of such funds as once a loan has been originated or acquired, the credit risk is the same.

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 acknowledge that there are differences between acquiring loans in the secondary market and loan origination. However, we do not accept that all of these differences make loan origination inherently a more risky proposition for an investor. The key will be adequate disclosure for investors of all relevant risks.

For example, the credit assessment and monitoring undertaken by entities that acquire loans in the secondary market is not necessarily significantly different from those that originate loans. An investment fund may acquire a loan on the secondary market in circumstances where the original lender may have viewed the original loan in light of the fact that it fully intended to sell down all or a very significant portion of its exposure to it shortly after making the loan in question. Accordingly, the acquiror of such a loan in a secondary market transaction cannot assume that the original lender has taken the same long term view as an entity that may look to hold the loan to maturity. In addition, a bank lender may have other commercial relationships with a borrower which may impact on the pricing for a loan that is ultimately sold on the secondary market whereas this pricing influence is less likely to occur in a loan origination transaction where the fund has no other commercial relationships with the borrower.

In addition, from an investor's perspective, having an investment manager that has undertaken enhanced due diligence before originating a loan or acquiring an asset must be seen as a positive as compared to relying on information available on the secondary market. This goes to the competence of the investment manager in question and details of their processes and experience could be sought as part of the fund approval process.

In addition, regulated funds have been entitled to invest in other asset classes where a significant amount of pre-acquisition due diligence and negotiation is required. While loan origination may call for specialist skills this is not inherently different to a variety of other classes that are permissible investments for QIAIFs.

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

We do not believe that the Central Bank should set out hard-coded diversification limits for this particular asset class, particularly as it has not done so for other comparable asset classes, not least for QIAIFs that can acquire loans in the secondary market and this is not required by AIFMD. Engaging in loan origination does not lead to less (or more) diversification risk.

Regulated investment funds that could originate loans will be subject to the provisions of the AIFMD and related regulatory provisions including those related to risk management and the obligation to take steps to mitigate risks. Accordingly, identifying, managing and mitigating concentration risks will be an obligation on such a fund (as an internally managed AIF), or on its AIFM.

Fundamentally, the issue of diversification should be a matter for disclosure to investors. If a fund intends to focus on a particular sector or geographical area this should be highlighted in its prospectus and then it would be for investors to determine whether or not they are comfortable with any possible resulting diversification risk. It may well be that investors want to take advantage of a manager's expertise in originating loans in a particular sector or region and accordingly would want them to limit their activities to the sector or region in question. Such investors may well be separately diversifying their own portfolio by making a variety of different types of investments.

Additionally, providing for hard-coded limits regarding the types of loans that can be originated would not necessarily change the risk profile of the fund. A senior secured loan made to party A is not necessarily a safer investment than a mezzanine loan made to party B. There are a variety of other factors that would need to be taken into account in any such analysis and ultimately these are not inherently different from the factors that would be taken into account if a fund was to acquire either or both loans on the secondary market or to acquire debt securities issued by either party.

Regarding the specific hard-coded limits proposed in the Discussion Paper (page 30):

- Excluding lending to investment funds and financial institutions or related entities could significantly limit the ability to lend into the real estate sector as often entities of this type are large owners of real estate. Any such restriction would need to take this into account.
- Excluding lending to persons which intend to acquire equities may limit the ability to engage in acquisitions. As a QIAIF could acquire the underlying equities there does not seem to be a reason to preclude lending to a party which intends to do so.
- Insisting on a 70% LTV ratio could also significantly limit the ability to originate loans, particularly loans to industrial entities whose assets and cashflows are less susceptible to independent valuation. In addition, there are no such limits for loans acquired in the secondary market which ultimately carry the same credit risk.

- We understand that insisting on a fully amortised basis would not be in line with market practice where few bank loans are fully amortised particularly as loans are often structured with bullet repayments. Such a restriction will limit loan origination to a very significant level that may impact on the availability of credit through this new source.
- We would need further clarity as regards proposals for provisioning as investments in a fund would be marked-to-market (which would reflect likely losses).

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

We do not believe that a geographic diversification requirement should be included for regulated investment funds that can originate loans. Please see our response to question 9 regarding diversification requirements.

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

We do not believe restrictions should be placed on the types of loans that could be originated or the term of such loans. Again, these matters would be best dealt with as disclosure items in the fund's prospectus in accordance with the fund's obligation to ensure that investors had received sufficient information to make an informed judgement as to the investment proposed to them. Additionally, we do not see why restrictions would be placed on this asset class when, for example, QIAIFs can invest in equities of a private company or an emerging market company which may exhibit far more volatility and risk than, for example, junior secured or even unsecured loans made to large developed market corporate borrowers.

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?

It really depends on what it meant by "closed-ended" in this context.

In dealing with funds where a predominant part of their investment policy would be to originate loans then we would agree that it would be difficult currently to house them in an open-ended fund which was required to offer at least quarterly liquidity and could only apply a 25% gate, as per the requirements for open-ended QIAIFs.

However, the use of limited liquidity funds which do not have to offer such a relatively high level of liquidity should be permitted for funds that have, as a predominant part of their investment policy, the origination of loans. Such funds should not be required to be entirely closed-ended as managers may wish to allow for redemptions in limited circumstances or, at least, to allow investors request redemption in limited circumstances (for example, where such redemption would be met by an in specie transfer of assets or could be delayed over a period of time to ensure that there was no fire sale of assets that may negatively impact on other investors). Once again, this would all be a matter for disclosure to investors before they made their investment decision.

Finally, open-ended QIAIFs should be permitted to engage in loan origination to a limited extent and in such a manner as would not prejudice their open-ended status.

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 do not believe that there should be leverage limits for investment purposes imposed on QIAIFs that engage in loan origination. Please see response to question 14 below.

In any event, there are a number of non-investment strategy related reasons where leverage may be allowed, including:-

- funding the purchase of assets pending the drawdown of capital commitments;
- meeting of fees, costs and expenses etc. including investigating investment opportunities;
- funding payment under any derivative or EPM obligations;
- funding redemption requests.

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

We do not believe that leverage limits should be imposed on QIAIFs that can engage in loan origination.

Under AIFMD, the fund would, directly or indirectly, be subject to a number of leverage related requirements and may, in certain circumstances, be subject to mandatory leverage limits imposed by regulators.

Once again, the possibility of use of leverage for investment purposes and the terms of such arrangements would be a matter of disclosure to investors to ensure that they were in a position to make an informed decision as to the investment proposal offered to them.

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

We do not believe that there should be any capital/co-investment requirement for managers of QIAIFs that originate loans. There is no such requirement on other comparably specialist or illiquid asset classes that QIAIFs currently invest in.

Under AIFMD, the AIFM and its delegates will be subject to a variety of requirements regarding the application of remuneration policies and ensuring such policies promote sound and effective risk management, for example.

In addition, managers of QIAIFs that can originate loans would have long term reputational and economic interests in the funds they manage, particularly through on-going management fees and suitably structured performance fees which, in comparable asset classes, are often only payable once investors have actually received a certain level of returns rather than being based on increases in net asset value which ultimately may not be realised.

Managers may choose to co-invest which may have appeal to prospective investors in their products but this should be a commercial consideration rather than one dictated by regulation.

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

We do not believe that additional constraints should be imposed on QIAIFs that can engage in loan origination.

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

We have noted the risk that have been identified. We believe that most of these risks apply to a whole variety of other asset classes that QIAIFs can invest in currently and, accordingly, there is no overriding necessity to provide for hard-wired risk mitigant requirements in place of relying on numerous and detailed requirements of AIFMD and related regulatory provisions that will apply, directly or indirectly, to a QIAIF that can originate loans.

We note the IFIA's response regarding money creation and the volume of loans which would have to be originated by investment funds to have any significant systemic impact.

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

As noted previously, we have agreed that limited liquidity funds as well as closed-ended funds would address many of the risks that have been identified. We would note, though, that open-ended funds should be entitled to engage to a limited extent in loan origination.