13 September 2013

Loan Market Association
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Sent via email to: **fundspolicy@centralbank.ie**

Dear Sirs

Response to the Irish Central Bank (the "Central Bank") Discussion Paper: Loan Origination by Investment Funds (the "Discussion Paper")

The Loan Market Association ("LMA") welcomes the opportunity to provide a response to the Central Bank in respect of the Discussion Paper and hopes that its comments will be useful in the Central Bank's upcoming review.

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 500 from over 50 nationalities across EMEA and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.

The LMA is also aware that the Irish Funds Industry Association (IFIA) intends to submit a response to this Discussion Paper. Since we have members in common with this organisation, we would be happy to work alongside them, as well as other trade associations where appropriate, to support this and other proposals going forward.

At present, Irish non-UCITS investment funds are prohibited from originating loans as part of their strategy to source assets for investment purposes. The Central Bank is currently reviewing this policy and has published the Discussion Paper to ascertain views on this topic.

The LMA would like to respond to some of the questions raised in the Discussion Paper as follows:

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

Yes. As a result of the financial crisis and the regulatory response to it, banks' ability to lend has been greatly reduced. In the face of new regulatory requirements and increased focus on the need to reduce risk and minimise debt, major banks are deleveraging on a global scale and as a result, are reducing the amount of credit they are willing to lend to businesses. Consequently, in order to bring about the growth necessary to fuel economic recovery, it is vital that other, non-bank, sources of credit are found to plug the gap and ensure that the funding requirements of businesses continue to be met. This is particularly pertinent given the regulatory capital treatment of European credit institutions following the implementation of CRD IV (Basel III), which will make lending to the sub-investment grade sector generally less attractive for such institutions. Whilst non-bank investors are already present in the credit markets, we believe much could still be done to broaden this valuable investor base and give it a meaningful diversity. On the other hand, if non-bank lending becomes overly constrained, it is difficult to see how the funding gap will be overcome.

In addition to the above, as a general societal trend over the last decade in Europe (and over the last four decades in the US) there has been increased disintermediation of the banking sector. It is important that the Central Bank recognises that this is something which does not have to be viewed as inherently negative. Whilst we would support efforts to tackle genuine systemic risks in the shadow banking system, we would also urge the Central Bank to recognise the potential benefits that non-bank investors are able to bring to the economy, particularly at a time when access to liquidity by ordinary businesses is becoming increasingly scarce.

As the Central Bank is aware, bank disintermediation is seen to a greater degree in the US than in Europe, with lending to US middle market businesses having increased from $71bn in 2009 to $180bn in 2012[1]. This issuance is facilitated by loan mutual funds, CLOs and listed companies known as Business Development Companies. It is our view that in order to generate additional liquidity to the Irish financial markets, appropriate non-bank vehicles, with appropriately tailored regulation, should be allowed to flourish. This could be achieved by relaxing the current regulatory restraint whereby investment funds are prohibited from originating loans.

We would also stress that the loan product itself (especially the syndicated loan product) is a particularly attractive and socially useful financing tool and investment into this asset class should be specifically encouraged. This is primarily due to its simplicity and flexibility. For example, there are various types of loan available to borrowers, e.g. term loans[2] or revolving credit facilities ("**RCF**")[3]. RCF facilities are particularly useful facilities because they enable businesses to borrow to support general working capital requirements. Loans can also offer borrowers flexibility on the amount of any drawing – for example, syndicated loans typically have no penalties for prepayment or cancellation. Furthermore, under an RCF, borrowers are not obliged to borrow the full amount of the commitment. This is in contrast to other debt products where the full amount of the debt is issued on day one and is not repaid until maturity. In addition to flexibility as a product, a loan can offer various financing solutions regarding tenor and volume and is available for a variety of purposes (acquisitions, letters of credit etc) all of which may be set out under one loan agreement. In addition, loans can offer a variety of options to borrowers e.g. regarding currency, repayment options or interest periods. Furthermore, loans are typically based on floating rates and can therefore usually be redeemed at any point in time, without triggering expensive "make whole" payments. Finally, a borrower under a loan agreement has the ability to amend its documentation during the life of the loan (albeit with the approval of the lender) whilst bonds, for example, offer limited or no such opportunities. This is particularly important in long-term financing where a company's requirements and circumstances may change over time.

In view of the above, we believe it to be in the public interest to direct efforts into encouraging more investment into loans, especially in the current economic environment.

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

1 Thompson Reuters LPC. US middle sized issuance equates to any issuance where both deal size and company revenue are less than $500mn and includes both sponsored and non-sponsored transactions.

2 A term loan enables businesses to borrow a committed lump sum, for a pre-agreed period of time and is usually either repaid at the end of the term, or amortised over its life. Interest in respect of a term loan is paid at the end of each interest period (selected by the borrower). Term loans are usually drawn shortly after the facility agreement is signed, although additional tranches (in different currencies if required) may be available for future drawings.

3 RCFs allow the borrower to draw and repay sums up to a specified maximum amount throughout the term of the facility. RCF loans may be drawn at any time, and are either repaid at the end of each interest period, or "rolled over" into the next interest period.

The FSB has defined the shadow banking system as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system".[4] We believe that the key concept here is that of "credit intermediation". The fact that an entity may obtain credit in some ways and grant it in others does not, in itself, generate systemic risk. An investment fund simply invests the monies which it manages on behalf of its investor base.

Furthermore, we do not consider that shadow banking risk is generated specifically by the loan origination process - the same issues arise when loans are acquired via the secondary market. If anything, it could be argued that systemic risk is lessened when loans are originated by investment funds rather than acquired by means of a loan participation. Under a true participation[5], the existing lender and the participant enter into a contract providing that the participant pays the existing lender an amount equal to all or part of the principal amount loaned by the existing lender to the borrower. The participation agreement must ensure that the existing bank is put in funds in time to meet the borrower's demands for drawdown. In return, the existing lender agrees to repay the participant all, or the relevant share of, the principal and interest only when the borrower services and repays the loan from the existing lender. A participation agreement is made between the existing lender and the participant. This creates new contractual rights between the existing lender and the participant which mirror existing contractual rights between the existing lender and the borrower. However, the existing lender remains in a direct contractual relationship with the borrower, and remains liable under the loan agreement. Therefore, under a participation, the participant takes a double credit risk, that of the borrower failing to pay and of the existing lender failing to pay. By lending to a corporate directly, the counterparty risk of the existing lender is eliminated.

Finally it should be noted that current rules allow non-UCITS funds to gain exposure to different assets through fairly complex investment strategies. These strategies may be more costly and have higher risk profiles as a result of the superposition of different products and intermediaries. Above all, the strategies devised by such investments are not always easily understood by investors. By contrast, loans are already widely invested in by professional investors and are a well-established and relatively straightforward and transparent debt product. Consequently, we believe that enabling funds to originate loans would bring about two clear advantages for investors: firstly, since they are priced more simply and involve fewer intermediaries, direct investment would reduce overall investment costs, enabling profits to be passed on to investors. Secondly, the ability to invest directly in loans could also bring about a natural reduction in other more complex investment products/strategies.

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

Yes. Within this context, we would also stress that in order to reduce the funding gap, whilst new alternative financing arrangements (e.g. the EU Long-term Investment Funds proposal, the European Venture Capital Funds regime and the European Social Entrepreneurship Funds regime for long-term investment) could fill a proportion of the shortfall, these will take time to set up and be implemented. By contrast, the loan product is an established form of debt provision, which many borrowers and lenders are already comfortable with using. Efforts should therefore be directed into encouraging more investment into loans, in addition to considering new types of investment. The intrinsic benefits of the loan product are set out fully in our answer to question 1 above.

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?

4 http://www.financialstabilityboard.org/publications/r_130829a.pdf.

5 As opposed to a legal assignment or novation.

Yes, but we would emphasise that the issues raised here do not relate specifically to the act of loan origination – the same issues may arise when loans are acquired via the secondary market.

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

Yes, but again we would emphasise that the issues raised here do not relate specifically to the act of loan origination – the same issues may arise when loans are acquired via the secondary market.

Please see our response to question 17 for further detail on this point.

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?

Please see our response to question 2 above .

As a general overarching point, we would also argue that there is little difference in terms of overall risk profile between a loan originated in the primary market and a loan acquired via the secondary market. We would like to make the following observations:

- **Standardised documentation**. The vast majority of mid-sized to large corporate loans are now documented on standard LMA terms which both lenders and borrowers (and their legal advisors) are accustomed to using. Although the LMA provides facility agreement templates specifically for use in the syndicated loan market, we understand that the core boilerplate terms are used for many large bilateral transactions as well. In addition, the LMA provides template ancillary documents which cover the whole life cycle of a loan transaction such as mandate letter and term sheet. Standard LMA documentation is also used if the loan is to be traded on the secondary market. Fund investors could therefore benefit from the use of standardised documentation when originating loans in the primary market.

- **Same credit analysis and due diligence process**. The same degree of credit analysis and legal and commercial due diligence would be undertaken, regardless of whether a loan is originated on the primary market or purchased via the secondary. The ability to lend directly, however, would also provide the fund manager with further additional benefits – for example, being a direct part of the negotiation process (rather than having to accept the terms of a previously negotiated loan agreement) and having a direct relationship with the borrower (and therefore a greater understanding of the borrower's business and overall strategy).

- **Access to the primary syndicated loan market.** The Discussion Paper observes that Irish investment funds currently source loan assets via the secondary syndicated loan market, which it describes as "a highly structured market, with specialised teams operating in banks…which structure a deal on the basis of their own detailed credit assessment and on the basis of bespoke structured documentation, fees and interest rates particular to that deal." We should emphasise that if loan origination by investment funds were to be permitted, these funds could originate loans alongside banks and simply act as original lenders/joint arrangers under a syndicated or club loan arrangement. In this instance, there would arguably be no difference between the fund acquiring the loan in the primary market or in the secondary, simply because there would be a lead arranger to the deal who would be responsible for the structuring and pricing etc and the fund would simply be involved in the loan transaction at an earlier stage in the syndication process. There would also then be an agent bank (usually from the same bank as the lead arranger) who would administer the loan, distributing interest and principal payments and managing the relationship with the borrower.

- **Active secondary market.** Syndicated loans already benefit from a well-established and active secondary market. In addition, there is nothing to prevent a bilateral loan from being transferable and hence trade-able on the secondary market, assuming that the loan is documented with this in mind.

- **Funds appropriately regulated for loan origination.** Even if the loans originated by investment funds were purely bilateral and not transferable via the secondary market, the fund would have certain obligations towards its investors as a result of the recent implementation of the AIFMD which imposes various valuation, due diligence and reporting requirements (see response to questions 14/15 below for further detail).[6]

9/10/11 How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund? How is a geographic diversification requirement best addressed within the requirements? / Respondents are asked for their views on the types of loans originated and their term?

We do not consider that particular diversification requirements should be put in place under legislation since this is likely to distort the market and lead to investment decisions which are not necessarily based on a particular fund manager's area of expertise. We would stress that whilst the mistakes made by certain financial institutions during the financial crisis cannot be denied, and the need to curb excessive risk taking should be accepted, responsibility for basic investment decisions must ultimately rest with the institutions themselves and this is not something which can, or indeed should, be governed by extensive legislation. In many ways, the financial services sector has already made substantial progress since the start of the financial crisis to strengthen its lending criteria, legal due diligence and credit/risk assessment processes and it is this, along with balanced and considered regulation, which will ultimately establish the foundations for a safer financial system.

14/15 Respondents are invited to offer views as to what the appropriate leverage restrictions would be?/ Respondents are invited to offer views as to the appropriateness of a capital / co-investment requirement

Although no concrete regulatory proposals have, as yet, been produced, the European Commission has recently published a communication ("Communication") in response to its Green Paper on shadow banking which was published as a consultation on 19 March 2012[7] (the Green Paper). This communication sets out the work undertaken by the Commission in respect of shadow banking regulation to date and also sets out further actions for consideration.

The first part of the communication provides details on the Commission's work to date, highlighting CRD risk retention requirements, Solvency II, AIFMD, EMIR and CRA[8] regulation as examples of current (proposed or actual) legislation aimed at tackling the risks inherent in shadow banking. We would stress in particular that both the AIFMD and the CRA legislation is likely to ensure that investors in loan origination funds are appropriately protected. For example:

- **AIFMD.** Some of the key issues that alternative investment fund managers (AIFM) should consider when investing in loans are as follows:

    - **Valuation of assets.** The valuation of assets that are not financial instruments must take place at least once a year (and "every time there is evidence that the last determined value

[6] The Alternative Investment Fund Managers Directive (*2011/61/EU*).

[7] http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf. To see the LMA's response to this consultation please go to the following link: http://www.lma.eu.com/submissions-regulators.aspx.

[8] Credit Rating Agency Regulation *(2013/462/EU).*

is no longer fair or proper") and be done either by the AIFM or a professional external valuer. An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified. Clearly, loan investments will need to be valued as part of this process. Furthermore, prices must be obtained from independent sources (where possible) and individual assets must be fairly and appropriately valued and also subject to a carefully considered review process where "a material risk of inappropriate valuation exists" (e.g. the valuation is based on prices only available from a single counterparty or broker source).

  - **Duty to act in the best interests of the alternative investment fund (AIF) or the lenders of the AIF and the integrity of the market**. Amongst other things, AIFMs must act in such a way so as to prevent "undue costs" being charged to the AIF and must also perform any due diligence prior to execution.

  - **Due diligence requirements**. The amount of DD required should be proportionate to the relevant asset. There will also be additional DD requirements for AIFM managing AIFs which invest in long duration, less liquid assets e.g. in this instance, AIFM must undertake more detailed DD, including "during the negotiation phase" of the agreement.

  - **Risk and liquidity management**. AIFMs should establish a risk management function (separate from the operating units) and implement and maintain both a risk management policy and quantitative and qualitative risk limits. They should[9] also set up a liquidity management system, adopt appropriate liquidity management policies to monitor the liquidity profile of the AIF's portfolio of assets, implement liquidity limits and conduct appropriate stress tests under normal and exceptional liquidity conditions. Loan investments will therefore need to be assessed in terms of underlying risk and liquidity both under normal and exceptional liquidity conditions.

- **CRA.** Under the recent CRA discussion paper published by The European Securities and Markets Authority (ESMA)[10], certain disclosure requirements are to be imposed on structured finance instruments (SFIs), with loan-level data being required to be posted on ESMA's Central Repository. We note from this discussion paper that the information to be published should relate to "the credit quality and performance of the underlying assets of the SFI…the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests of the cash flows and collateral values supporting the underlying exposures." Given that the view appears to be that the information should be detailed enough to enable investors to "do their own due diligence, thereby allowing for reducing their reliance on external credit ratings", this will enable investors to make well-informed decisions about whether to invest in a particular fund, should these proposals be adopted.

The second part of the Communication sets out five additional priority areas. These centre around the need to have: 1) increased transparency of the shadow banking industry to enable supervisory authorities to collect detailed, reliable and comprehensive data; 2) an enhanced framework for funds; 3) well-developed securities laws which limit the risks associated with securities financing transactions (i.e. repurchase agreements and securities lending); 4) strengthened prudential arrangements in the banking sector; and 5) improved supervision of shadow banking activity.

From this communication (and other reports/non-legislative resolutions by ECON and the European Parliament respectively) it is clear that the Commission and other European bodies are seeking further ways to regulate the shadow banking industry.

9 Except in the case of unleveraged, close-ended AIF.
10 http://www.esma.europa.eu/system/files/2013-891_discussion_paper_on_cra3_implementation.pdf.

Although more clarity and guidance from the European Commission is required before it becomes possible to assess the form that any regulation is likely to take, it seems very likely that, at some point in the near future, shadow banking entities will be subject to bank-like regulation, such as limits on leverage, capital requirements, liquidity buffers and restrictions on exposures to, and receipt of funding from, banks and other financial entities. We therefore do not think it necessary for the Central Bank to introduce additional regulatory requirements on Irish investment funds at this stage until it becomes clearer what shape the European regulatory regime is likely to take.

As a general point, we would stress that any additional legislative measures adopted specifically in Ireland are analysed closely with any that are agreed internationally. There are two principle reasons for this. Firstly, the impact of all of these proposals on the industry is cumulative and they must therefore be considered as part of a "package" – too many individual pieces of regulation are likely to lead to confusion, and ultimately suffocation and disruption in the market and a reduction in the number of participants. Furthermore, the cumulative nature of the regulations could also choke off any economic recovery. This risk is magnified given that the composite effect of UK and EU regulation must in turn be assessed in the context of global legislation, including both significant national legislation of non-EU countries and supranational initiatives (such as the G20 and the FSB). Secondly, it must be borne in mind that any requirements imposed solely in relation to the Irish investment funds industry could mean that it is put at a competitive disadvantage to the rest of Europe in some areas.

Finally, we would also urge caution about introducing specific "skin in the game" or retention requirements for loans originated by funds (which are not intended to be securitised and thereby already caught by the Article 404-410 CRD IV requirements). Firstly, no such rules exist in other jurisdictions (except in the context of securitisations), which would result in a competitive disadvantage and the potential for regulatory arbitrage (as discussed above). Secondly, the aim of retention requirements is to ensure appropriate origination standards and ensure that interests between originator and investors are aligned. However, in the context of pure loan origination, a fund manager would be able to independently assess the quality of its loan portfolio and would be free of the possible negative incentives which can arise in an "originate-to-distribute" securitisation model. For example, investment managers are already incentivised to act in the best interest of the investors through the structure of their fees. The majority of management fees are performance-based and as such the investment manager will only receive these fees if the fund is performing. This compensation structure ensures that the interests of asset managers are appropriately aligned with those of its investors throughout the life of that fund.

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

In addition to the mitigants listed in the Discussion Paper, it should also be emphasised that loans (whether originated in the primary market or purchased via the secondary) are a safe, liquid, remunerative and transparent asset class. Some of the specific loan-related mitigants which we believe advocate relaxation of the prohibition include:

a) Loans are an established product from an investment perspective

We would envisage that investment funds would be most likely to act as joint arrangers or original lenders to originate senior, secured non-investment grade loans, which form the bulk of non-investment grade[11] debt raising and which already have a long history of institutional investment ("**Senior Secured Loans**"). In addition, Senior Secured Loans benefit from a well-established and active secondary market which would aid the liquidity of any loan investments made by a particular fund.

[11] By non-investment grade loans, we are referring to borrowers rated lower than BBB by Standard & Poors (S&P) or Baa by Moodys.

b) Senior Secured Loans are not a complex product from an investment perspective

Unlike more complex products that are already eligible for investment by investment funds, loans do not require a highly sophisticated investment strategy in order to generate returns. As a result of their straightforwardness, direct investment in loans would allow profits to be passed on to investors (by reducing the number of products and intermediaries involved in more complex products) and would improve the level of transparency of the information provided to investors.

c) Senior Secured Loans present an attractive investment and risk profile

In addition to generating attractive returns on investment, it is also important from an investor perspective that assets do not demonstrate high levels of volatility over relatively short periods of time. This is another area where loans are likely to be attractive to investors, on the basis that they generate far lower levels of volatility than other financial products.

When comparing the volatility of Senior Secured Loans against the FTSE 100, by analysing both average monthly returns and annualised standard deviation (ASD)[12], it is clear that, as an asset class, loans are noticeably less volatile. For example, in the period between January 2010 and August 2012 (selected as being an extremely unstable period across the financial markets generally) monthly returns for the FTSE 100 sank as low as -6.8% in May 2012. By contrast, the lowest Senior Secured Loan Market monthly return (looking at Western Europe) within the same period was -3.4% in August 2011. Furthermore, whilst the FTSE 100 showed an ASD of 14.4% between January 2010 and August 2012, the Senior Secured Loan Market in Western Europe showed an ASD of only 5.3% for the same period.

It is also vital from an investment perspective that any asset eligible for inclusion within a fund demonstrates consistently low default rates in the event that the asset becomes distressed. Furthermore, in the event that a distressed asset does default, it is equally important to ensure a high level of recovery for the investor. Looking specifically at historical default rates for Senior Secured Loans in Western Europe, in 2011, the annual default rate stood at 0.95%. By contrast, within the Western European high yield market, the default rate for the same period stood at 3.20%[13]. In addition, as well as showing low default rates, loans may also be seen to offer higher rates of recovery in the event of default when compared to other asset classes such as senior secured and unsecured bonds. For example, looking specifically at the average global recovery rates for defaulted assets in 2009[14] (one of the worst years for corporate defaults) whilst loan recovery was just under 80%, recovery rates for senior secured and unsecured bonds stood at 65.6% and 51.6% respectively. Not only does this illustrate higher overall recovery rates for loans when compared to other asset classes, it also highlights that loans offer reliable preservation of capital.

d) Senior Secured Loans are sufficiently liquid, negotiable and transferable

We recognise that whilst factors such as yield, low volatility and low rates of default are all important considerations for investors there still remains an underlying need to ensure that any asset held as part of an investment portfolio is sufficiently liquid. We believe that Senior Secured Loans have a sufficient degree of liquidity.

By way of background, secondary loan market liquidity is facilitated by "market makers" who provide two-way pricing and by more than 20 institutions which could be considered regular market

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[12] Source: Credit Suisse WELLI Index and FTSE 100 (Total Return Index).

[13] Source: Exhibit 4, page 5 and Exhibit 107, page 61: Credit Suisse Leveraged Finance Default Review, 11 July 2012.

[14] Source: "European Leveraged Loans: Robust Recoveries in Recent Downturn" published by Moody's, July 2011.

participants. As stated above, volumes in the European secondary loan market were US$75bn in 2011, achieved similar levels in 2012 and stand at approximately US$50bn after the first half of 2013[15]. In addition, whilst trading of loans may not be seen at the levels witnessed in the high yield bond market, it should be clarified that this is not as a result of a lack of willing buyers present within the market. Rather, given current volatility within the financial markets generally, many investors have chosen to adopt a "take and hold" position with respect to their loan portfolios – something which is not surprising given the healthy returns generated by loans (even from a pure income perspective) and their low levels of volatility and default when compared to other types of financial products. Furthermore, there is currently an overall lack of new issuance in the primary market, albeit now improving, which is again not surprising given the current economic environment. As a result, loan volumes within the secondary market should still be seen to be relatively healthy and, most importantly, regularly traded through a fully functioning and effective market.

It should also be highlighted that, as well as trading on a well-established secondary market, loans are also relatively transparent in terms of price, despite the fact that prices are not quoted via an exchange. As outlined above, loans are traded via "market makers" who provide two-way pricing. This is stabilised by the presence of more than 20 regular market participants, many of which are major bank trading desks. Consequently, in the event that Senior Secured Loans became eligible assets for origination by investment funds, it would be possible for loan funds to publish either a weekly, or even daily, NAV. We understand from our members that there are already certain loan funds in existence which publish daily NAVs.

Finally, we would also like to add that, given the requirements of both the Markets in Financial Instruments Directive and the Alternative Investment Fund Managers Directive, which will impose various valuation and transaction reporting requirements, it is likely that loan pricing will become increasingly transparent as a matter of course.

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

Although clearly, close-ended investment funds with limited leverage do mitigate against the risk of financial instability, we believe it to be possible for open-ended funds to originate loans and that this could be achieved in one of two ways. Firstly, the loan fund could be required to maintain a short term liquidity facility to manage settlement risk in the fund. Secondly, the loan fund could co-mingle loans with bonds and other more traditionally liquid securities (which are required to settle at T+3) in order to maintain enough diversity within the portfolio to ensure redemptions within the required time periods.

In addition, although many open-ended funds are daily dealing, some do deal on a more infrequent basis. Therefore it would not represent a dramatic departure for loan funds to be structured with redemption requirements and notice periods which are more appropriate to the product (e.g. monthly redemptions and 30-day notice periods). Given the other intrinsic benefits that loans offer, we do not consider that investors would find this particularly detrimental, provided the redemption conditions were clearly highlighted to them in advance. We would also emphasise that there are already several funds in existence aimed at professional investors which function well with these sorts of provisions.

Given that loans are not traded in the same way as other types of financial products, we recognise that some form of liquidity provision may be considered useful to help manage short-term liquidity. That said, given the fact that loans are traditionally less volatile than, for example, equities, and offer an attractive risk profile, particularly in terms of low default rates, we do not consider that investors would necessarily expect the same level of liquidity for loans than they would for other assets.

[15] Source: Thomson Reuters LPC Secondary Loan Trading Volume Survey.

Conclusion

As clearly illustrated by our arguments set out above, it is our view that investment funds should be permitted to originate loans. Whilst we understand the importance of liquidity and investor protection, the loan asset should also be assessed based on its other inherent benefits. This would include its long history of institutional investment in the secondary market, its relative lack of complexity as a debt product and its proven reputation of providing investors with attractive returns, low volatility and low loss given default rates (all of which are important factors from an investor perspective).

Furthermore, we also believe that allowing Irish investment funds to originate loans would benefit not only the professional investment community, but also the wider community of borrowers themselves, many of whom are currently struggling to find access to credit. This, in turn, would enable a much needed injection of liquidity to the wider financial markets and assist in contributing to a healthy economic recovery.

Finally, we would like to stress again that, when undertaking a review of the QIAIF framework, the Central Bank should analyse any additional legislative measures adopted specifically in Europe alongside those that are already in place internationally, particularly in the US. Without any form of international convergence, there is the potential for financial markets in Europe to suffer from severe competitive disadvantages.

We would be pleased to discuss any aspect of this response with you in more detail. If we can be of any further assistance, please do not hesitate to contact me by email at nicholas.voisey@lma.eu.com or by telephone on 020 7006 5364. We would also be pleased to meet to further discuss this initiative at your convenience.

Yours faithfully

N A Voisey

Nicholas Voisey
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