STATE STREET.

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Via e-mail: fundspolicy@centralbank.ie

Central Bank of Ireland
Block D
Iveagh Court
Harcourt Road
Dublin 2

Discussion Paper – Loan Origination by Investment Funds

Dear Sir/Madam:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Discussion Paper issued by the Central Bank of Ireland ("CBI") regarding loan origination by investment funds.

Headquartered in Boston, Massachusetts, with branches and subsidiaries throughout the European Union ("EU"), State Street specialises in providing institutional investors with investment servicing, investment management and investment research and trading. With EUR 19.7 trillion in assets under custody and administration and EUR 1.6 trillion in assets under management, State Street operates in 29 countries and in more than 100 markets worldwide. Our European workforce of 9,000 employees provides services to our clients from offices in ten EU Member States and includes 2,000 employees and 5 locations in Ireland.

General

State Street welcomes the CBI's consideration of loan origination within a regulated Irish domiciled fund structure. Loans are a very important asset class for the Irish fund range and in order to allow access to the full spectrum of loans for Qualifying Investors, it is necessary to allow exposure to be achieved through loan origination. It is worth noting that loan origination is only likely to be an attractive proposition to sophisticated and experienced investment managers, who already operate in the loan markets. That said, we do see significant demand for the asset class among this part of our client base and we strongly believe that allowing Irish funds to originate loans will be an important step in keeping Ireland as jurisdiction of choice for such sophisticated investment managers seeking to do business in a regulated environment.

Please find below further comments on the particular matters raised within the Discussion Paper, including our response to the specific questions posed.

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

As a result of the financial crisis, 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 tightening 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 ensure that the funding requirements of businesses continue to be met.

We believe that the weight of evidence strongly supports having a regulated fund that allows loan origination as a mechanism by which finance can be made available. Furthermore, we expect there is substantial demand from a sophisticated investor base for appropriately regulated investment funds which will invest in these types of products either as part of a wider fixed income mandate or as a discrete investment in originated loans.

It should be noted that investors in an investment fund typically provide a qualitatively different source of capital compared to the traditional source of bank capital lending. Investment fund capital is prevalently more non-cyclical and non-correlated to the economy, on the basis that investors in such funds are essentially long term institutional investors seeking long term opportunities. This represents a better matching of borrower and investor objectives and arguably adds stability to the market.

Origination by investment managers is a relatively mature, widespread and understood practice. We do not think that allowing origination in Irish funds would represent a departure of strategy for many existing managers of Irish Qualifying Investor Alternative Investment Funds ("QIAIFs"). Such managers are already operating in the loan markets and manage funds in other jurisdictions holding originated loans. State Street has worked with clients, who have originated loans in investment funds in other jurisdictions such as the UK, USA, Luxembourg, Channel Islands and Cayman Islands. We take the view that Irish QIAIFs should be allowed to source originated loans, subject to the appropriate management of controls around structuring, risk and disclosure.

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

We agree that points 1, 2 and 5 of the shadow banking risks identified in section 3 of the Discussion Paper under the heading "Economic Functions" may be of relevance. However, there are provisions of the AIFMD which address most of these concerns. Specifically, AIFMs are obliged to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place.

This requires due consideration to be given to the nature of the fund, including the type of underlying assets and the amount of liquidity risk to which the fund is exposed, the scale and complexity of the fund or the complexity of the process to liquidate or sell assets. Reporting is also a key provision of AIFMD designed to give greater transparency. These requirements address the risks identified at points 1 and 2 in section 3 of the Discussion Paper.

It is the acceptance of funding by banks or non-bank financial entities which would appear to be the cause of concern identified at point 5 in this section, rather than the activity of an investment fund itself. Imposing requirements on those entities regarding from whom they could receive such funding and the manner of treatment of such funding should address this risk rather than seeking to specifically regulate loan originating funds.

In addition the AIFM of a loan fund would be required to specify a pre-determined investment strategy and a funding model commensurate with the liquidity of the assets which would be documented and disclosed to interested investors prior to their investment. Further, the requirement on AIFMs to identify and avoid conflicts of interest should mitigate the risks identified in relation to any such activity between a fund, its AIFM and a related entity.

Accordingly, we do not consider that relaxation of the current policy would necessarily raise risks in relation to shadow banking. In addition, as investment funds in other jurisdictions are already participating in loan origination, we do not see this potential relaxation by the Central Bank of Ireland creating any additional shadow banking risks.

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

We expect that funds will be structured and operated in a way commensurate to the risks related to the asset allocation profile. In reality we expect that many AIFMs will seek to operate closed-ended vehicles, and, if deciding to employ leverage, will arrange their funds in a way to safeguard the on-going operation of the fund from the risks associated with the leverage employed. These requirements are prescribed under AIFMD.

If an AIFM decides to use a closed-ended fund, we expect the risks noted are essentially removed from the equation. Should a closed-ended fund not be the structure of choice and the AIFM wanted to establish an open-ended fund or fund with limited liquidity, then it would be incumbent on the AIFM to ensure that the risks are mitigated. We feel the risks as presented in the Discussion Paper are dealt with in the existing framework as noted below:

1. Susceptibility to runs

This risk is mitigated by the requirements imposed on the AIFM in respect of liquidity management, including the requirements to employ an appropriate liquidity management system, adopt procedures to enable the monitoring of liquidity risk of the

fund and to ensure that the liquidity profile of the investments of the fund comply with its underlying obligations to investors. The requirements to maintain a level of liquidity appropriate to the fund's underlying obligations, taking into account the time required for liquidation and value at which those assets can be liquidated should ensure that the liquidity of a fund's assets is consistent with its redemption frequency.

2. Loan provision that is dependent on short term funding

In addition to the liquidity requirements above, an AIFM is required to set maximum leverage limits which may be employed by the fund. The AIFM is also required to disclose the right to reuse collateral and the extent to which it is reused, calculate exposures generated within the fund and regularly disclose the amount of leverage employed, all within an appropriate risk management system which involves the setting of risk limits for the fund. AIFMD prescribes additional requirements, including specific reporting requirements for AIFMs of funds which employ leverage on a substantial basis. Accordingly, this risk is mitigated by the requirements in the AIFMD and we do not consider that any additional leverage limits should be imposed. Should an AIFM secure a source of leverage, we would expect that the provider of that leverage would also perform separate due diligence around the fund’s suitability and capability to borrow. We feel this would add a further degree of mitigation to the process.

Loan originating funds will 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 loan fund. The fund documentation will ensure that it is not sold to investors as a banking product. We do not see how funds’ activities could be seen as creating excessive maturity and liquidity transformation if target borrowers are predominantly non-financial institutions.

3. Securitisation and funding of financial entities

As noted in our response to Question 2, the concern around the sources of funding to banks or non-bank financial entities would not be best dealt with through the regulation of investment funds, which are adequately restrained from engaging in related party transactions that may give rise to conflicts of interest by the principles embedded in the AIFMD.

Question 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?**

In relation to investor protection, we agree that the AIF Rulebook, together with the directly applicable EU AIFM Regulations (“AIFMR”), provides a framework within which investor protection is enshrined for any fund falling within scope.

Each fund is required to appoint an authorised AIFM, which itself is subject to organisational requirements including:

- Minimum capital requirements

- Rules governing the reputation and experience of the individuals in the AIFM who are responsible for the operation of a loan origination fund
- Duty to act honestly and in the best interests of investors and the integrity of the market
- Remuneration policy ensuring alignment with investor interests
- Conflicts of interest policy
- Strict risk management provisions
- Liquidity management provisions to ensure that the fund is structured in such a way that the fund's liquidity profile matches the liquidity of the underlying investments
- AIFMR Art 18 – requirement for AIFM to carry out due diligence on investments
- AIFMR Art 19 – specific due diligence requirements when investing in illiquid investments.

It can be noted that the Article 19 requirements referred to above relating to due diligence when investing in assets of limited liquidity are particularly exacting and as such seem ideally suited to loan origination. Article 19 states:

> 1. Where AIFMs invest in assets of limited liquidity and where such investment is preceded by a negotiation phase, they shall, in relation to the negotiation phase, in addition to the standard due diligence requirements:
>
> (a) set out and regularly update a business plan consistent with the duration of the AIF and market conditions;
>
> (b) seek and select possible transactions consistent with the business plan referred to in point (a);
>
> (c) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, tax-related, financial or other value affecting factors, human and material resources, and strategies, including exit strategies;
>
> (d) perform due diligence activities related to the transactions prior to arranging execution;
>
> (e) monitor the performance of the AIF with respect to the business plan referred to in point (a); and .
>
> (f) retain records of the activities carried out pursuant to the above for at least five years.

For each fund it manages, an AIFM needs to apply the AIFMD valuation requirements and the rules governing either the appointment of an external valuer or the maintenance of the function within the AIFM.

Each fund is required to have a depositary to verify ownership of loan positions as other assets, monitor cash flows and provide oversight over the administration of the fund.

There are prescribed transparency requirements requiring periodic reporting to the relevant competent authority and investors. There must also be upfront disclosures to investors of investment policy, risks, leverage, liquidity management provisions, etc. Further, the funds are subject to the requirement for audited annual financials.

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

The evidence provided supports our view of the funding gap and appears to indicate significant potential for loan origination by funds.

As noted, the funding gap 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 CBI 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 CBI 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 CBI will be 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, Collateralised Loan Obligations ("CLOs") and listed companies known as Business Development Companies. It is our view that in order to generate additional liquidity to the financial markets, appropriate non-bank vehicles, with appropriately tailored regulation, should be permitted. This could be achieved by relaxing the current regulatory restraint whereby investment firms are prohibited from originating loans. Loan origination is already an established form of debt provision, with which borrowers and lenders are already comfortable.

Question 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?**

[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.

We agree that those risks in the first and second of the FSB defined economic functions as written could exist. However, we do believe that the concerns are addressed by the specific requirements applicable to AIFMs and that these risks are not more prone to arise in originated as opposed to non-originated loans. It is equally likely that more market entrants engaging in origination may widen the areas of lending rather than concentrate the practice.

An open-ended fund will have mechanisms to deal with stressed market conditions disclosed in its prospectus and can be structured to restrict investor redemptions through redemption gates, side-pockets or ultimately suspensions in investor dealing.

Concerns in relation to function five would, as we have stated previously, appear to be issues for banking and non-banking financial supervisory authorities as to where they are allowed to source funding from rather than a cause of concern for fund regulation.

Please refer to response to Question 4 around how we think particular concerns are addressed.

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

Risks are associated with investments in all corporate debt loans and these risks as presented do not, in our view, represent a significant departure from the risks borne by other funds investing in illiquid securities. We do not believe some of the risks inevitably increase when loans are originated by a fund.

Of course, liquidity is clearly a key area for consideration. As noted in Question 4, an AIFM will be prescribed a number of regulatory requirements, including the obligation to act in the best interests of investors. As such, we expect that loans will be structured for broad commercial appeal and on marketable terms such that positions could be sold if it were required.

Mispricing of credit risks are also linked to loan terms being marketable. AIFMD requires rules to be outlined regarding the valuation policy of each fund including the review of valuation techniques. Furthermore, it is usual for originated loans to use the same Loan Market Association ("LMA") legal templates when executing agreements, which seek to safeguard certain standards around agreements to support transparency and potential transferability. This would lead us to conclude that the AIFM will be required to ensure that market diligence on the loan is available and can be validated independently. We expect this will eliminate any concerns noted in the paper regarding misalignment of incentives.

We note the comments around the potential for concentration risk. There is no specific requirement on any QIAIF in relation to diversification and, given the professional nature of the investor base, we believe this is appropriate with the correct disclosure. We do not see any specific issue around concentration of borrower types in the syndicated loan market and would be persuaded that a wider population of loan originators may actually lend itself to wider diversification rather than promote concentration.

While we accept that the other risks referenced in the paper exist, e.g. dominant lenders, leverage, investor runs, we do not believe they are 1) always inherently more prevalent in originated loans or 2) not mitigated by the effective liquidity management and controls already prescribed.

Question 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?**

Although there is an 'inherent discipline' within the syndicated loan market we do not agree that loan origination unilaterally creates additional risk. In fact we would argue that the process of loan origination gives the AIFM the opportunity to reduce risk by being able to carry out more detailed due diligence on the borrower and also to strengthen or renegotiate conditions and covenants around a deal.

With regard to the point on credible pricing there is also an argument that there is equal or greater risk of the occurrence of mispriced credit in loan participation arising from 'hot markets', or intermittent supply driven by an uncertain primary lending market which is at the mercy of bank lending.

Additionally, it is usual practice for borrower/lenders to adhere to LMA standard legal templates regardless of whether being originated by an investment manager or structured for syndication via banks. As such, we would expect a certain legal transparency, discipline and standard around originated loan deals, comparable to that in the syndicated market, sufficient to allow for potential transfer of assets on industry commercial terms, if that becomes desirable

We also note that the paper refers to manager rejection rates and the time taken typically to structure originated deals. Based on our understanding, this would not be uncommon. In our opinion, these statistics speak to the level of due diligence, expertise and assessment employed by managers in this area.

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

Any fund established as a Part XIII Investment Company is obliged to be operated in accordance with the principle of risk spreading. It should not be necessary for the CBI to impose additional diversification requirements for loan origination funds. It should be sufficient that the AIFM is authorised and has the necessary expertise to appropriately structure the fund.

Based on our experience of other fund structures holding originated loans, it is unlikely that any fund will wish to have diversification requirements hard-coded. Investors should decide based on a pre-determined, disclosed fund strategy if they have a desire for products that do not impose any specific diversification limits in excess of the principle to operate on the basis of risk spreading. Diversification will also be a significant consideration in the AIFM's liquidity management responsibilities.

Question 10: **How is a geographic diversification requirement best addressed within the requirements?**

Please see our answer to Question 9. We believe it would be inappropriate to specify a requirement for AIFMs to diversify geographically. There is no such existing requirement for any other Irish regulated QIAIF. The AIFMD requires the AIFM to have the necessary expertise in the markets in which the fund invests so, in our view, it would not make sense to force an AIFM to diversify into markets in which they may not have the same high level of expertise. Secondly, prescribed geographic diversification may only serve to limit investor choice if an investor is only interested in certain markets.

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

Senior Secured Debt will likely be the most liquid type of loan product and will typically have a commercially marketable set of loan terms. As such, we would expect to see them perform like the existing names of senior debt in the syndicated market.

It is also likely that funds could seek to originate mid-market debt or mezzanine loans. We would not agree with a position that would restrict this type of lending on the grounds of liquidity. QIAIFs are currently allowed to invest in bilateral and mezzanine type investments, placing the onus on the AIFM to ensure the fund is being managed in accordance with risk and liquidity provisions. We do not see why any specific additional restrictions should be placed as a result of allowing origination.

The overriding principle should be that the AIFM must ensure that the risk and liquidity profile of the underlying investments mirrors that of the fund rather than imposing specific limitations. We believe this is more preferable than seeking to impose restrictions on investments.

Question 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?**

We have not made this conclusion and think that to do so could be overly-restrictive and potentially counterproductive.

That said, we understand why one might consider that to be the prudent position. In practice, we would expect to see that funds with 100% allocation (or some other significant allocation) in originated loans, will be closed-ended.

We also think that funds may want to hold allocations of originated loans along with other fixed income allocations such as syndicated loans or bonds. In that context,

allowing only closed-ended funds to hold originated loans would be highly restrictive and not meet investor requirements.

We do think it is worth considering whether it is essential to be prescriptive on this subject given the prevailing requirements to meet liquidity management provisions embedded in AIFMD. The over-arching requirement on the AIFM to ensure that it has carefully assessed the liquidity of investments and the liquidity needs of investors: this should influence the structure of the fund, rather than it being prescribed via regulation.

Since the AIFMD requires a comprehensive liquidity management process, the AIFM is required to be in a position to understand the investments, and monitor and keep track of what liquidity requirements the fund would have.

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

As noted by the CBI in its Discussion Paper, there might be a need to permit some use of leverage as a temporary measure to facilitate treasury management.

For example, it could arise that a fund has a committed investor base ready to fund an investment via a drawdown type arrangement. Having the ability to call on a short term facility in exceptional circumstances, for example the delayed receipt of committed funds, may be a prudent approach to safeguard proper cash flow. Other funds may seek to mitigate this risk by maintaining cash buffers. In any event the AIFM will be required to demonstrate that it has an appropriate liquidity management process.

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

We believe that it should not be necessary to put a strict limit on leverage on a fund. The AIFM should have the flexibility to structure the fund according to the risk appetite and policy of the fund and its investors. Investors in such funds will be sophisticated investors. These funds will also be subject to the transparency requirements of AIFMD including both upfront investor disclosures and reporting to competent authorities as noted in Question 4 above.

We understand that other jurisdictions to not impose leverage limits on investment funds that may originate loans.

Question 15: **Respondents are invited to offer views as to the appropriateness of a capital / co-investment requirement?**

The aim of 'skin in the game' requirements is typically to try to safeguard appropriate origination standards by ensuring that interests of the originator and the investors are aligned.

On the merits of 'skin in the game' itself, it is important to bear in mind the respective roles played by parties in investment funds. The manager is mandated to invest the funds based on the wishes of the investor and based on the disclosed investment policy in the fund's documentation. In this regard, a fund manager is acting as the agent of the investors in the financial markets. To require a manager to co-invest in the fund could serve to blur the lines between these roles and potentially open up possible conflict, such as to inhibit the manager's desire to invest an investor's funds according to that mandate. In any event, the application of other regulatory constraints on the ability of investment managers affiliated with banking institutions to make investments in own funds, such as in the Volcker rule, may prohibit this activity.

We know that co-investment within CLOs is currently required, but we understand the nature and limit of practice is under review. In the fund landscape, we are not aware of 'skin in the game' type requirements for regulated funds in other jurisdictions or other products such as private equity or property funds. We would be concerned that the implementation of any such measures may create a level of regulatory arbitrage and cost for managers which could render the initiative unworkable when compared to other domicile options.

That said, we know that it is not uncommon for potential investors to look for a form of financial commitment by the investment manager at the fund's capital raising phase, and often such commitment is agreed bilaterally. We think that this is the appropriate forum to consider this question rather than via regulation.

In relation to safeguarding the underlying objective, i.e. ensuring alignment of objectives, we believe that AIFMD does have effective requirements to deal with the issue. The AIFMD organisational requirements including the requirement for a remuneration policy, detailed conflicts of interest policy and the governance of the board of directors is a sufficient operating model in our view. Aside from AIFMD, we believe that investment managers' business and reputation is dependent on the performance of the portfolio and therefore alignment of interest sufficiently exists. For these reasons, we believe it would be an unnecessarily excessive measure to try to prescribe any additional arrangement.

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

We believe, for the reasons noted in our answer in Question 15 that any decision for co-investment should be one settled between the investment manager and its investor base, providing that any such arrangement is clear, documented and disclosed.

Beyond that, we think it would be wrong to attempt to hard code any co-investment requirements into regulation, and instead the AIFM discharging the relevant requirements under AIFMD would deal with the issue.

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

Please see our answer to Question 7 above.

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

For the reasons identified in the CBI's paper, we agree that a closed-ended structure with limited leverage could automatically alleviate some of the risks noted.

However, we are of the view that the AIFMD regime imposes requirements to ensure the safeguarding of liquidity management sufficient to allow for open-ended structures holding positions in originated loans. As already noted, the overriding principle is that the fund should be structured appropriately to deal with those risks, together with limiting investment to sophisticated investors who are capable of understanding the risks that an investment in originated loans creates.

Please feel free to contact me should you wish to discuss State Street's submission in greater detail.

Sincerely,

Susan Dargan, Head of Global Services Ireland
State Street International (Ireland) Limited