BLACKROCK

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RE: Discussion Paper – Loan Origination by Investment Funds

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to the Discussion Paper on Loan Origination by Investment Funds.

BlackRock is one of the world's pre-eminent investment management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world.

As of 30 June 2013, BlackRock's assets under management totalled €2.96 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds ("ETFs"). Through BlackRock Solutions®, the firm also offers risk management, strategic advisory and enterprise investment system services to a broad base of clients, including governments and multi-lateral agencies, with portfolios totalling more than €10.84 trillion.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public sector and multi-employer pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.

BlackRock firmly supports initiatives which drive investment and growth in the European economy. As an asset manager, we continually assess new instruments for their ability to meet clients' investment needs and actively seek innovative solutions for investments which support the financing of the European economy.

We believe that loans constitute an asset class which will be of interest to a number of our larger institutional clients and, therefore, welcome initiatives such as that of the Central Bank of Ireland that will facilitate investments into this asset class. Companies and individuals will benefit from access to more diversified sources of capital. Moreover, the provision of loan capital by non-bank sources of capital should contribute to the liquidity and stability of financial markets. We note, however, that in many jurisdictions a fund structure is not permitted to be the lender of record and measures, such as a European asset passport to allow non-bank lenders to originate loans will be needed. In the meantime, existing loan participation vehicles will still continue to play a significant role for investors wishing to access loans in countries with a bank monopoly on originating loans.

The development of loan origination funds would also require additional initiatives at Member State level to align tax incentives including the removal of withholding and of transaction taxes on lending / interest, at least within the EU and the legislative preference given to banks, for example in taking security (stamp duties etc.) and transaction taxes.

As we see it, the Discussion Paper focusses on two key areas of risk to policy makers:

– firstly, concerns as to whether pooled fund solutions such as loan funds ("LF") providing funding in a sector previously dominated by banks raise issues of systemic risk, and

– secondly, whether all key risks inherent in managing this asset class have been identified. We have examined the questions and proposed risk mitigants raised in the Discussion Paper in the light of these concerns as well as considered how LFs should be structured to meet clients' investment needs.

Key points

Loans – a diverse asset class

Our primary comment is that loans as an asset class vary significantly from sector to sector. The loan market and the need for funding extend far beyond small and medium enterprises (SMEs) and mid-cap companies. Real assets, such as infrastructure debt, residential mortgages, aircraft and ships, will all be affected by the deleveraging and bank recapitalisation process which is currently under way. We see a gap in funding across all loan classes as well as demand from investors across the loan sector. The diagram below sets out the various types of loans and their different characteristics:

The structuring of loans depends on a number of characteristics such as borrower profile, ease of credit assessment, availability of security intermediation in the sector, lender's ranking on default and the ability to take effective security against the loan.

Individual/consumer loans	Large loans
• Due diligence on individual consumer loans which do not form part of a pool of loans is typically not possible • Origination via a bank raises the risk of adverse selection • Some sub-markets may be more liquid • Loans may be of shorter duration • Loans may be secured or unsecured	• Due diligence on individual single loans is possible • Typically highly illiquid with not obvious secondary market • Primary origination is possible • Sometimes very long duration • Often tangible collateral

The design of any loan origination vehicle needs to be flexible enough to reflect the different characteristics of various loan types. The product structuring issues raised in the Discussion Paper come with very different responses, depending on the type of loan in question and the identity and credit assessment of the borrower. As such, BlackRock believes "one-size-fits-all" rules on diversification or leverage are inappropriate – rather, the focus should be on the credit and risk assessment process operated by the manager.

We are assuming that LFs will be AIFs and their managers will be AIFMs. On this basis, the Central Bank of Ireland will have access to the regulatory toolkit in AIFMD regarding appropriate regulation of the AIFM. We strongly believe that existing securities markets tools used in AIFMD can be effectively combined to meet the policy concerns raised in the Discussion Paper without necessarily mandating loan funds to be closed-ended. In particular, we believe existing liquidity management tools and leverage limits under AIFMD could be used to provide more flexibility in meeting clients' investment needs without requiring the LF to be a closed-ended vehicle.

Systemic risk concerns

The Discussion Paper specifically refers to the work conducted by the Financial Stability Board (FSB) on the regulation of “shadow banking”. BlackRock supports the recognition by the FSB of the positive contribution to markets and to individual investors of many of the activities described as “shadow banking”. We believe that they play a key role in providing benefits and appropriate protections for end-investors. These activities are also important in funding banks, the ‘real economy’, as well as contributing to the liquidity and stability of financial markets. The development of LFs could, for example, contribute to reducing costs to the end-borrowers by increasing the supply of available credit and the access of borrowers to sources of finance alternative to traditional banking channels.

BlackRock also appreciates the FSB’s strategy of balancing comprehensive data monitoring with a narrow approach toward regulatory policy proposals. We also welcome the FSB principles, such as “focus” and “proportionality”. We believe it is critical that regulatory responses should be proportionate to the risks that “shadow banking” activities pose to the financial system. The terminology applied to these activities is important. In our view the term “shadow banking” would be more appropriately used to refer to certain off balance sheet structured finance entities sponsored by banks. This would appropriately focus regulatory attention on the area that gave rise to some of the greatest systemic issues during the financial crisis of 2007 and 2008, and has been largely addressed by reviews of the prudential regulation including rules on consolidation and bank capital. “Market finance”, on the other hand, would more accurately describe the broader set of activities often included in the “shadow banking” discussion such as credit intermediation by funds.

BlackRock would therefore argue that the appropriate tools from securities markets supervision should be applied to LFs – including increased disclosure, deferred redemptions, gates and even side pockets – and that reinforced conduct of business rules should be deployed where regulation is deemed to be necessary to mitigate systemic risk.

In particular, we do not believe that an open-ended fund structure leads to systemic risk concerns. The investment fund structure gives AIFMs a number of tools to manage investor liquidity in times of market stress or volatility. In addition, as LFs are only aimed at qualified investors, we believe that appropriate pre-sale disclosure is sufficient to explain that market circumstances may prevent investors from exercising redemption rights in certain circumstances.

Liquidity

We disagree that LFs should automatically be closed-ended vehicles. We believe there will be demand from professional investors for LFs which offer periodic liquidity, say 6 monthly or annually, on appropriate prior notice.

The AIFM’s ability to offer liquidity to professional investors will very much depend on the liquidity of the underlying loans. Indeed, some loans in some markets (e.g. Schuldschein in Germany, high grade senior syndicated corporate loans in Europe, leveraged loans) exhibit high degrees of liquidity, whereas others (e.g. Spanish residential mortgage loans) exhibit low liquidity. Again, BlackRock believes that “one size fits all” rules may have unintended consequences for the cases where the rules may not apply. As the industry is allowed to expand and offer “direct lending”, the infrastructure surrounding it will grow – leading potentially to more liquidity as seen in the syndicated loan market with LMA and LSTA standard documentation (where market participants continue to try and improve liquidity in syndicated bank loans).

In order to manage such risks, AIFMD requires managers to put in place detailed procedures to manage liquidity risk which are similar to those in CRD and make clear disclosure to investors of how they intend using these liquidity risk management tools.

Leverage

We believe that a hard limit on leverage would prevent a number of strategies being offered by LFs. The risk associated with leverage varies considerably between type of loan and quality of the borrower. For example, higher leverage may be appropriate and safe for a commercial real estate portfolio with long-dated government-backed leases, while wholly inappropriate for a portfolio of distressed corporate or SME loans.

From a regulatory perspective, we would recommend focusing on the quality of the disclosures made to investors and regulators under AIFMD on the use of leverage. More specifically, the enhanced disclosures which can be required for any AIF which is more than three times leveraged, should be used to determine which loan strategies merit specific additional regulatory attention and monitoring.

BlackRock also would draw attention to the fact that counterparties providing credit facilities to the LF perform their own credit assessment as to the appropriate and safe level of debt/leverage within a LF. This provides an additional level of scrutiny and protection to the asset manager's and investors' review of the appropriate use of leverage, particularly where counterparties require contractual terms such as asset / liability covenants..

Co-investment and managing the risk of information asymmetry

Whilst we understand the attraction of co-investment as a means to 'align interests' between fund managers and their clients, we note that this is not possible for many asset managers, such as smaller firms, that do not have large reserves of capital or due to regulatory reasons limiting investment in funds they manage. We refer to specific examples in our answer to question 15. Clients have noted a number of flaws in the so-called co-investment model where conflicts of interest become more readily apparent than in a fiduciary model. For example, in a co-investment model, it is not clear whose interests need to come first, the shareholder's or the investors'.

In addition, much of the motivation for co-investment requirements appears to stem from concerns about ensuring a continuous focus on quality of asset data and risk assessment. We believe there are other ways of focussing on continued engagement by the AIFM by requiring transparency of data, appropriate risk models / framework and robust disclosures to regulators and to investors. The investment manager of a LF will have to perform the credit assessment, due diligence and on-going monitoring of the borrowers. The AIFM will need to be transparent to investors / regulators on how these processes are operating, how positions are valued and how the risk the LF is exposed to will be measured.

Moreover, fund structures under AIFMD require investment and risk limits and guidelines which limit the types of risks assumed by LFs. Compliance with these guidelines (assuming these are properly designed for the asset class) should address many concerns about 'incentive asymmetry'.

Responses to questions

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

We agree there is a “public good” in allowing pooled investment funds to originate loans in terms of the growth of non-bank financing as banks deleverage their balance sheets. Corporations and consumers need credit and the investment fund structure allows the matching up of those who wish to lend and those who wish to borrow more efficiently rather than requiring that LFs acquire loans only through banks.

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

Overall, we believe the regulatory framework for AIFs under AIFMD provides sufficient tools to adequately mitigate any risks related to the provision of credit by providers of market finance. These include the requirements imposed on AIFMs to manage liquidity and the amount of leverage in the AIFs they manage. All AIFMs have to provide regular periodic reporting of all the positions their AIFs hold to regulators and, in the case of more highly leveraged vehicles, regulators have already access to more detailed information about the strategy and risk controls used.

In the worst case scenario, if a LF fails, the fund could be wound up in accordance with normal procedures and investors (who are institutional / sophisticated investors) lose the value of their investments. The economic risk of failure would fall on professional investors rather than on the asset manager. Interconnectedness is therefore limited unlike the banking model where depositors are exposed to the fate of the leveraged balanced sheet of a bank.

Under the terms of the Discussion Paper, LFs would only be offered to professional investors as an investment product, and designed with restricted redemption rights that are commensurate with the liquidity of the assets (loans) of the fund and the investor base of the LF. The Fund documentation will ensure that it is not sold to investors as an investment product with a guaranteed return of capital. Consequently, if a LF were to experience difficulties, the fund could apply a number of tools, such as deferred redemptions, gates or even side pockets, which would provide an effective risk mitigant, without affecting the wider economy. The typical professional investor such as a pension fund or insurance company will invest in a LF precisely because of the potential for long-term returns aligned to their long-term liabilities. As such these investors are better placed to withstand market volatility than other investors and less likely to require the type of sudden redemptions that lead to a fire sale of fund assets.

In addition, investors will benefit from the on-going independent oversight by the depositary of the assets of an AIF even where the assets are not capable of being held in custody. Given the extent of the depositary liability regime in AIFMD, it is in the depositary’s interests to ensure the AIFM puts in place proper valuation procedures in order to be able to assess the quantum of its own potential future liability in the event of loss of assets.

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

We suggest the following mitigants could be used:

- restrictions on the issue or redemption of shares in the fund, tailored according to the liquidity profile of the assets of the fund,
- use of limited short-term liquidity or repo facilities to facilitate limited redemptions,
- monitoring and reporting requirements of AIFMD to both regulators and shareholders to ensure transparency particularly on the use of leverage within the LF.

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

We believe that the rules in AIFMD, particularly the requirements by which the AIFM ensures that the investment strategy, liquidity profile and redemption policy are consistently applied provide a high level of investor protection. We believe that the tools used to bring about this alignment will mitigate potential mismatch issues raised in the shadow banking debate.

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

We agree that the process of bank deleveraging may lead to banks focussing their lending capacity on a number of core sectors, leading to underfunding in other sectors or within segments of certain sectors.

The funding gap is likely to affect different sectors in different ways. We believe one of the sectors most likely to be adversely affected is that of intermediate-sized companies ("ISC"s). A number of reports indicate the impact deleveraging is likely to have on this sector (for example see Standard & Poor's, "The "Squeezed Middle": S&P Says Europe's Midsize Companies Need Up to €3.5 Trillion Funding by 2018"). [1] BlackRock believes that market finance can – in part – respond as more ISCs raise finance directly through markets and via LFs.

However, the loan market and the need for funding extend far beyond small and medium enterprises (SMEs) and mid-cap companies. Real assets, such as infrastructure debt, residential mortgages, aircraft and ships, will all be affected by the deleveraging and bank recapitalisation process which is currently under way.

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?

BlackRock believes the high-level policy framework and toolkits proposed by the FSB have the ability to affect the five defined economic functions in a variety of ways, including through changes in product, market liquidity, leverage and transparency.

In assessing the five economic functions defined within non-bank financial entities by the FSB, BlackRock does not believe the management activities relating to LFs are caught by Economic Function 1 - Management of client cash pools.

Regarding client cash pools, BlackRock manages low-risk client cash separate accounts of various scope and design to help investors address their evolving cash management needs. Separately managed cash accounts offer alternative risk profiles and achieve different goals than registered funds' because many institutional investors use such accounts as a complement to their mutual fund investments. Mutual funds and separately managed accounts are distributed differently, operate under different legal and regulatory structures (AIFMD and UCITS for funds and MiFID for separate accounts) and have different business risks.

The unique features and operating structures that institutional investors seek within separately managed accounts offerings are the driving force behind the existence of the asset class. As such, the high level of customisation that investors seek in individual separately managed accounts tends to make these cash pools long-term, multi-year investments. Institutional investors utilise these pools for specific pockets of cash that are labelled as "core" or "long-term" with typical investment horizons of three to five years. These are very different structures to the loan origination vehicle envisaged in this Consultation.

Economic Function 2 refers to loan provision dependent on short-term funding. In our experience, professional investors do not seek to invest in LFs for the short term, in part as a result of the operational intensity of provisioning short-term financing. Instead, they are seeking to use LFs to make a long-term allocation to this asset class for liability matching or income generation purposes. As such, a LF which is subject to infrequent, though regular, redemptions, potentially with gating, should not be included in this function.

[1] Available here: twitdoc.com/24Z3

We agree that the third and fourth Economic Functions should not be taken into account.

The fifth Economic Function is subjective and relates to “excessive” maturity transformation as a result of the provision of funding by entities ***related-banks or non-bank financial entities***. Referring back to the types of loans in the market we described in our introductory remarks, these will be predominately made to commercial bodies – not to banks or financial sector institutions. If target borrowers are predominantly non-financial institutions, we do not see how a LF’s activities could be seen as creating excessive maturity and liquidity transformation in the financial sector.

An important determinant of the supply of credit intermediation within various segments of the capital markets is the existence of distinct classes of institutional buyers within the economic functions listed in the proposal. The classes exist for a variety of reasons, such as a special expertise, which may be required to perform the function; institutional buyers may be less risk averse or more optimistic about returns on the particular business. At the highest level, the proposed framework may restrict the ability of the non-bank financial entities to provide efficient means of allocating capital.

Furthermore, the policy framework and general principles for regulatory measures are not without risks as the unintended consequences may include a permanent decrease in the supply of investment capital within the credit intermediation chain. A sizable supply-side disturbance may shift the aggregate supply curve, resulting in financial intermediary supply decreasing at many levels of the credit market. Increased regulation aimed at non-bank activities, already subject to detailed regimes of capital markets regulation, could reduce market liquidity and efficiency. It is plausible that current participants may reconsider, and ultimately exit, affected businesses while potential new investors would look for other, more attractive options. In such a scenario, market liquidity and efficiency within broad areas of credit intermediation would decline, which would increase borrowers’ cost of credit as access is decreased.

While the ultimate effects of a disruption in the supply of intermediation are unclear, a large enough disturbance is likely to result in higher equilibrium credit spreads across multiple markets (and hence, corporate borrowing costs rising) and the potential for a contraction in economic activity.

Regarding the issue of regulatory arbitrage, we do not agree with the notion of the perceived deficiencies or fractional nature of regulation to which the defined economic functions are currently subject.

In this context, in our response to the FSB we recommended re-evaluating the current regulations of these entities and the extensive regulatory framework and oversight to which these entities are subject through numerous securities and capital markets laws.[2]

In particular, existing legislation such as in AIFMD generally imposes requirements for leverage, liquidity, and concentration and help provide assurance that non-bank entities will be able to meet their obligations throughout market cycles. As such, we believe existing regulations reasonably limit the risks non-bank entities might pose to the financial markets broadly.

Combining the analysis in Section 2, with the framework in Section 3, leads to the overall conclusion that with appropriate risk mitigants in place, the balance of public interest might be served by allowing investment funds to originate loans in certain circumstances. Respondents are asked if they agree?

Yes, we believe that a response to reduced bank lending is served by permitting alternative sources of financing. We also strongly believe that there is an appropriate regulatory toolkit available in AIFMD to allow loan origination to be conducted by AIFs, especially in terms of

[2] See our response to FSB’s consultation: http://www.blackrock.com/corporate/en-gb/literature/whitepaper/strengthening-oversight-and-regulation-of-shadow-banking-fsb.pdf

liquidity management and of the potential by regulators under the AIFMD to impose leverage limits in the case of systemic risk and independent depositary oversight.

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

Overall, we agree with the risk factors identified but have the following comments on the specific risk factors identified.

Illiquidity risk
We note the comments on private loans but our experience is that private loans in some cases are offered on the secondary market. Increased focus on standardised loan terms could therefore enhance secondary loan market liquidity.

Currently, market participants are required to retain "skin in the game" in securitisations (e.g. vertical or horizontal slices) and to reduce capital requirements.

We believe LFs and their managers which are subject to the full requirements of AIFMD and who act as a fiduciary on behalf of their clients should not be treated in the same way as a securitisation with a bank sponsor or originator dealing as principal. Applying this risk retention model to asset managers dealing on an agency basis or to LFs themselves would be problematic. Such retention rules would significantly reduce a fund's ability to generate liquidity and exit a loan portfolio through securitised markets.

Redemption rights with appropriate prior notice periods and the ability to apply gates would mitigate concerns over fire sales. These tools are already available in AIFMD as part of the considerations AIFMs must apply when defining their liquidity management policy. We describe the use of gates and side pockets further in our answer to question 18.

Risk of investor runs
As the investment horizons and liabilities of a typical professional investor are likely to be aligned to the long term assets held buy a LF we do not believe that run risk is of significant concern.

Misalignment with investor risk appetite or investor capability
LFs are only intended to be open to professional investors who will benefit from the reporting and on-going valuation requirements under AIFMD.

Mispricing of credit
We believe the key mitigant for the mispricing of credit and other risks (e.g. prepayment) to be the quality of the manager's process for selection, implementation and monitoring of loans in the LF's portfolio. In practice, this would mean that the AIFM would have to able to justify on an on-going basis to the Central Bank of Ireland that it has allocated adequate resources to its credit and risk functions.

Operational risk
It is essential that the AIFM has adequate operational support with appropriate levels of control and governance. We see this as a higher priority than potential misalignment of incentives. As said above, the AIFM would have to justify that it has adequate controls in place on an on-going basis.

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?

As noted in earlier discussions with the Central Bank of Ireland, we recommend ensuring that the need for loan origination funds to act as lender of record relates not only to primary bilateral loans but also to primary syndicated loans. In the latter case, if LFs are to have the same access as banks and other institutional investors, they would need to act as primary participants in syndicated lending arrangements – i.e. as lenders of record – as well as secondary acquirers of loan positions.

The differences between loan participation and loan origination do not in our opinion equate to differences in risk profile. Where loan origination leads to particular concerns similar to those raised in the Discussion Paper, those risks could be offset / managed by the Central Bank of Ireland as part of its on-going monitoring of an AIFM's risk and liquidity policies. For a large AIF or AIFM, this level of reporting will be made on a quarterly basis by the AIFM.

In addition, direct origination of loans by LFs does offer advantages to investors in that loans are structured to meet the investors' needs and can be the subject of tailored due diligence. For example, a loan originator is much more likely to obtain a fixed charge over the borrower's assets thereby reducing risk to investors in the event of borrower default, whereas a participant in the secondary market is more likely to be an unsecured creditor.

Syndicated loans have to offer terms which appeal to multiple lenders in the market. It does not follow that simply because a bilateral loan does not have such a broad appeal that further regulatory oversight is required for LFs which directly originate loans. The AIFM is still required to act as a fiduciary towards investors and to perform a high level of due diligence in the selection and on-going monitoring of its investments. In addition, the provision of capital by investors and facilities by counterparties will be dependent on the ability of the AIFM to show that it has the requisite / abilities to assess and manage a loan portfolio.

Finally and most critically, restricting LFs to secondary loan investments will necessarily imply that they will not have access to the same investment universe as parties which can act as lender of record.

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

Given that many loans are illiquid it is important that any numerical or percentage diversification limit is applied at the time of acquisition rather than on an on-going basis as liquidating loan positions to rectify a passive breach caused by market movements is difficult. This is not just an issue for LFs but also for many other funds investing in assets without a liquid secondary market.

We find it difficult to set a minimum level for diversification given the very different types of loans which exist. The most appropriate level of diversification for a book of residential mortgages will be very different from that of a book of commercial mortgages with different terms and loan size.

Finally, in some cases, diversification is not important or may impede a more important investor objective – for example, that of a rapid ramp-up.

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

General diversification requirements are sensible to mitigate risks but should form part of an AIF's general risk management process. Any conditions that impose blanket diversification limits would prevent sector or country funds from being developed. Investors may well call for a specific sectoral and geographical focus. It would be more appropriate to provide full transparency of country and sectoral requirements to allow investors to determine risk as part of their total portfolio exposure.

We recommend basing percentage limits on the amount lent rather than on current value to avoid forced sell offs arising from movements in value.

As noted by the CBI, diversification would be very difficult to achieve during ramp-up. As a minimum, we would recommend disapplying the investment limits for at least the first year of an LF's life or until the fund is fully invested if capital commitments are drawn down over an extended period (similar to private equity approach to investing clients' monies). There are a number of mechanisms focussing on commitments and drawdowns which limit the impact of a lack of diversification during the initial stages of a fund's life.

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

Please see our introductory comments on the various types of loans which could be originated. As with diversification, we believe that hard limits may not be beneficial to or desired by investors given the diverse nature of loans as an asset class. The key issue is the risk management process used to assess and manage loans within the portfolio and the extent to which the assets can be sold on if required to meet redemption requests.

We also recommend that LFs should have the flexibility to invest in or hold a variety of positions in loans, for example, acquiring equity stakes in the borrower as a result of a debt restructuring. Funds which specialise in mezzanine financing do already exist in the alternative space. We do not think that these should be automatically excluded provided there is suitable manager experience and oversight.

We can see the case for loan terms extending beyond the term of the fund if there is a secondary market and appropriate investor disclosure. However, if LFs are not created for a specific term but have a limited redemption open-ended structure, this should not be relevant.

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?

The decision to structure as a closed-ended vehicle will depend both on client demand and on the existence of a secondary market for the loans held in the portfolio and the time required to transfer them to a third party or to securitise and sell all the issued securities.

Given the wide variety of loans in the market, this does not necessarily mean that LFs will have to be closed-ended. For example, a fund may decide to have a liquidity profile with staggered loan maturities that are aligned, at minimum, to its gating policy. In addition, closed-ended funds might have and should be allowed to have share buy-back facilities at the total discretion of the Directors of the LF, in the same way that UK investment trusts have in order to manage discounts to NAV. These funds will also need to have this power to be able to repay surplus capital to investors.

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 believe that is the responsibility of the AIFM to place limits on the use of leverage as part of their credit assessment policy. We would not recommend prescriptive limits which would prevent efficient management of LF. In the main, this is because certain investors may require certain risk and return profiles necessitating certain leverage levels. Moreover, for some asset classes, substantial levels of leverage may be entirely appropriate depending on the underlying risk (e.g. NHG mortgages in the Netherlands, guaranteed by the Kingdom of Netherlands).

As suggested in the Discussion Paper, one could expect that a firm issues a loan before the cash call is fully processed – and that would introduce temporary leverage which would need to be met by temporary borrowing.

We do not agree with a blanket ban on leverage as it could prevent the AIFM from using derivatives for efficient portfolio management purposes, for example to hedge interest rate and currency risks. Use of these instruments will also contribute to leverage within the LF itself, though only on a gross notional basis.

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

We believe that a limit on leverage would prevent a number of genuine strategies being offered by LFs. The risk associated with leverage varies considerably between type of loan and quality of the borrower. From a regulatory perspective we would recommend focusing on the quality of the use of leverage disclosures made to investors and regulators under AIFMD. Specifically, the enhanced disclosures which can be required for any AIF that is more than three times leveraged should be used to determine which AIF strategies merit specific additional attention and monitoring.

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

Co-investment is not an option for many managers, including smaller managers that do not have a large capital base, and in light of the forthcoming Volcker Rule in the US.
It is undoubtedly a good idea to maintain as close a link as possible between those who ***understand*** the risks and those who are ***taking*** the risk. Securitisation-style risk retention rules, however, are not appropriate in an agency business model such as asset management particularly in the light of the stringent on-going risk management and valuation rules in AIFMD. The AIF's depositary has also to conduct on-going independent oversight which requires it to be confident that the assets are being valued correctly, not least because the depositary will want an accurate valuation to assess its potential liability in case of failure of oversight or loss of assets.

The typical asset management remuneration model is based on long-term incentives created by calculating variable remuneration based on investment results typically over short, medium and long-term rolling periods. The combination of variable compensation reflecting long-term investment performance and the deferral of that compensation as required by AIFMD means that the total remuneration received in any one year reflects the investment performance achieved over a prior period well in excess of five years. This is an effective way of aligning manager remuneration to the client experience and ensuring that the AIFM's remuneration is closely linked to the long-term performance of the LF. This does not, however, mean that variable compensation has to be in shares of the LF itself; it can quite as easily be paid out in a variety of different instruments which can have the same effect as direct co-investment in the LF itself.

We note that the AIFM will be subject to the ESMA Guidelines on Remuneration for AIFM which recommends that key staff are remunerated by shares in the AIF or in equivalent instruments. While ESMA did not provide detailed guidance on co-investment we have recently seen guidelines from regulators such AMF in France and FCA in the UK acknowledging that this alignment of interest has to be applied flexibly. For example, the FCA noted that examples where investment in shares of the AIF might be inapplicable if:

- The AIF is closed-ended and there are no shares available to acquire as is likely to be the case with many LFs.
- The AIF's incorporation instrument prescribes a large threshold investment amount that could not be met by staff investments.
- The AIF is subject to laws or regulations which prevent staff of the AIFM receiving shares in the AIF (e.g. the US Volcker Rule).
- An investment by staff of the AIFM would result in adverse tax consequences for any third party AIF investors.

As an alternative, the FCA recommends that, as best practice, firms should still elect to pay AIFM staff in shares or instruments linked to the AIFM or its parent company, or in shares or instruments linked to a weighted performance average of the AIFs managed by the AIFM to achieve an alignment of interests.

Finally, BlackRock notes that while 'co-investments' may appear superior due to purported 'alignments of interest', our experience from discussion with clients is that the opposite may be true due to the existence of conflicts and certain *treating customers fairly* concerns. In particular, the conflict is one of whose interests to represent first – the shareholder or the investor / client. This is true just as much on the way in (i.e. allocation policy) as it is on the way out (whose position is sold first? At what price? Is there a distressed or limited market?).

Investor types
We agree that investors should be limited to professional clients as defined under AIFMD, but we query the way the existing QIF definition of investor types works in the new AIFMD regime, as this seems more restrictive. Given that LFs will be marketed on a cross border basis under AIFMD we would recommend remaining with the AIFMD / MiFID-derived definition.

Are there particular issues in relation to investment funds which originate loans which might merit further constraints on the remuneration of investment managers?

We are not aware of any. The AIFMD rules provide a comprehensive framework as noted in our response to the previous question.

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

Yes.

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

We believe that the nature of AIFs means that it is not appropriate to provide hard-wired constraints but to focus on the quality of the AIFM's management and risk controls.

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

One key additional risk for clients in asset class such as loans is information asymmetry.

The investment manager of a LF will have to perform the credit assessment, due diligence and on-going monitoring of the borrowers. The investment manager may outsource parts of these duties to specialist providers, subject to its overall oversight. There are presumably many firms offering this service but, in the absence of a traded market, it needs to be made transparent to investors / regulators on how these processes are operating, how positions are valued and how the risk the LF is exposed to is measured. Otherwise, there is a risk of limited transparency of information to investors on the actual composition and quality of the loan book.

In terms of wider market structure if the AIFM is acquiring loans from a bank, it in turn will have to assess the quality of the loan portfolio and credit carried out by the bank. This process could be facilitated if public development banks such as the EIB are able to underwrite the first tranche of such loans.

Given the variety of loan types we see it as quite likely that the LF and its AIFM may well engage a specialist third party to carry out the actual origination and servicing of the loans on behalf of the LF within preset underwriting criteria. This may also be particularly useful if the third party holds a banking or other license such as a consumer credit license required in a particular jurisdiction and which are not typically granted to funds. This may also mean that the loans are held by an underlying special purpose vehicle on behalf of the LF.

In this type of scenario, one would expect the AIF to perform on-going audits on the service provider's underwriting process pre and post completion, and including financial provisions for non-performance or breaches in underwriting in the service agreement with the originator. With these types of controls in place there should be no risk that the AIFM is avoiding its duty to conduct thorough credit assessment and monitoring.

These points need to be considered in how LFs are marketed at the outset – e.g. disclosure of underwriting criteria, credit ratings etc. and on an on-going basis. For example, the loans themselves may not be traded but in terms of information asymmetry, there may well be plenty of market data about the borrower which can be made available. Additional guidance on the level of on-going reporting to investors which exists under AIFMD may be required for this specific asset class.

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

While we agree that leverage and liquidity are key issues to address we believe more flexibility can be included in the design of the product by using tools from securities markets regulation. A bank is naturally exposed to liquidity mismatches in their balance sheet because its depositor liquidity requirements are not aligned with the bank's asset liquidity profile. This liquidity risk is exacerbated by bank leveraging. Funds are structured differently and can rely on different tools to offset financial stability risks. Using these tools, we do not believe that LFs necessarily have to be closed-ended.

AIFMD imposes very specific duties on AIFMs of open-ended funds to ensure that they manage their liquidity risk by aligning investment strategy, liquidity profile and redemption policy consistently. In the case of a LF, the AIFM will also need to take into account the profile of the fund's professional investors and the degree of alignment of fund and investor in terms of investment horizon. While the loans being originated are typically illiquid, an open-ended fund with limited redemption rights, say every 3 / 6 or even 12 months with provision for advance notice of redemptions is in our view sufficient to mitigate these risks.

An AIF such as a LF is well-placed to match capital needs and funding:

- A fund has more flexibility and control in designing a loan portfolio that matches the liquidity needs of the investors. We agree that LFs should not be accepting deposits though would not entirely rule out efficient portfolio management techniques such as the use of repo.
- Funds have segregated liability, which protects investors by ring-fencing their assets from others. This does not apply to bank depositors.
- In addition to managing the redemption process so that investor liquidity calls do not lead to a fire sale of the underlying loans, AIF have the option of gating and side pockets etc. provisions to help manage redemptions for other less liquid portfolios. While not always appropriate these may well be useful while the manager investigates appropriate secondary market opportunities to sell on the loans. We set out below comments on how gating should occur.
- There needs to be some flexibility in product structuring as some loan types are more liquid than others.

Use of gates and side-pockets to manage potential liquidity issues

Redemption gates and other measures such as the use of side pockets may be essential in order to protect investors in the event of unusual or unforeseeable market conditions. AIFMs need to bear in mind the requirements of the Level 2 Regulation under AIFMD (in particular articles 47 and 48) which require the AIFM to consider and put into effect "*the tools and arrangements, including special arrangements, necessary to manage the liquidity risk of each AIF under its management. The AIFM shall identify the types of circumstances where these tools and arrangements may be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors in relation to each AIF under management. The AIFM may use such tools and arrangements only in these circumstances and if appropriate disclosures have been made in accordance with Article 108.*"

We set out below how we would envisage the use of gates and side pockets in practice:

- Where an AIF holds illiquid assets and there are significant redemptions, remaining investors will be left with a greater holding of an illiquid portfolio that is harder to value accurately and realise quickly. This may occur where the level of illiquid investments in the fund has reached a level such that it might affect the ability to carry out redemptions on a regular basis or where a lack of a readily determinable market value for an investment could result in subscribing shareholders unfairly receiving a windfall by achieving exposure to the investment at a price below its value. AIFMs need to ensure where possible that remaining investors do not suffer because of others redeeming investors. AIFM also need to ensure the redeeming investors receive a fair price. In some cases redemption gates are used to defer or stagger the payment of redemption proceeds over a matter of days or weeks.

- In some fund structures, side pockets are used to separate illiquid assets from other more liquid assets. Once an investment enters a side pocket, only the existing participants in the fund will be entitled to a share of it. Where an illiquid asset is moved into a side pocket, the investors will typically be issued new shares (S shares) representing the value of the asset, in exchange for an equal redemption in their holding of the original share class. The S shares effectively lock in the investors so that they cannot redeem their S shareholding until those assets are realised. The assets in the side pocket no longer form part of the assets of the remaining share classes in the fund and form the only assets in the new side pocket share class.

- Once the AIFM makes the decision to create the side pocket, shareholders in the fund at the time the side pocket is created will have an amount of shares redeemed, reflecting the value of the assets transferred into the side pocket and in turn will be issued the new S shares created for the side pocket. Those shareholders will not be able to redeem these S shares until the underlying assets have been realised. Any new shareholders subscribing into the fund will not be exposed to the side pocket. While the assets are held in the side pocket they will be valued at the price at which they were transferred in for the purpose of calculating any fees.

- Consideration will need to be given to the treatment of any management fee and performance fee. Typically at the time the S shares are created any accrued performance fee should by crystallised and the management fee and performance fee for the S shares should be accrued but not paid out until the S shares are realised.

In other jurisdictions we have seen regulatory guidelines on the use of side pockets which are consistent with the provision of the Level 2 Regulations including:

- Supervision of auditor and depositary on the transfer of assets into the side pocket
- Safekeeping of assets by the depositary
- Annual audit
- Minimum annual valuation
- Expectation of liquidation within a minimum number of years, e.g. six years
- If a separate special purpose vehicle is used to constitute the side pocket
- Detailed disclosure of the terms under which side pockets would be used.

Use of tools such as side pockets would allow the AIFM to offer redemption facilities while not disadvantaging remaining shareholders.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Discussion Paper and are happy to work with the Central Bank of Ireland on any specific issues which may assist in developing an appropriate regime for LFs. In particular, we note that the variety of loans and their differing characteristics mean that flexibility in design and structuring is essential. Crucially, restricting loan funds to secondary market opportunities will reduce investor access to the loan asset class and thereby reduce borrower access to disintermediated financing sources.

Clearly, transparency and disclosure of the AIFM's policies on diversification, liquidity and leverage to both regulators and investors using the basis set out in AIFMD are key to building an effective regulatory regime.

Yours faithfully,

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