Loan Origination by Investment Funds

We welcome the detailed Central Bank Discussion Paper on Loan Origination by Investment Funds of July, 2013 (the "**Discussion Paper**") which addresses the main issues for consideration in determining whether to lift the current prohibition on loan origination by Irish domiciled investment funds. We are in favour of lifting that prohibition.

Funding Gap/Non-Bank Funding Options

We note the Discussion Paper's analysis of the "funding gap" and of non-bank financing options and to the public interest. We have little to add to that other than to note that we have been approached on several occasions over the last 18 months or so by asset managers experienced in this sector who have wished to launch loan origination funds, indicating the availability of alternative funding options. In addition, it is clear both domestically and internationally that loan origination funds funded by private investors and by governments have recognised and are filling that gap. Recent examples include:

(i) Irish Government initiatives via the National Pension Reserve Fund [Dept. of Finance SME Credit and Funding Newsletters of Spring and Summer 2013; NPRF announcement of January 9, 2013; Joint NPRF/BlueBay Asset Management LLP announcement 10 July 2013];

(ii) UK Government Initiatives allocating funding of Stg£1.2 billion to direct lending funds [Hedge Funds Review, February 2013. See article from Risk Net);

(iii) Wall Street Journal article, "*Seeking Yield in Direct Loans*", Jan 4, 2013;

(iv) Financial Times article, "*Highbridge raises $3bn for direct lending fund*", June 19, 2013;

(v) Hedgeweek Special Report (April 2013), "Investment Opportunities in Debt Fund Strategies".

Principal Issues

We consider that the principal issues to be addressed are as follows:

(i) appropriate liquidity matching between portfolio level liquidity and the fund's redemption obligations;

(ii) the need to avoid funding mis-match between longer term nature of loans granted and any short term financing granted to the loan origination QIAIF;

(iii) the expertise and experience of the asset management team and adequacy of risk management systems and processes tailored to the asset class.

QIAIFs and AIFMS

The Discussion Paper does not, for obvious reasons, consider UCITS as potential loan origination vehicles and focuses correctly on qualifying investor AIFs ("**QIAIFs**"). In considering the approach to take to such funds and to the risk mitigants considered in the Discussion Paper, it is important to note that under the new regime, AIFMs are subject to quite significant requirements relating to:

- investment due diligence;
- the identification, measurement, management and monitoring on an ongoing basis (including through use of appropriate stress testing procedures) of the risks associated with each investment position;
- the implementation of adequate risk management systems;
- ensuring that the risk profile of the fund corresponds to the size, portfolio structure and investment strategies and objectives set down in the offering document;
- liquidity risk management;
- valuation of assets;
- transparency requirements, including annual and periodic reporting to investors; and
- remuneration rules for risk takers, subject to proportionality principles.

In other words, AIFMs should in any event be taking into account many of the issues raised by the Central Bank under the regulatory regime as it now stands. It also needs to be noted that under the AIFMD regime, the AIFM of an Irish domiciled QIAIF may be:

(i) an authorised AIFM domiciled in another EU Member State and subject to regulation / supervision by the competent authorities of that other EU Member State;

(ii) an AIFM domiciled outside the EU and subject to regulation / supervision by the competent authorities of that Non-EU State;

(ii) and Irish domiciled authorised or registered AIFM; or

(iii) the QIAIF itself as an internally managed AIF.

Given these different possibilities, we accept that the Central Bank may wish to seek additional information from the AIFM of a proposed loan origination QIAIF as to its expertise and experience in the asset class and as to the systems and processes it operates to manage the risks particular to loan portfolios.

However, if the Central Bank does adopt such an approach, we recommend that it sets out its requirements in writing, that it should not be overly prescriptive and that it has a process of fast track approval for authorised EU AIFMs, for MiFID firms and for Non-EU AIFMs and Non-EU asset managers with demonstrable experience in running loan portfolios.

We have set out below our responses to the various questions posed in the Discussion Paper.

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

Rather than attempting to determine what is or what is in the "public good", we simply note that the availability of traditional bank funding has been reported to have contracted significantly, that demand from commercial enterprises for alternative funding exists and that regular economic commentary suggests that the lack of available funding is holding back economic growth.

Where that alternative funding is available through investment funds whose investors (and not the public purse) bear the full economic risk of portfolio default, we are of the view that it makes clear sense to remove the current prohibition on loan origination funds.

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

We agree with the Central Bank analysis that the two principal risks are:

- management of cash pools with features which make them susceptible to runs;
- loan provision that is dependent on short-term funding.

Although not a limitation that should be imposed on the loan origination funds themselves, it may be that banking regulators would also wish to limit or control bank investment in such funds (as opposed to providing arms length credit to such funds).

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

The consideration of the first of the two risks identified above should not, in our view, be any different to consideration of the same issue for other QIAIFs which invest predominantly in illiquid or less liquid assets.

Loan portfolios – at least until they reach large sizes with high levels of diversification – should be considered illiquid or less liquid. Whilst the loan terms may allow for assignment, there is unlikely to be any developed market for such loans and a purchaser's due diligence process and the commercial negotiations where a sale proceeds justify their treatment as illiquid or less liquid.

In addition, the valuation of such loans, whilst expected to be carried out in accordance with relatively standardised models, cannot be considered to provide the reliability which one would normally expect from a fund which facilitates regular redemptions at investors' discretion.

Therefore, other than where it can be clearly justified on portfolio liquidity grounds, it should be expected that loan origination funds be established as closed-ended schemes where investors have no right of redemption for a finite period, of say 10-15 years. For as long as the fund remains closed-ended, the "run risk" should be alleviated.

We would add, however, that the following matters also need to be taken into account:

(i) at the end of the closed period investors will have an expectation of a final distribution/return (distributions/returns may of course have been made during the closed period). That investor expectation must be a key driver of the maturities of the loans originated but it must also be expected that a proportion of loans will default, that security will need to be enforced, that litigation may follow and that that will necessarily extend, perhaps by several years, the possibility of returns on certain loans.

The regulatory regime for loan origination funds must recognise and provide for that likelihood. In that regard, we feel that provision should be allowed not only for side pocketing of problem assets (more relevant clearly for funds which establish or at a later date convert to limited liquidity status) but also for enabling problem loans be moved out of the fund itself into, for example, a special purpose vehicle (SPV) where problem loans can be managed/administered without the significant costs of the AIFMD regulatory regime. If this is not provided for, it may mean that funds may need to be kept alive unnecessarily after the end of the closed period at significant cost to investors but without any corresponding investor protection justification;

(ii) we expect that, akin to private equity schemes, managers will want loan origination funds to be able to operate on a capital commitment/drawdown basis to avoid diluting the IRR with uninvested cash and where the investor base is locked- in by the final closing. In any guidance provided it should allow for industry standard mechanisms to penalise defaulting investors, allow for borrowing to cover time lags in drawing down commitments and to replace defaulted commitments where other investors do not take up;

(iii) a closed-ended fund should be allowed, at the end of its closed-ended period, to become a limited liquidity scheme where it has assessed that its loan portfolio is appropriate (e.g. number of loans; level of diversification; availability of new investment etc) to that status and where it can provide periodic (e.g. annual) redemption facilities. Such funds will need the capacity to impose gates; holdbacks; operate side pockets etc. to avoid run risk.

In relation to the second risk mentioned above, it is clear that leverage can have the effect of significantly accelerating losses and can wipe-out a fund. That however is a risk faced by all leveraged funds and the Central Bank has not, to date, imposed leverage/borrowing constraints on QIFs/QIAIFs. We do not consider it appropriate to do so for loan origination funds either but the funds must disclose to investors that leverage may be sought and security granted, must disclose the effect of leverage and potential for accelerated losses.

In implementing its leverage/borrowing strategy the AIFM/asset manager must carefully assess the term to avoid replacing or diluting longer term investor funding with short term Bank funding creating the type of liquidity mismatch which the closed-ended nature of the fund is designed to avoid. Consideration might even be given to requiring fund boards to take that into account when exercising leverage/borrowing powers.

As the rationale for loan origination funds comes from lack of available bank funding, one would expect that loan origination funds should not be used as indirect lending vehicles by banks themselves. Banking regulators may wish to place limits on banks investing in loan funds (limits on the banks, not on the loan funds) but arm's length bank financing should not be prohibited for loan origination funds where that is provided for within the fund's investment programme.

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, we consider that it does.

Note however that we consider that investors interests are not served by the requirement in para 13, Section 1, Chapter 2 that investment limits should apply "at the time of purchase of the investments and continue to apply thereafter".

Investment limits if any should be set by the funds themselves, and stated as a % of aggregate capital commitments, not of monies drawn, plus borrowings. If the fund is fully funded (ie. not a capital commitment fund) the limits can be set on the basis of NAV plus borrowings.

Compliance should be measured at date of investment but not thereafter. Assuming closed ended with the investor base locked- in, applying the limits based on a % of aggregate capital commitments, not of monies drawn, plus borrowings at the date of investment should mean that compliance is readily achievable. However, it is not correct for those limits to continue to apply thereafter. Date of investment is what is relevant. In addition, the "remedying/priority objective" etc requirement is inappropriate, impractical and should be removed. Adjusting the portfolio for such reason is not realistic and does not seem to be in the interests of investors.

We also recommend that clear parameters for loan origination funds (and all their permitted features) be set out either within the Rulebook or in guidance and that, as suggested above,

that should include capacity to put problem loans into what would, in effect, be run-off SPVs which could be administered outside the regulatory constraints post the end of the closed period.

Provision also needs to be made for allowing such SPVs to be sufficiently funded (including through drawdowns from the fund/borrowings) to allow them pursue defaulting borrowers to the extent the fund manager considers that to be in the interests of investors.

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

We note the Central Bank's analysis of the funding gap. We can simply note that since the onset of the financial crisis it has been widely and regularly reported that commercial enterprises have experienced difficulty in obtaining credit, that governments appear exasperated with even nationalised banks being unwilling to lend/renew facilities, that commercial enterprises need and seek funding and that governments (including our own) and asset managers have set up funds to fill that gap.

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?

Yes, we agree.

We would point out, however, that although reasonable to expect that loan origination funds be closed-ended schemes, there should not be an absolute prohibition on schemes which, either at the outset or at the end of a closed period, wish to operate on a limited liquidity basis where they have taken appropriate steps to maintain liquidity to meet redemptions.

See Hedge Funds Review/Risk Net article reference to Pricoa's Privest Fund which suggest that it allows for investor redemptions.

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 agree but believe the risks can be mitigated.

We also point out:

(i) private investors should not be prohibited from accepting concentration risk. That is exclusively a matter for them. Whilst concentration risk has been one of the central elements of our own domestic banking crisis, it should only be of concern if the public purse at risk. Where it is not, we see no reason why sophisticated investors should not be free to assume concentration risk;

(ii) leverage risks need to be offset with potential need of a fund to obtain external financing in various scenarios. Leverage should not be prohibited. Rather the

possibility of leverage, leverage limits, parameters as to maturity (depending on size of portfolio v. leverage sought) and security offered should be determined in advance and disclosed. Alternatively, investor approval should be required to exercise;

(iii) dominant lender risk does not seem to be an immediate risk. We would also assume that, as greater levels of bank lending resumes, it should become a competitive marketplace. Noting the Central Bank's counter argument, this is a risk that a fund should be able to document and it is for investors to accept or reject;

(iv) we would consider that the risk of "significant information asymmetry" is no different to that which exists in the private equity and real estate fund sectors. However, AIFMID transparency obligations will also apply. The annual report; periodic information to be made available to investors; and regular leverage disclosure obligations significantly enhance the information to be provided to investors under AIFMD. These include particular reporting obligation in respect of illiquid assets, their valuation and for risk profile/risk management disclosures.

(v) we feel that placing limitations on the types of loans that can be made (secured first charge v. mezzanine) may not be appropriate. It is for the investor to determine its risk appetite and for the fund manager to disclose what its investment programme will allow and its experience in managing pools of loans of the different types.

Clearly risk of default and capacity for investor losses (but also returns) are higher with mezzanine debt but the investor should decide its own risk/reward appetite.

If the Central Bank insists on imposing limits, perhaps it would do so by setting higher subscription/commitment amounts for funds which exceed a threshold percentage of portfolio invested/capable of being invested in mezzanine.

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 are in favour of allowing loan origination funds as set out in this response. We do not think it necessary to consider loan participation vehicles here.

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

To the extent that a loan diversification limit is imposed by the Central Bank (which we do not consider appropriate) or by the Fund itself, we consider that, in similar fashion to other closed-ended capital commitment schemes, diversification limits be applied based on % of aggregate capital commitments [plus borrowings] and apply at time of purchase/acquisition but not on a continuing basis thereafter.

As we do not expect these funds to be open for subscription after final closing, we think this is the appropriate mechanism.

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

There should not be any geographic diversification requirement imposed by the Central Bank. It should be for the fund to disclose its geographic focus/limitations, if any.

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

See point 7 above dealing with types of loans.

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?

Whilst it may be difficult, it may also be the case that certain funds can overcome that. It should be for the promoter to make its case if it wants to set up a limited liquidity scheme, explaining what liquidity it will provide and how and what restraints it will impose to address run risk and valuation risk.

We do not expect that such funds would however offer new subscription opportunities.

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

Noting our views on leverage generally set out above, other purposes might be:

(i) where the fund has been fully drawn but the fund manager feels the need to extend further financing to a borrower to protect the fund's original investment. The capacity to draw down further monies from investors may have expired or part of the investor base may not want to participate and the fund manager may want to avoid creating potential differing treatment as between those who want to participate and those who do not. Setting up a co-investment arrangement may also be too expensive and take too long;

(ii) for liquidity management (i.e. to facilitate funding of redemptions);

(iii) for funding post closed-ended period litigation.

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

To the extent that leverage restrictions are imposed by Central Bank (and we consider that not to be appropriate), limitations might include:

(i) % limit on short term funding, setting the % based on aggregate commitments;

(ii) Not set a limit but require board consideration of potential for funding mismatch when exercising borrowing powers;

(iii) Investor approval above certain limit.

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

We do not consider imposition of capital/co-investment requirements to be appropriate. We understand the reasons why "skin in the game" proposals are in vogue but we think it preferable for investors to dictate (as they often do to private equity managers) whether they want that. They may well require co-investment, clawback arrangements etc. However, that should not be dictated by regulators.

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

We are assuming that the reference to hard-wired constraints are to the following matters set out in the Discussion Paper – ie. not allowing lending:

- to any connected party of any investment fund, its manager or its service providers under any circumstances;
- to other investment funds;
- to financial institutions or related entities;
- to persons intending to invest in equities or other quoted investments or commodities;
- other than on a secured basis with an LTV of, approximately 70 per cent at origination based on at least two independent valuations;
- other than on a fully amortised basis;
- as part of a complex investment strategy;
- to natural persons.

With two exceptions, we agree.

For the reasons set out above we do not agree with limiting lending to secured loans, nor do we accept that a LTV of, approximately 70 per cent at origination is required. Clearly investors may be better protected with such limits but investors should be allowed decide themselves what risk they want to assume. These are QIAIFs after all.

We also do not agree with the reference to funds with a complex investment strategy.

We also think that the proposals set out as to how/whether to assess the quality of the lending on a post-authorisation basis are not appropriate. Bear in mind the AIFMD controls already mentioned plus the investor and regulator transparency requirements under AIFMD.

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

See answers above.

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

We consider that it makes sense to impose requirements designed to seek to ensure (but not guarantee) that funds are not set up with fundamental flaws embedded in the structure or with features which increase the likelihood of encountering difficulties.

For that reason, we consider that such funds should (save where clearly justified by the promoter to the Central Bank) be established as closed-ended, should link maturity of the loans to the length of the closed period and that dependence on short-term borrowing/leverage should be avoided (that does not mean cannot have short-term funding, the issue is extent of dependency).

However, notwithstanding such requirements, the reality is that investors must accept – and they are required to state that they do – that these funds may lose money, they may become insolvent and investors (and creditors) may lose their entire investment.

If that is not a risk they want to accept, then they should not invest.

Andrew Bates
Dillon Eustace

September 13 2013