IRISH FUNDS INDUSTRY ASSOCIATION

Submitted via email to:
FundsPolicy@CentralBank.ie

13 September 2013

Re: Loan Origination by Investment Funds
– Central Bank of Ireland Discussion Paper July 2013

The Irish Funds Industry Association (IFIA) is the industry association for the international investment fund community in Ireland, representing the custodians, administrators, investment managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland. As the leading centre for alternative investment funds (AIFs), Ireland services over 40% of all hedge fund assets globally, with EUR 280 billion of assets in Irish domiciled non-UCITS funds, EUR 220 billion of which is in "qualifying investor funds" regulated by the Central Bank of Ireland (CBI) as of June 2013. Accordingly, all developments in the alternative investment arena are of particular importance to the Irish industry.

The IFIA welcomes both the publication of, and the opportunity to comment on, the Central Bank of Ireland's Discussion Paper "Loan Origination by Investment Funds", July 2013.

Given the well documented need for non-bank financing of the economy, the existence of sophisticated investors looking to access the risk and diversified return characteristics of this asset type via pooled investment funds, and an increasing body of experienced investment managers who can provide the expertise to link this supply and demand, we believe that discussion and consideration of policy change in this area is not only timely but necessary.

AIFs which are established as loan funds and loan origination funds can play an important role in non-bank financing. European banks hold large amounts of non-core loans and subject to a combination of capital pressures, the continuing economic downturn and strategic re-orientation could see more loans become non-core. The significant on-going deleveraging is estimated to take many more years to complete and the subsequent funding gap is one which loan origination funds can help fill. The IFIA firmly believe that an AIF should be able to originate loans.

By way of general response to the Discussion Paper, we do not agree that the risks which have been outlined are brought about by a fund's ability to originate loans. There is a strongly held view that any risks which may apply to a loan origination (or other type) of fund have been thoroughly considered and adequately addressed by many of the requirements in the AIFM Directive, including the liquidity, risk, leverage, reporting requirements etc. In relation to the issue of co-investment in particular, it is stressed that an AIFM (already itself subject to regulation) has a long term reputational and direct economic interest (typically through the provision of management and performance fees) in the long term performance of an AIF, including one which originates loans.

IRISH FUNDS INDUSTRY ASSOCIATION

Below are our detailed responses to the series of questions, posed in the Discussion Paper. All responses and questions reference the numbering used in the Discussion Paper.

Yours sincerely

PATRICK LARDNER
Chief Executive

Question Number	Page Reference	Question
1	4	Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?

We agree there is a public good in allowing pooled investment funds to originate loans. We have seen significant deleveraging by European banks resulting in a reduction in lending, particularly in the SME sector. As banks have withdrawn from that space there is clearly room for the growth of non-bank financing for corporate entities struggling to borrow from the traditional lenders.

Effective flows of capital to enterprises across an economy serve to stimulate investment, unemployment and general economic growth.

At the same time, investors (particularly professional investors who invest in QIAIFs) are searching for alternative asset classes to invest in to enhance yield and diversify risk.

Corporations and consumers need credit and the investment fund structure allows the matching up of those who wish to invest via the debt element of the capital structure of an enterprise and those who wish to borrow.

Question Number	Page Reference	Question
2	4	What are the "shadow banking risks" raised by the relaxation of the current policy?

The relaxation of current policy in allowing an Irish regulated QIAIF to originate loans for part or all of its investment portfolio as opposed to the existing policy of allowing a QIAIF to participate in (potentially exactly the same loans) in itself does not introduce any "shadow banking risks". Although the ability to originate as opposed to participate in loans would not affect shadow banking or systemic risks, that is not to say that in aggregate QIAIFs generally could give rise to the build-up of systemic risks or a risk of disorderly functioning of markets. These risks are clearly considered and addressed under the AIFMD, where specific requirements, detailed reporting and policy tools are available to Competent Authorities and the European Systemic Risk Board, to monitor and address these risks should they deem necessary.

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 be given to the nature of the AIF, including the type of underlying assets and the amount of liquidity risk to which the AIF is exposed, the scale and complexity of the AIF or the complexity of the process to liquidate or sell assets.

Any potential build-up of systemic risks relating to those identified by the FSB and potentially relevant in this instance, as outlined in the Discussion Paper (susceptibility to runs, dependency on short term funding and avoiding bank regulation) are all more than adequately addressed by the highly regulated AIFMD framework, which a loan origination QIAIF would fall within. This is expanded upon in subsequent answers below.

Question Number	Page Reference	Question
3	4	In what way could these risks be mitigated such that loan origination by investment funds could be a viable credit channel?

Susceptibility to runs

QIAIFs that can originate loans are very likely to be of a size that will have an authorised AIFM. Such AIFM (or the QIAIF itself as an internally managed AIF) will be subject to the liquidity management provisions of the AIFMD which should address misalignment between the asset class and the redemption provisions offered to investors.

In addition, the Central Bank could require that the proposed redemption provisions for a fund that proposes to engage in loan origination are outlined in advance to the Central Bank before submission of any formal application for authorisation of the QIAIF in question.

In addition, the Central Bank could require managers of proposed QIAIFs that are to engage in loan origination to provide the Central Bank with details of their (or their personnel's) experience in the area of loan origination and as applicable, experience in the area of liquidity risk management.

Dependency on short term funding

Please see our response to question 14 below where we set out that we do not believe there should be limits as regards the use of leverage for investment purposes in QIAIFs that engage in loan origination.

In addition, as noted above, the QIAIF or its AIFM (if externally appointed) will be subject to the provisions of the AIFMD which deal with a variety of matters including leverage reporting and imposition of leverage limits.

Avoiding bank regulation

The FSB in commenting on non-banking entities were commenting on the whole spectrum of entities involved in non-bank lending which includes a large number of unregulated entities operating in the sphere.

Conversely, a QIAIF that is permitted to engage in loan origination will

(i) be regulated by the Central Bank as a collective investment scheme under the relevant Irish statutory provisions and

(ii) be an internally managed AIF or have an external AIFM, in either case subject to the provisions of the AIFMD. Accordingly it will, directly and indirectly, be subject to a significant degree of both regulation and regulatory reporting obligations which should assuage any concern that in selecting to use a QIAIF, a manager is endeavouring to avoid regulation.

Question Number	Page Reference	Question
4	4	Does the current Alternative Investment Fund Rulebook ("AIF Rulebook") provide sufficient protections for investors in the case where investment funds are allowed to originate loans?

Yes. Historically, one of the attractions of the QIF regime was its balance as a robustly regulated product which nonetheless facilitated very broad investment flexibility. The trade-off for the relative lack of mandatory product restrictions was an emphasis on detailed disclosure and on limiting investment to sophisticated investors who understood and were willing to assume the inherent risks of investing in an alternative vehicle. The advent of AIFMD and the replacement of the QIF with the QIAIF product has only accentuated that trade-off. Since a number of product restrictions have been removed or relaxed in the AIF Rulebook, it is now possible more than ever for promoters to deliver a wide range of alternative strategies into a QIAIF.

AIFMD has also increased the regulatory emphasis on the investment manager rather than the fund itself, thereby (as acknowledged in the Discussion Paper) justifying exploration of new and higher-risk strategy options. Indeed it is worth noting that the AIFMD securitisation rules for the monitoring and stress testing of an AIF's exposure to the credit risk of underlying loans clearly envisages loans to be an eligible asset class for AIFs, albeit one that should be subject to appropriate regulatory oversight. This eligibility is further supported by the inclusion in the Annex IV regulatory reporting template of loans as one of the asset classes which an AIF may hold.

Under the provisions of the AIFMD each AIF would be required to have a depositary, responsible for verifying ownership of loan positions as other assets, monitor cash flows and provide oversight over the administration of the AIF. It is likely that verification of ownership would include initial and ongoing verification. Originated loans will typically have the same documentation as with loan participation, therefore the steps around initial ownership verification required under AIFMD can largely be replicated in the same way as with loan participation.

Our view is accordingly that the trend for product flexibility should be continued by allowing loan origination without imposing any further restrictions within the AIF Rulebook, and rather that any additional comfort specific to loan origination which the Central Bank requires could be addressed during its AIFM/ investment manager pre-approval process.

The following requirements support the view that the AIF Rulebook already provides sufficient investor protection:

- the minimum subscription requirement of Euro100,000 per investor and the Qualifying Investor eligibility criteria, which limit access to only sophisticated investors. This is a key point, because as noted above, there must be a distinction drawn between the shadow banking debate raised in the Discussion Paper and alternative products authorised as QIAIFs, which are not open to retail investors and where applicants are specifically obliged to certify that they are on notice of the potential risks;

- the requirement for the prospectus to contain "sufficient information for investors to make an informed judgment of the investment proposed to them" and for the essential details to be kept up to date. The requirement for the QIAIF's legal advisers to certify compliance with the Central Bank's

requirements (including as to the adequacy of prospectus disclosure) also acts as an important control in ensuring transparency to investors. This is further bolstered by the requirement for the AIFM of the relevant QIAIF to disclose any subsequent material new information to investors; and

- the wide range of liquidity options. The Discussion Paper flags the risk associated with any mismatch between the duration of loans granted and the liquidity required to meet redemptions. However, the AIF Rulebook already offers ample scope to address such concerns without imposing any product restrictions. In this regard, a QIAIF may be established as open-ended, open-ended with limited liquidity or closed-ended, and may avail of several different liquidity management techniques if required, including redemption gates, the use of in specie redemptions, side pockets, redemption charges and soft closings. It is also worth repeating that every authorised AIFM is obliged to have a liquidity management policy in place, pursuant to which it must ensure that the liquidity of the assets of all AIFs it manages is adequate to meet the liquidity profiles of those AIFs.

A QIAIF originating loans would be expected to be of sufficient size to have an authorised AIFM or be an internally managed QIAIF.

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

- Minimum capital and resource requirements
- Rules governing the reputation and skills, knowledge and experience of the individuals in AIFM who are responsible for discharging responsibilities in the operation of a loan origination AIF
- Duty to act honestly and in best interests of investors and the integrity of the market
- Remuneration policy ensuring alignment with investor interests
- Conflicts of interest policy
- Strict risk management policies and provisions, including in relation to monitoring as well as management (Articles 44 and 45)
- Liquidity management provisions to ensure that the AIF is structured in such a way that the AIF's liquidity profile matches the liquidity of the underlying investments (Articles 46-49). There is in fact a specific requirement to ensure the alignment of investment strategy, liquidity profile and redemption policy (Article 49).
- The AIFMD Level 2 Delegated Regulations (or "AIFMR") Article 18 – requirement for AIFM to carry out due diligence on investments
- AIFMR Article 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. For example they require that:

> 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.

In addition, the prudential, organisational and operating conditions applicable to the AIFM of an AIF ensure significant protections for investors.

Each AIF needs to apply the AIFMD valuation requirements and the rules governing the appointment of an external valuer or keeping the function within the AIFM. There is a requirement for model pricing to be subject to external review.

Each AIF 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 AIF.

AIFMs must have adequate risk management systems to manage risks relevant to the AIF's investment strategy and are required to set risk limits, including in respect of credit risk and a maximum level of leverage employed for the AIF as well as the extent of the right to reuse collateral taking into account the investment strategy of the AIF, the sources of leverage, any inter linkage or relationships with other financial services institutions which could pose systemic risk, the extent to which leverage is collateralised, the asset liability ratio and the scale, nature and extent of the activity of the AIFM on the markets concerned.

AIFMs are subject to liquidity management provisions to ensure that the AIF is structured in such a way that the AIF's liquidity profile matches the liquidity of the underlying investments and is consistent with its redemption policy. In addition, AIFMs are required to monitor the liquidity profile having regard to the contribution of individual assets and the profile of the investor base and to periodically disclose any new arrangements for managing the liquidity of the AIF.

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 AIFs are subject to the requirement for audited annual financials.

In summary, we believe that the AIF Rulebook already addresses the key product requirements of transparency and restricted investor access. Instead of imposing additional (potentially arbitrary) restrictions on loan origination products within the AIF Rulebook, we believe that the better approach would be to continue the trend of product flexibility but at the same time ensure the adequacy of the relevant AIFM's/ investment manager's credentials during its Central Bank pre-approval process.

Question Number	Page Reference	Question
5	8-10	Respondents are asked with they agree with the analysis of the funding gap?

The evidence appears overwhelming that a significant funding gap has developed in Europe because of the deleveraging of banks' activity and the over reliance on this form of finance.

As elaborated upon in our responses to other questions raised in the Discussion Paper, the IFIA feels that Irish QIAIFs are well positioned to provide alternative financing in a solid and transparent framework and can go part of the way to reduce the funding gap.

Question Number	Page Reference	Question
6	11	Do respondents agree loan origination funds would fall squarely into the first and second of the FSB defined economic functions if open-ended and even if structured so as not to do so, could still be argued to fall under function five?

These concerns are addressed by several of the specific requirements applicable to AIFs under the AIFMD.

As noted in the answer to question 3, we do not believe that originating loans itself brings with it the risks outlined by the FSB. However, any risk of a run would be mitigated by the requirements of liquidity management which the AIFMD details. These liquidity management (including stress testing) provisions are well documented and as we outline in the response to question 3 the Central Bank could require loan origination funds to outline in advance their proposed redemption provisions in advance of authorisation.

Similarly dependency on short term funding and any associated risks are not of themselves caused by originating loans. Loan provision would for the most part (if not all) be dependent on investment by investors and not short-term funding. If there is leverage or short-term funding employed, any risks associated would be captured and addressed by the risk provisions of AIFMD, which include among other matters requirements for leverage reporting, an imposition of leverage limits and other risk management provisions.

Again as outlined in the response to question 3 a QIAIF authorised and regulated by the Central Bank, with an AIFM subject to the provisions of the AIFMD is not a structure which attempts to avoid regulations.

Question Number	Page Reference	Question
7	21-24	Respondents are asked whether they agree with the main risks with loan origination identified in Section 5 and whether there are other risks? [Concentration Risk , Illiquidity risk , Risk of investor runs, Leverage , Money Creation , Dominant lenders , Misalignment with investor risk appetite or investor capability , Mispricing of credit]

It is generally agreed that these risks are relevant. However, with the exception of money creation these risks appear to be essentially similar to risks borne by existing AIFs, particularly where they are focussed on shallow and illiquid markets.

Question Number	Page Reference	Question
8	16-17	Respondents are asked for their views on the analysis of the differences between loan origination and loan participation and the resulting risks which arise?

We agree that loan syndication/ participation and loan origination are two distinct activities. However, it is queried whether evidence from financial markets, in particular since the financial crisis of 2008, supports the notion that loan participation is less risky or less subject to mispricing than origination.

We also broadly agree that loan origination has the potential to involve the risks highlighted in the Discussion Paper. However, we believe that those risks stem from a common theme which could be negated through a sufficiently robust analysis of the AIFM/investment manager during its Central Bank approval process.

i. In particular, we agree that the requirement for a syndicated loan to have commercial appeal to multiple lenders as opposed to a single lender does impose a market discipline by dictating that such loans must have credible terms and prices. However, the fact that a bilateral loan does not have this inherent market discipline does not therefore automatically mean that further regulatory overlay is justified for loan origination AIFs. Not only is there a regulatory obligation for every AIFM to act in the best interests of investors and to perform a high level of due diligence in the selection and on-going monitoring of its investments, but ultimately every AIFM is subject to the discipline of its investors' judgment of its performance. In other words, irrespective of any mooted regulatory overlay, any AIFM of a loan origination QIAIF will already be motivated to carry out appropriate due diligence to enter into the most secure bilateral loans on the best possible terms so as to maximise the performance of that QIAIF, because failure to do so will prompt investors to vote with their feet.

   A QIAIF has long been permitted to engage in bilateral transactions in a wide range of assets which are not regularly traded or valued, without the need for any additional regulatory constraints. So in our view, the fact that bilateral loan origination does not have the same market-imposed discipline

as loan syndication does not on its own mean that by extension, loan origination requires additional regulatory scrutiny.

ii. We also agree with the Discussion Paper's analysis that the best practitioners in the loan origination market boast specialist skills, carry out extensive due diligence/ screening and detailed negotiation of contractual terms, leading to a very in-depth investment process, and that this standard of investment process should be upheld in any loan origination AIFs. Accordingly we propose that, as has historically been the case for other specialist asset classes such as real estate and venture capital, the proposed AIFM/ investment manager of a loan origination AIF should be subject to such additional due diligence as the Central Bank believes necessary in order to demonstrate that it has sufficient expertise, experience and resources to operate effectively in this asset class.

The key overall point however is that once an AIFM has satisfied the Central Bank of its loan origination credentials, there should be no arbitrary product restrictions. We strongly support the AIFMD trend of heightened scrutiny of AIFMs in exchange for greater product flexibility of AIFs.

Question Number	Page Reference	Question
9	23-24	How should a loan diversification requirement be structured so that it comes into force over the life-time of the investment fund?

While diversification is a sensible measure in terms of mitigating risks, any limits should be agreed and set by the independent Risk function of the AIFM and the Manager and disclosed in the prospectus. Hard-coded diversification limits established externally and without regard to the AIFs investment objectives would be counter-productive and inhibit the successful management of such funds.

There is no obligation for AIFs to observe a specific diversification requirement at present and therefore it is not anticipated that one should apply in respect of AIFs using this asset class.

It can be noted that the Central Bank currently offers a potential derogation in respect of its risk spreading requirements during the first year of a fund's operations where appropriate and this may also be appropriate in the context of loan origination funds.

The obligation to ensure appropriate diversification is essentially addressed at present within the general requirement on AIFMs to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed. It is not anticipated that more onerous obligations would be appropriate for loan originating funds.

The Discussion Paper refers to diversification as a means of reducing investor risk, which has been one of the key investor protection pillars within UCITS. While that may be the case, AIFs are only marketed to professional investors and there are already significant other investor protections in place for AIFs as outlined in response 4 above and as noted in the Discussion Paper.

Question Number	Page Reference	Question
10	23-24	How is a geographic diversification requirement best addressed within the requirements?

There is no obligation for AIFs to observe a geographical diversification requirement at present and therefore it is not anticipated that one should apply in respect of AIFs using this asset class.

The obligation to ensure appropriate diversification is essentially addressed at present within the general requirement on AIFMs to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

It can be noted that the AIFMD requires the AIFM to have appropriate professional expertise and knowledge of the assets in which AIFs are invested and to employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them. Accordingly imposing a mandatory geographical diversification requirement would appear to impose an extremely onerous and potentially disproportionate cost on AIFMs if they were to be forced to increase staff to meet this requirement.

This would also be consistent with the approach to other AIF asset classes, such as property and private equity.

Question Number	Page Reference	Question
11	24-25	Respondents are asked for their views on the types of loans originated and their term?

Placing reliance on the obligations of the AIFM to ensure that the risk and liquidity profile of the underlying investments reflects that of the AIF, as is currently the case with all portfolio investments, would appear preferable and more appropriate rather than seeking to impose absolute restrictions on this investment category via rules regarding the types of loan that might be offered or their terms.

The driver should be investor demand and the Manager’s skill and expertise in selecting loan opportunities. The fund prospectus is required to make the appropriate disclosures about the investment objectives and the fund would need to comply with the risk framework under AIFMD.

In particular, any proposed limitation of loan type to senior secured debt would appear inappropriate given that loans generally would rank in an insolvency ahead of equity investments, which are unrestricted.

One exception to this might be non-recourse loans, but, again, it would be reasonable to expect the risk policy of the AIFM to prohibit these.

Question Number	Page Reference	Question
12	25-26	Respondents are asked whether they agree that it appears difficult to make a case for anything other than such investment funds being closed-ended?

The IFIA contends that whilst it is understandable to have the view that such funds would typically be closed ended the facility to have limited liquidity open ended funds should exist too.

While use of a closed-ended fund would reduce certain of the liquidity risks associated with loan origination funds, this is an onerous and restrictive obligation. Closed ended funds may not be as attractive a proposition from the investor perspective due to the inherent requirement for capital to be tied up and the potential lack of any secondary market which investors could realise their units upon.

Given the obligations under the AIFMD for AIFMs to employ an appropriate liquidity management policy this issue would appear to already be addressed.

The question appears to contemplate funds being 100% invested in loans, but the more likely scenario, particularly given the requirements regarding liquidity management which are already applicable, is that these would only comprise an element of the portfolio.

We note that the recently proposed European Long Term Investment Funds ("ELTIF") makes a strong argument to be closed ended in that the investments in this structure will be long term in nature and their illiquidity could make it difficult to meet redemption requests before an asset meets its expected maturity or that any need to maintain liquid assets would divert attention away from the primary purpose to invest in long term assets. This fund will however be made available to retail investors and therefore to have a closed ended structure makes sense.

Investors in QIAIFs are sophisticated and therefore aware of the risks associated with the investment strategy for loan origination funds. They are comfortable with structures that allow for limited redemptions and may not wish to subscribe to a closed ended vehicle. Managers of loan origination funds will have to meet the demand of these investors.

Question Number	Page Reference	Question
13	26	There may be other legitimate purposes, outside of the investment strategy, for which limited leverage might be usefully allowed. What would these be?

We do not believe there should be leverage limits for investment purposes imposed on QIAIF funds that pursued loan origination as an investment policy. Please see our response to Question 14 for further detail.

In any event, there are a number of non-investment related purposes for which leverage should also be permitted. They include the following:

- Funding redemption requests;
- Funding the purchase of assets pending the drawdown of capital commitments;

- Meeting fees, costs and expenses, particularly, without limitation, as regards investigating new lending opportunities; and
- Funding payment obligations under any derivative or EPM obligations.

Question Number	Page Reference	Question
14	26	Respondents are invited to offer views as to what the appropriate leverage restrictions would be?

We do not believe it necessary or beneficial to impose restrictions on leverage in excess of the existing AIFMD requirements.

Loan Origination Funds would be regulated under the AIFMD framework and marketed to professional investors not depositors. The concept of investor capital being at risk is well established in this investor class and the entities from whom the funds would borrow are typically large global prime brokers or custodians and are of sufficient scale and expertise to be able to monitor collateral and exposure risks.

AIFMs are subject to a requirement that they demonstrate that the leverage limits for each AIF it manages are reasonable and are complied with at all times. AIFMD requires the AIFM of an AIF to set maximum leverage limits which may be employed by the AIF as well as the extent and of the right to reuse collateral, to calculate exposure, have appropriate risk management systems and set risk limits and regularly disclose the amount of leverage employed.

The competent authorities of the home Member State of the AIFM are able to impose limits to the level of leverage where financial stability risks are identified. There are reporting requirements for highly leveraged AIFs. It is submitted that a similar approach would be appropriate in this regard also. These requirements should be sufficient to mitigate potential financial stability issues and to protect investors.

As noted by the FSB in its consultation paper, the policy tools that may be adopted, such as leverage limits, should take into account the adequacy of the existing regulatory framework as well as the costs and benefits of applying the tool.

In the event that “money creation” is deemed to be a systemic risk, there are already provisions in the AIFMD which allow for direct intervention on the amount of leverage an AIF can employ. For example, recital 133 of the Level 2 regulations states: “Competent authorities should make appropriate use of the information they receive and should impose limits to leverage employed by an AIFM or other restrictions on the management of the AIF with respect to the AIFs managed where they deem this necessary in order to ensure the stability and integrity of the financial system.”

We feel the emphasis should be on transparency of disclosures surrounding the investment objectives within the fund documentation and the expertise and skill deployed to assess the credit risk of the loans. It would be inappropriate and misleading to investors to suggest that an unleveraged portfolio is fundamentally safe when the real risk is the creditworthiness of the borrower and quality of assets lent against.

Question Number	Page Reference	Question
15	27	Respondents are invited to offer views as to the appropriateness of a capital / co-investment requirement

We do not believe that there should be any capital/co-investment requirement for managers of QIAIFs that originate loans.

It can be noted that under the AIFMD, AIFMs are already now obliged to ensure that their remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage. In addition it must be in line with the business strategy, objectives, values and interests of the AIFM and the AIFs it manages or the investors of such AIFs, and include measures to avoid conflicts of interest. Variable remuneration is subject to additional specific requirements, designed to align incentives with the interests of the AIFM and the AIFs it manages and the investors of such AIFs. It is submitted that these requirements, which are deemed sufficient in the context of AIFs in general would also be appropriate and sufficient in the context of loan origination funds and no further more onerous obligations should be added.

There are a variety of different assets classes, particularly private equity and property, where investors are relying on the specialist expertise of the manager to not only select assets but to manage the underlying assets on an on-going basis, where there is no regulatory obligation on the manager to co-invest.

The proposal around co-investment does not take account of the fact that an investment manager (or AIFM) has a long term reputational and economic interest (through management and performance fees) in the performance of a loan origination fund.

Furthermore, there will be occasions when co-investment by the manager in the QIAIF may not be permitted due to other external regulatory requirements, for example application of the Volcker Rule for certain managers.

To mandate co-investment by the manager, suggests that there is insufficient regulatory incentive and obligation on the manager to act in the best interests of its clients, which is not the case.

Finally AIFMs are subject to the requirement to adopt an appropriate conflict of interest policy which should also mitigate any potential misalignment of the interests of investors and management.

Question Number	Page Reference	Question
16	27-31	Views are invited on what the appropriate hard-wired constraints might be.

It is submitted that it would be inappropriate to apply hard-wired constraints which differ from those applicable to other types of funds. Imposing principle based generic obligations, such as obligations around risk and liquidity management, which as noted above are already applicable under the AIFMD, ensures that funds are subject to the general requirements which are adaptable to any situation.

Question Number	Page Reference	Question
17	21-31	Respondents are asked whether they agree with the analysis of the main risks and mitigants for loan origination investment funds? Are there others?

The risks identified are noted.

It is submitted that the primary risks identified are also applicable to existing funds, especially those investing in shallow or illiquid markets, albeit possibly for slightly different reasons and to a greater or lesser extent in each case. For example, concentration risk, illiquidity, substantial redemptions and leverage are all risks commonly cited in relation to funds generally.

The only exception to this is that of "money creation". It is submitted that this is largely a theoretical risk as the volume of loans which would have to be created by funds to have any significance (as evident from the graphs on page 7 of the CP) is immense. Furthermore as previously stated, there are already provisions in the AIFMD which allow for direct intervention on the amount of leverage an AIF can employ.

The risks created by "dominant lenders" and "mispricing of credit" are essentially the same as those which existing funds focussed on specific areas can become exposed to. It is submitted that the requirements applicable under the AIFMD in relation to risk have been designed in a generic manner to ensure that AIFMs are structured to meet these risks as appropriate in the specific cases where they arise.

In the section of misalignment with investor appetite or investor capability we do not believe it is correct to state that loan funds do not pay cashflows on a regular basis during the early life of the fund, particularly where the loans originated are senior secured loans.

With regard to the mispricing of credit, as with other risks discussed in the paper this is a risk which is not unique to loan origination but the where the skill and experience of the AIFM is crucial.

We do not see why the Bank would need additional powers to appoint administrators to insolvent loan origination funds as, once a loan has been originated or acquired, the credit risk is the same.

Question Number	Page Reference	Question
18	25-26	Respondents are asked if they agree that closed-ended investment funds with limited leverage mitigate many of the financial stability risks?

The use of closed-ended investment funds with limited leverage would mitigate many of the financial stability risks.

However, for the reasons noted above, these risks can also be mitigated within the context of open-ended funds and limited liquidity funds. Many of these risks are also present to a greater or lesser extent in relation to existing open-ended and limited liquidity funds and the AIFMD imposes a range of requirements to limit the risks in this regard.

AIFMs are already subject to a requirement that they demonstrate that the leverage limits for each AIF it manages are reasonable and are complied with at all times. The competent authorities of the home

Member State of the AIFM are able to impose limits to the level of leverage where financial stability risks are identified.

Additionally, providing for hard-coded limits regarding the types of loans that can be originated would not necessary change the risk profile of the fund. For example, a senior secured loan made to party A is not necessarily a safer investment than a mezzanine loan made to party B. There are a variety of other factors that would need to be taken into account in any such analysis and ultimately these are not inherently different from the factors that would be taken into account if a fund was to acquire either or both loans on the secondary market or to acquire debt securities issued by either party.

Furthermore, regarding the specific hard-coded limits proposed in the Discussion Paper:

- Excluding lending to investment funds and financial institutions or related entities could significantly limit the ability to lend into the real estate sector as often entities of this type are large owners of real estate. Any such restriction would need to take this into account.

- Excluding lending to persons which intend to acquire equities may limit the ability to engage in acquisitions. As a QIAIF could acquire the underlying equities there does not seem to be a reason to preclude lending to a party which intends to do so.

- Insisting on a 70% LTV ratio could also significantly limit the ability to originate loans, particularly loans to industrial entities whose assets and cash-flows are less susceptible to independent valuation. In addition, there are no such limits for loans acquired in the secondary market which ultimately carry the same credit risk.

- We understand that insisting on a fully amortised basis would not be in line with market practice where few bank loans are fully amortised particularly as loans are often structured with bullet repayments.

- We would need further clarity as regards proposals for provisioning as investments in a fund would be marked-to-market (which would reflect likely losses).

Closed ended funds may not be as attractive a proposition from the investor perspective due to the requirement for capital to be tied up and the potential lack of any secondary market which investors could realise their shares upon.

Furthermore, limits on leverage which do not apply to other funds would tend to reduce the comparative potential return available to such fund. Limits on leverage would also limit the potential to achieve diversification within the portfolio as such a restriction would inevitably reduce the size of the portfolio as a whole.

Therefore any such restrictions would limit the potential to achieve the “public good” inherent in providing for loan origination funds, identified in 1 above, of permitting investors access to a broader spectrum of investment opportunities which hitherto were largely confined to the banking sector.

Imposing a requirement for loan origination funds to be closed ended and for leverage to be limited in a manner which does not apply to other existing categories of funds would therefore appear to be a disproportionate and inappropriate response.

Ends.