July 2014

Loan Origination QIAIFs - Central Bank Consults

As interested readers may recollect, in mid-2013 the Central Bank of Ireland ("**Central Bank**") issued a Discussion Paper in relation to loan origination by Irish domiciled regulated alternative investment funds. Context for that Discussion Paper included the evident appetite for launching direct loan origination products on the part of credit managers as well as the apparent need for alternative credit sources for commercial enterprises in an environment where the bank lending had been significantly curtailed.

On July 28, 2014 the Central Bank issued a Consultation Paper (CP 85) indicating its intention to allow the establishment of Irish domiciled qualifying investor alternative investment funds ("**QIAIFs**") which can engage in direct loan origination. Alongside the Consultation Paper sits a proposed new Chapter to the Central Bank's AIF Rulebook to provide for such loan originating QIAIFs.

In order to mitigate the risks which the Central Bank considers apply to loan origination funds (the risk of regulatory arbitrage; the risk of runs; contagion risk with the banking sector; and the risk of excessive credit growth and pro-cyclicality) it proposes to impose quite a number of restrictions or constraints on such QIAIFs. The Consultation Paper provides some background to the main elements of its proposed new regime and requests input into the shaping of that regime by no later than August 25, 2014. We recommend that interested parties take the time to participate in the consultation process.

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Some Additional Background

Loan funds are not new to the Irish environment but, to date, have only been able to acquire loans or participations in the secondary market as there has been a general prohibition on Irish regulated funds originating loans. That is what is now set to change.

Responses to the Central Bank's original mid-2013 Discussion Paper were required by mid-September 2013 and the 14 responses received are now available on the Consultations page of the Central Bank website. It may be of assistance to interested parties to review those responses prior to responding to this Consultation as that may avoid unnecessarily going over old ground.

It should also be borne in mind that to allow loan originating funds within a regulated structure is quite a significant step for the Central Bank and we can understand a somewhat cautious approach in that context. Also of note is that, in addition to the responses to the prior Discussion Paper, the Central Bank sought views of various other bodies, including the views of the European Systemic Risk Board (ESRB), before releasing this Consultation Paper.

In that regard, at its meeting on March 20 this year, the ESRB General Board approved the following response to a public consultation by the Central Bank of Ireland entitled 'Loan Origination by Investment Funds':

> *While still limited at this juncture, loan origination by investment funds could be a valuable source of financial intermediation and thereby contribute to a welcome diversification of funding for the real economy. Nonetheless, if not subject to adequate macro- and micro-prudential regulation, this activity could grow rapidly and introduce new sources of financial stability risk. It was noted that this activity could increase regulatory arbitrage opportunities between the banking and non-banking lending sector. It could also raise the financial system's vulnerability to runs, contagion, excessive credit growth and pro-cyclicality. Authorities should have adequate tools to monitor and mitigate these risks before providing support to this activity. ESRB members noted also the need to ensure appropriate levels of consumer protection if investment funds that originate loans were to be offered to retail investors. Without prejudice of a further analysis of potential systemic risks arising from loan origination by investments funds, the ESRB response provides a broad outline for developing potential macro-prudential measures to mitigate these risks, beyond those already available in the current EU legislation (Alternative Investment Fund Managers Directive).*

Clearly, this may influence the Central Bank's willingness or otherwise to accept material change to its proposals.

Readers must also note that the Central Bank intends to impose significant rules and obligations on the QIAIF itself (not on the AIFM). It is principally the QIAIF which will have to comply with the new requirements and put in place new procedures, oversight arrangements, disclosures and contractual protections.

Key Features

Key features of the Central Bank's proposal to allow loan originating QIAIFs include:

(i) QIAIFs with authorised AIFM

Loan originating funds will only be permitted under the QIAIF regime and will require an authorised AIFM. It will not be possible to avail of the registered QIAIF option.

The QIAIF may be the authorised AIFM itself (as an internally managed vehicle) and may appoint an external credit/portfolio manager or the QIAIF may appoint an external AIFM which either itself carries on the credit management process or alternatively appoints a credit/portfolio manager to do so.

(ii) Legal Structure

Given the activity of lending, given the sole activity requirement given the imposition of new regulatory requirements on the QIAIF itself, it seems clear that only QIAIF type investment companies (and not unit trusts, CCFs or ILPs) will be suitable for establishment as loan originating funds.

(iii) Sole Activity

A loan originating QIAIF must restrict its activity to the issuance of loans. It will not be able to engage in other forms of commercial activity nor will it be able to pursue any other or even a hybrid investment strategy. Loan origination must be its sole activity. It may, however, be possible to have a loan originating QIAIF as one dedicated sub-fund of a QIAIF umbrella which has other non-loan originating sub-funds.

(iv) Prohibited Loans

Loans cannot be originated to natural persons; to certain related parties (the AIFM, management company, GP, depositary or to delegates or group companies of these); to other funds; to financial institutions or to their related companies (save in limited circumstances); nor to persons intending to invest in equities or other traded investments or commodities.

In addition, a loan originating QIAIF will not be permitted to acquire a loan from a credit institution under arrangements which involve:

- retention by the credit institution or a member of its group of an exposure correlated with the performance of the loan;

- the provision of an administration, credit assessment or credit monitoring service in relation to the loan whether on an individual or portfolio basis by the credit institution or a member of its group,

unless the QIAIF is satisfied that the credit institution has in place and implements particular policies and procedures (including as to valuation, performance, monitoring, stress testing, etc.) and retains a material net economic interest of at least 5% of the nominal value of the loan as measured at origination (i.e. skin in the game).

Loan originating QIAIFs will also be subject to the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises when lending to Irish SMEs.

(v) Portfolio Diversification

Loan originating QIAIFs are to be subject to portfolio diversification rules, unlike other types of QIAIF. Such a fund will need to specify in its prospectus that it will achieve a portfolio of loans which is diversified and must state that it will limit exposure to any one issuer or group <u>to 25% of net assets within a specified time frame</u>. To the extent that there is a failure to achieve that strategy within the set timeframe, the QIAIF will need to go back to its investors and seek approval to continue with the level of diversification actually achieved. In the event that the investors do not approve the proposal, the QIAIF must terminate. There should be no intentional breach of the risk diversification strategy.

We view this diversification rule as unnecessary. Portfolio level diversification is generally seen as an investor protection mechanism but is not required for QIAIFs – portfolio diversification has been required for retail targeted products only.

Loan originating QIAIFs are designed for sophisticated professional investors who, we think it reasonable to assume, can determine what level of concentration risk they want to accept. No such portfolio diversification rules apply to private equity funds, to real estate funds or to any other QIAIF product and the requirement to maintain such diversification could, in certain expected scenarios such as early repayment cases, require the QIAIF to either retain cash, re-lend even if not most opportune to do so or seek investor approval. This seems to build inflexibility into the structure as may the application of diversification limits at any time other than the time of investment. If it remains the intention to apply the limit <u>at all times</u> that will not really be practical in our view.

(vi) Leverage

Leverage is limited to 200% - any indebtedness by the loan originating QIAIF must have a total asset coverage of at least 200%, but there seems a capacity for other limits to apply (these could of course be higher or lower and may be for a particular fund or for a class of loan originating QIAIF).

The Central Bank explains that the ratio of 1:1 (for example, an AIF with assets of 100 may borrow 100) means that should the value of the assets decline, the leverage level must also be reduced and, accordingly, leverage must be managed to ensure compliance with the leverage limit in changing market conditions. Breaches of leverage limits require Central Bank approval for a formal plan to bring the fund back into compliance with the leverage ratio and the Central Bank retains the ability to tighten the lending standards, including in cases where this is deemed necessary for financial stability and macro prudential purposes.

Similar to the portfolio diversification requirement, this throws up the issue as to when does the limit apply? Historically limits applied only at the point in time at which, for example, investment was made or leverage incurred. However, the Central Bank changed that position as part of AIFMD so that the borrowing limit may apply <u>at all times</u> and not simply at point of borrowing. That needs to be clarified as it could create difficulties when dealing with leverage. Other questions remain, including as to how to calculate leverage and what to include in the asset calculation when, for example, dealing with undrawn commitments from investors.

(vii) Liquidity and Distributions

In the context of concerns regarding runs, the Central Bank proposes that loan originating QIAIFs:

- be closed-ended and established for a finite period. The QIAIF however may have discretion to invite at dates determined at the authorisation date and without commitment and on a non-preferred basis request for redemption of holdings from unitholders;

- only make distributions or provide for redemptions during its life to the extent that there is unencumbered cash or liquid assets available for distribution or redemption purpose and such distribution redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating QAIF.

We agree that loan originating QIAIFs should normally be closed-ended in order to avoid a liquidity mismatching. However, when a QIAIF has reached a size/level of diversification which may allow for periodic liquidity rights exercisable by investors, that should be permissible.

We understand that the concern on the part of the Central Bank is to ensure equitable treatment as between investors and that where distributions are being made to all investors *pro rata* or where redemptions are being effected for all investors *pro rata*, the Central Bank's concerns should be addressed.

(viii) Credit Granting, Monitoring and Management

A party wishing to establish loan originating QIAIFs needs to appreciate that the Central Bank proposes that the QIAIF itself must establish and implement a variety of documented and regularly updated procedures, policies and process in respect of a variety of credit granting, monitoring and management activities, including:

- the setting of a risk appetite statement;
- the assessment, pricing and granting of credit as well as the monitoring of credit and its renewal and refinancing (including in both cases criteria, governance and decision making and committee structures);
- collateral management policies;
- concentration risk management policy;
- valuation, including collateral valuation and impairment;
- credit monitoring;
- identification of problem debt management;
- forbearance;
- delegated authority;
- documentation and security.

The draft new Chapter to the AIF Rulebook sets out a variety of additional controls and restrictions around the credit granting, renewal and refinancing processes; the credit risk assessment process; and processes for value adjustments and provisions (including the requirement for effective systems) and adequacy of credit position diversification.

(ix) Due Diligence by Investors

Where an AIFM intends to provide access to its records/staff to an investor for the purposes of the investor carrying out due diligence on the AIFM, the AIFM must ensure that such access is made available on a non-discriminatory basis to all investors and not be structured so to materially mis-represent the business of the loan originating QIF. The Central Bank has made very broad statements in this regard which may need to be revisited. In particular it states "*the AIFM shall not intentionally or negligently conceal or fail to disclose information that a reasonable person would be likely to have considered important in considering an investment in the loan originating QIAIF.*" We take it that the AIFM will seek to impose this contractually on credit managers it may engage.

The explanation given by the Central Bank regarding this due diligence requirement (relating to due diligence by investors on the management of a loan originating QIAIF) is in our view somewhat unclear, both as to objective and requirement. The Central Bank is not setting out what due diligence may be required, nor is it requiring that due diligence access be provided at all.

What it says in its consultation paper is that "*it merely requires that where provided a non-discriminatory outcome for all investors is achieved*". The way in which it has emphasized its requirement suggests a potential look back scenario which is not consistent with the general idea of the investment contract.

The Central Bank highlights in its concentration "*the proposed rule requires that there will have been non-discriminatory access for investors – it does not require that all potential investors who approach the AIF expressing an interest in investing will be given the same access*". The purpose behind providing information pre-contract is to enable a prospective investor determine whether or not he/she wishes to invest. The idea that the information could be required to be provided after the person has invested does not appear to be correct. We see problems arising with closed-ended funds which offer commitment opportunities over, for example, first, second and final closings where not only the commitment to invest but also perhaps an initial drawdown may have been made of investors at the first closing but where, potentially, the provision of due diligence information to an investor at the final closing may trigger a requirement to go back and provide the same information to the investors who subscribed to the first closing. The Central Bank seems to suggest that, if that was not possible or if it made a material difference to the original investor's decision making, then that investor may be able to get out. We do not consider that practical.

(x) Stress Testing

A loan originating QIAIF must have a comprehensive stress testing programme which includes a variety of specific requirements including a programme which identifies possible events or future changes in economic conditions that could have unfavourable effects on the fund's credit exposures. It also requires an assessment of the fund's ability to withstand such changes.

Transactions and aggregate exposures across all forms of counterparty credit risk at the level of specific counterparties must be comprehensively captured in a sufficient timeframe to conduct the regular stress testing, with a minimum monthly frequency for exposure stress testing of principal market risk factors such as interest rate, FX and credit spreads for all counterparties.

The Central Bank also imposes at least quarterly multi-factor stress testing requirements and minimum scenarios which must be addressed. It also imposes a requirement for reporting at least on a quarterly basis to senior management of the results of the stress testing under the programme. The Central Bank has also indicated that, in addition, it intends to put in place similar reporting on individual loans as is provided by the banking sector and that its requirements in that regard will evolve with developments in banking.

(xi) Disclosure to Investors

Certain minimum information must be included in the QIAIF's prospectus, including information on risk and reward profile, on levels of concentration, geographical location and sectors as well as risks arising from the proposed concentration. Details of the credit assessment monitoring process and information on whether the AIFM would provide investors with access to records and staff for the purpose of a due diligence process (albeit that it may need to do so from a contractual perspective with the underlying credit portfolio manager records) must be disclosed.

It requires a prominent risk warning and that the capacity on the part of the Central Bank to tighten lending standards and leveraged limits be expressly drawn to the attention of investors in the prospectus and all sales materials (and the impact that may have on the QIAIF in following its investment strategy). It also requires a risk warning drawing attention to the potential implications from the application of the Central Bank's Code of Conduct for business lending to SMEs (where loans are issued to SMEs operating within Ireland). It is also imposing requirements as to the minimum content of periodic reports including, for example, the breakdown of the originated loans between senior secure debt, junior debt and mezzanine debt etc.

Conclusion

There is plenty to debate within these proposals. Interested parties need to respond promptly and in some detail with justification for their approach.

Please feel free to share your thoughts with us as we intend to submit a response to this Consultation.

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29 July, 2014

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