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EUROPE LIMITED

Submitted via e-mail to:
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Dear Sirs

Loan Origination by Investment Funds
Response to Central Bank of Ireland Discussion Paper (July 2013)

Babson Capital Europe Limited ("**BCE**") is one of the leading investment managers of European sub-investment grade credit and has approximately €8.0 billion in assets under management. BCE is part of Babson Capital Management LLC ("**BCM**"), an investment firm with approximately US$180 billion in assets under management. Within this total, US$44.8 billion is managed in syndicated high yield, senior secured loans and bonds. In addition, BCM and BCE (together "**Babson Capital**") manage c. US$4.8 billion in senior and mezzanine loans provided to mid-market companies which are typically self-originated investments. Babson Capital has been an arranger of loans since the early 1990s. BCE manages three mezzanine funds and has been originating loans in Europe since 2005.

BCE welcomes the publication of and opportunity to comment on the Discussion Paper published in July 2013 by the Central Bank of Ireland entitled "Loan Origination by Investment Funds".

By way of a general response, we note that there has been strong growth in the volume of corporate bonds, high yield bonds and syndicated loans being issued during the last 15 years. In what used to be a bank dominated market, non-bank institutional and retail investors are now providing the majority of the liquidity in both the North American and Western European debt capital markets. In the case of funding mid-market corporates and Small and Medium-Sized Enterprises ("**SMEs**"), however, debt is still primarily provided by banks and to a lesser extent by institutional asset managers.

There is now a substantial body of evidence suggesting that banks which previously funded middle market companies are increasingly constrained in their ability to do so, in part as a result of their obligation to build higher capital levels. At the same time, institutional investors such as insurance companies, pension funds, foundations and endowments continue to show strong appetite for exposure to corporate credit, viewing it as a less volatile and more predictable investment than equities.

More recently, we have been observing a growing interest of institutional investors in debt investments in mid-market corporates. In times of constrained supply from banks and increased demand from institutional investors, we regard the continuing involvement of corporate credit asset managers such as BCE as a vital source of funding for SMEs. Several fund formats that facilitate the offering of mid-market loans to investors already exist, such as the English limited partnership or certain Luxembourg fund structures. These formats have begun to attract institutional investors who want to invest in asset manager originated loans on a pooled basis.

Babson Capital and its subsidiaries currently sponsor two umbrella platforms set up to provide investment solutions in syndicated loans. These platforms comprise a total of nine sub-funds authorised by the Central Bank of Ireland as either Qualifying Investor Funds ("**QIF**") or Qualifying Investor Alternative Investment Funds ("**QIAIF**"). We would welcome the opportunity to be able use these fund formats for products offering exposure to manager-originated mid-market loans to institutional investors.

Finally, we would like to stress that we are of the view that the activities of asset managers will not replace the provision of bank lending to mid-sized corporates. When being part of an arranging "club" on day one of a financing transaction, we usually act in concert with banks and other asset managers when lending to a company. Banks would typically offer products such as revolving loan facilities, letters of credit and FX hedging facilities and also participate in the term funding alongside ourselves and other asset managers.

Loan origination or arranging activities by asset managers should therefore be seen as a form of finance that is complimentary to bank finance to SMEs. It has the potential to relieve the burden on banks while offering flexible funding solutions to corporates and attractive products for investors.

We attach a schedule setting out our detailed responses to the series of questions raised in the Discussion Paper. For convenience, all responses and questions use the same numbering as the Discussion Paper.

Yours faithfully

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Babson Capital Europe Limited

Oliver Burgel
Chief Operating Officer
Babson Capital Europe Limited

Attachment: Schedule

SCHEDULE

No.	Page Ref.	Core Question	Response
1	4	Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?	You quote an exhaustive body of evidence suggesting that non-bank provision of finance can play an important role in promoting the growth of enterprise. We would be inclined to agree with that view. We would add that direct loan origination by non-bank institutions provides an important additional source of capital to companies to finance, inter alia, capital investment and research and development, and in doing so promote economic growth. The referred regulatory pressures under which banks have to operate underline the need for such alternative finance sources. A lot of progress has been made in recent years to reduce the magnitude of the “maturity wall” of loan repayments in the European leveraged loan market. Nonetheless, many businesses with good operating performance face re-financing risk of debt which was arranged several years ago in more buoyant markets. Banks, due to capital, liquidity, and internal credit policy pressures, may be constrained or unwilling to extend maturities. Non-bank institutions can provide additional sources of refinancing debt of this kind and in doing so relieve pressure upon companies’ balance sheets and provide management teams with more time to execute business plans. At the same time, any non-bank driven solutions will, through facilitating the repayment of loans to banks, have the impact of replenishing the supply of capital and thereby reduce the potential systemic risks in banking.
2	4	What are the “shadow banking” risks raised by the relaxation of the current policy?	We are not of the view that relaxing the current policy will lead to increased “shadow banking” risks. The Irish QIF (or QIAIF) framework has been used for a number of years by asset managers investing in syndicated loans and bonds on behalf of institutional investors. Relaxing the current restriction would merely remove the anomaly of not being able to invest in loans where the investment manager had a substantial role during the arrangement process. We believe that being an arranger, and therefore closer involved in the due diligence process with a borrower is positive from a risk mitigation perspective (see below).

No.	Page Ref.	Core Question	Response
			We view several of the risks highlighted in the paper not as a function of a relaxation of the current restriction, but a function of inappropriate fund structuring. You are correct in highlighting potential risks of runs, which can be exacerbated when illiquid assets are being purchased with short-term funding. Furthermore, you caution against the use of short-term leverage. However, the resulting risks are not intrinsic to self-originated loans. The same risks could occur in a fund vehicle investing in property related assets or certain structured assets with limited secondary liquidity. In our experience direct lending funds managed by investment managers usually have long-term committed capital and therefore appropriately match the tenor of the underlying loan assets. The Alternative Investment Fund Managers Directive ("AIFMD") addresses many of these risks and imposes additional risk mitigation and disclosure obligations on asset managers, which we view as appropriate and sufficient in the institutional investment space.

No.	Page Ref.	Core Question	Response
3	4	In what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?	As an organization which has been an active arranger and originator of loans for over two decades, we are of the view that loan origination by investment funds **is** a viable credit channel. Above all, the key structural features of any investment fund (liquidity terms, use of leverage, risk profile, etc.) need to be tailored to the nature and mix of the underlying assets. In addition, it is of paramount importance that an investment management company wishing to operate in this space is appropriately resourced and has experienced personnel to handle the due diligence requirements during the loan origination process. We would like to stress that we are of the view that the activities of asset managers will not replace the provision of bank lending to mid-market companies. When being part of an arranging "club" on day one of a financing transaction, we usually act in concert with banks and other asset managers when lending to a company. Banks would typically offer products such as revolving loan facilities, letters of credit and FX hedging facilities and also participate in the term funding alongside ourselves and other asset managers. Loan origination or arranging activities by asset managers should therefore be seen as a form of finance that is complimentary to bank finance. It has the potential to relieve the burden on banks while offering flexible funding solutions to corporates and attractive products for investors.
4	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?	Yes, but investors should also examine the level and experience of personnel and the firm's track-record in this area. The AIF rulebook contains obligations in the areas of risk management, liquidity management and limits the use of leverage. Among the most important requirements of AIFMD is the obligation to ensure that the liquidity of assets is appropriate to meet the liquidity profile of a fund. In practice, in many areas, the AIF rulebook formalises what has been good practice at many asset management firms for years. In addition, AIFMD also leads to more exhaustive pre-investment and ongoing

No.	Page Ref.	Core Question	Response
			disclosure of risks to investors.
5	8-10	Respondents are asked whether they agree with the analysis of the funding gap?	Please see our response to Question 1.
6	11	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?	Loan origination funds structured as open-ended vehicles could lead to the risks described in the first two FSB functions if the assets in which they invest have no secondary market liquidity. As mentioned several times throughout this document, we believe that it is important to align the liquidity provisions of a fund with the liquidity characteristics of the invested assets. However, we disagree with the second part of the question. While closed-ended funds using leverage might exhibit a superficial similarity to securitisations, we strongly disagree that (i) this would lead to the creation of excessive liquidity (unlike synthetic credit structures, which enable the multiplication of credit notionals at risk, we view the "credit creation" risks through fund structures investing in cash loans as limited), (ii) this would lead to excessive maturity transformation (as per your question these funds are closed ended), or (iii) they are set up to avoid banking regulation. Instead, these funds are formed to address the demand from corporates for financing and the demand for exposure to corporate credit from institutional investors.

No.	Page Ref.	Core Question	Response
7	21-24	Respondents are asked whether they agree with the main risks with loan origination identified in Section 5 and whether there are other risks?	The risks listed in Section 5 can also be associated with many investment activities currently permissible under the Irish QIF framework. As an organisation that has been an active originator for over 20 years we do not view loan origination as an activity with inherently “higher risk” than many other investment activities. Intensive credit risk assessment and the consistent application of rigorous credit policies are core pre-requisite skills of investors in loans, whether they are involved in the origination of loans or participation in broader loan syndications. This is equally true for liquid and illiquid loans.
8	16-17	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 are of the view that both markets are attractive to investors in their own right. Whether an investment manager is originating loans or purchasing loan participations, it is always required to carry out robust due diligence as part of the selection and ongoing monitoring of investments. However, we agree that the investment process related to direct loan origination is distinct from the process of participating in syndications. Due to the workflows being sufficiently different, we have different teams working on these two activities. The process of originating loans for investment generally takes longer than purchasing loan participations. As noted above, the secondary market for mid-market loans is also less developed than for syndicated loans. Rather than such features resulting in an investment with greater inherent risk, it results in an enhanced credit appraisal process (both in terms of time and depth). The originating investment manager also has a greater ability to shape the terms of an investment (e.g. loan covenants, direction of enquiry of due diligence reports) before issue rather than being presented with the asset as a finished product. Originators of loans will conduct a very detailed due diligence process covering a period of several weeks/months. This will involve an intensive review of the business, interviewing of management, and which will be backed

No.	Page Ref.	Core Question	Response
			up by third party expert reports covering inter alia, the financial health of the business and its competitive strengths and weaknesses. The ongoing monitoring of the quality of the investment post-investment and the ability to have early warning of any emerging debt service problems may be enhanced by the institutional loan manager taking non-executive board director or observer positions. Investment funds investing in mid-market loans tend to adopt a “take-and-hold” strategy. This means that there is a long term alignment of interest between the originator and the long term holder of the asset, whereas in syndicated transactions or securities offerings the originator/distributor may retain little (if any) of the asset in the long term. Lastly, while direct debt-financing may not be subject to a formal syndication process, such financings are frequently arranged on a “club basis”, with the discipline that such a structure implies. Whilst we can originate investments as a sole provider, borrower often prefer a club group of lenders and we usually act in concert with other asset managers and bank lenders, with the latter providing products such as revolving credit facilities, letters of credit and FX hedging lines. In practice, the direct lending business has therefore many more similarities with the widely syndicated loan or bond businesses than what your analysis implies. There are many additional similarities between these activities. For example, mid-market loans in Europe are typically documented using exactly the same document templates as those used in syndicated transactions, namely those produced and maintained by the Loan Market Association (“**LMA**”). To conclude, we disagree with the suggestion that direct loan origination is an activity of intrinsically higher risk which warrants regulatory restrictions that go beyond those applicable to other investment activities.
9	23-24	How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund?	We believe that there is no need for mandating diversity at fund level through regulation that goes beyond of what is currently contained in the QIF and AIFMD frameworks.

No.	Page Ref.	Core Question	Response
			It is important to recognise that loan originators will have to satisfy their underlying investors that an appropriate level of diversification will be in place. Any weakening in standards would (and resultant credit losses could) have repercussions for the manager's ability to raise additional funds. We believe that this is best addressed through up-front disclosure about the risk inherent in a fund (as mandated by AIFMD).
10	23-24	How is a geographic diversification requirement best addressed within the requirements?	We believe that there is no need for mandating geographic diversity at fund level through regulation. For example, certain industries such as chemicals are driven by global market trends and investment in two chemical companies in two different countries could provide a false sense of diversification. Please see also our answer to Question 9.
11	24-25	Respondents are asked for their views on the types of loans originated and their term?	As mentioned as part of our answer to Question 8, we usually act in concert with other asset managers and banks when arranging a loan. Mid-market businesses and their owners usually welcome the flexibility that asset managers can bring to the table when providing a financing package. We therefore provide senior secured loans, mezzanine loans and uni-tranches to corporates. We would reiterate the argument put forward in our response to Question 7, relating to the extensive due diligence, monitoring controls, and the imperative of maintaining investor support. We would also reiterate the observations under the response to Question 1 concerning the "public good" of the provision of corporate loans by non-banks. These arguments are just as valid for mezzanine or subordinated debt as for senior debt. Mezzanine debt will typically be governed by similar documentation and the same covenant structure as the senior loans It should also be recognised that mezzanine debt is only one type of subordinated debt. It constitutes a relatively small market compared to public subordinated high yield bonds, for example, which represent a much larger market in terms of annual issuance levels. Accordingly we believe that any

No.	Page Ref.	Core Question	Response
			systemic implications would be very limited indeed, and the benefit of mezzanine financing to small-to-medium sized business in particular should be regarded as an overwhelming advantage.
12	25-26	Respondents are asked whether they agree that it appears difficult to make a case for anything other than such investment funds being closed-ended?	Our firm does not envisage launching a liquid, open-ended fund product purely based on loans originated directly by ourselves (and we hold the view that it would not be possible to do so under AIFMD at this moment in time). Given current market liquidity, we believe that a closed-ended format or a format with limited liquidity or long redemption notice periods is more appropriate for this asset class. However, we would caution against ruling out more open formats in the future once secondary liquidity has developed. While there is currently only limited secondary market liquidity in mid-market loans, this is a situation not unlike the European syndicated loan market in 2002/03. In the syndicated loan market, secondary market liquidity started building up from 2005/04 once a critical mass of market players had established viable fund operations. The secondary market for syndicated loans is now approaching liquidity levels similar to bond markets.
13	26	There may be other legitimate purposes, outside of the investment strategy, for which limited leverage might be usefully allowed. What would these be?	Funds regularly borrow for a variety of working capital purposes. Legitimate purposes can include liquidity facilities to bridge capital drawdowns, to meet margin calls as part of a currency or interest rate risk hedging programme or to bridge redemptions to investors. These forms of borrowing are almost always secured against the fund's assets (lenders would usually not lend on an unsecured basis). They often result in no or only small amounts of net leverage, but are occasionally seen as leverage by regulators. We view them as an essential part of a fund's infrastructure and are strongly of the view the ability of a fund to borrow needs to be maintained by any regulatory framework.
14	26	Respondents are invited to offer views as to what the appropriate leverage restrictions would be?	We believe that this is a decision best left to the potential investors in a fund as opposed to being mandated by regulation.

No.	Page Ref.	Core Question	Response
15	27	Respondents are invited to offer views as to the appropriateness of a capital/co-investment requirement	We have historically co-invested substantial amounts through the balance sheet of our parent company (a US insurance company) of practically every asset class we offer to third party investors. Many of our staff also co-invest in the funds they manage on a regular basis. As firm, we therefore believe that we can always demonstrate a strong alignment of interest with our investors. However, we do not believe that there should be mandatory co-investment requirements through regulation. We believe that the implementation of any co-investment arrangement is best negotiated by the investment manager and potential investors in a fund. The “skin-in-the-game” debate in the area of securitisations has illustrated that a co-investment requirement - however well-intentioned it may be - had severe adverse effects on that market (securitisation activity is at a historic low in Europe). A formulaic co-investment requirement is likely to prevent market participants from engaging in the very activities that are identified as a public good in your paper. To our knowledge, the Central Bank of Ireland has not mandated co-investment or capital requirements for any other asset classes that are permissible under the QIF / QIAIF formats. It is not obvious to us why loan origination would justify this level of discrimination. To the contrary, skin-in the game is often thought of as a mitigant to align interests in originate-to-distribute business models whereas loan origination typically involves holding a loan asset to maturity.
16	27-31	Views are invited on what the appropriate hard-wired constraints might be.	We do not think that it is be appropriate to introduce hard-wired constraints that would only apply to manager-originated loans and no other asset class currently admissible under the institutional QIF framework. Furthermore, risk management and investment policies will differ between fund managers according to specific investment strategies and the imposition of a generic regime of the type suggested could be counter-productive to achieving an efficient flow of loan capital into the economy. We believe that comfort should be taken from the requirements imposed upon managers by the AIFMD.

No.	Page Ref.	Core Question	Response
17	21-31	Respondents are asked whether they agree with the analysis of the main risks and mitigants for loan origination investment funds? Are there others?	Please refer to our answers to Questions 7 and 8. The risks of loan origination investment funds are not dissimilar from those of any other type of investment fund investing in more well-established asset classes. For example, equity funds are highly diversified, but have historically exhibited higher levels of volatility than corporate debt funds. Property funds exhibit similar liquidity and diversification characteristics as loan origination funds but are deemed to be mainstream investments.
18	25-26	Respondents are asked if they agree that closed-ended investment funds with limited leverage mitigate many of the financial stability risks?	Limiting the up-front authorisation of structures to those that are closed-ended and with limited leverage would be one way to address the risks and concerns as viewed by the Central Bank of Ireland. But as we tried to illustrate with our responses, we do not necessarily agree with the nature of the risks as identified in the paper. Except with regards to current illiquidity, we are not of the view that the origination of corporate loans by non-depositing taking asset managers (as opposed to banks) poses financial stability risks that are materially different from their investment activities in many other related corporate asset classes.