July 2013

Central Bank Consults on Loan Originating Funds

As envisaged during its consultation on the implementation of the Alternative Investment Fund Managers Directive ("**AIFMD**"), the Central Bank of Ireland ("**Central Bank**") has issued a detailed discussion paper seeking industry comment on the possibility of allowing Irish domiciled non-UCITS funds engage in direct loan origination (the "**Discussion Paper**").

Many client asset managers, particularly US and UK managers, have regularly expressed interest in setting up funds which can engage in direct lending to commercial enterprises, having recognized that many such enterprises have found it difficult to access lending facilities since the onset of the global financial crisis.

Although Irish funds have for many years been able to invest in loan assignments and loan participations, the Central Bank has not to date permitted Irish funds to originate loans (i.e. for lending to form part of its investment strategy). In its Discussion Paper, the Central Bank has indicated that it is reviewing this position and is considering allowing Irish Qualifying Investor AIFs ("**QIAIFs**") to be authorised to engage in loan origination as part of their investment strategy.

This is a keenly awaited development and it is important for industry participants interested in this area to contribute to the debate.

The Discussion Paper notes that it has been issued following international debate surrounding "shadow banking" and the role that non-bank entities might play in providing funding to the international and European economies. This topic has come into focus as, in the aftermath of the financial crisis, banks are being required to deleverage and to increase capital, thereby reducing their appetite

For further information on any of the issues discussed in this article please contact:

Brian Higgins
DD:+ 353 (0)1 673 1891
brian.higgins@dilloneustace.ie

Brian Kelliher
DD:+ 353 (0)1 673 1721
brian.kelliher@dilloneustace.ie

and capacity to supply credit to the real economy at a competitive cost. This issue was raised at the G20 Summit in Seoul in November 2010 (following which the Financial Stability Board has been considering the matter) and in a recent European Commission Paper on Long-Term Financing of the European Economy. In fact, the issue is particularly important in Europe as, according to ECB president Mario Draghi quoted in the Discussion Paper "*…in the United States 80% of credit intermediation goes via the capital markets. In the European situation it is the other way around. 80% of financial intermediation goes through the banking system.*". The EU Commissioner for internal markets, Michel Barnier, has also indicated that alternative sources of finance need to be found for the European economy with the caveat that such alternative sources need to operate within a solid and transparent framework.

The fact that the European Commission recently issued proposals for EU Long-Term Investment Funds ("ELTIF") and introduced Regulations concerning European Venture Capital Funds ("EuVECA") and the European Social Entrepreneurship Funds ("EUSEF") would however suggest that the Commission is satisfied that such a transparent framework is already provided for under AIFMD.

The Central Bank has set out a number of matters whichit feels warrant further consideration from a regulatory perspective. These include whether loan originating funds would:

- be susceptible to investor runs (which may be intensified if the fund is leveraged);
- be dependent upon short-term funding (this could occur if the fund seeks to provide a high level of liquidity to its investors which may give rise to a mismatch between the fund's liquidity and the maturity of its assets);
- require different skills, expertise and administrative requirements than those required for the operation of funds which simply acquire a portfolio of loan participations; and
- could give rise to a risk of concentration of loans in certain industry sectors.

However, the Central Bank has also outlined a number of regulatory measures which may mitigate such risks including:

- some form of diversification requirements (such as a maximum percentage of asset exposure to a single borrower);
- limits on the types of loans which may be granted (asking, for example, whether it should be possible to grant unsecured loans?)
- limiting loan origination funds to closed-end structures (in order to avoid the liquidity mismatch outlined above) or at least requiring them to have robust redemption management tools in times of market stress (such as significant gates and redemption fees);

- imposing leverage limits (although the Central Bank acknowledges that such limits would differ depending on the type of loans which a fund intended to originate);
- imposing a "skin in the game" requirement to ensure that incentives between the investment manager and investors are aligned;
- requiring investment managers of such funds to demonstrate that they have sufficient expertise in this are (including sound credit assessment and monitoring policies in place);
- loan origination funds to have certain operating policies and procedures in place (including credit; collateral valuation; impairment and problem debt policies).

A copy of the Central Bank's Discussion paper can be found on the Central Bank's website. The Central Bank is accepting responses to the questions it has raised its Discussion Paper until 13 September 2013.

Dillon Eustace
July 23, 2013

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

Hong Kong
604 6F Printing House, 6 Duddell Street, Central, Hong Kong. Tel: +852 352 10352.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.