Central Bank publishes Discussion Paper on Loan Origination by Investment Funds in Ireland

The Central Bank of Ireland (the Central Bank) has published a discussion paper in relation to loan origination by Irish investment funds. This paper follows an information gathering process conducted by the Central Bank which included discussions with other regulators, industry representative bodies, fund service providers and investment managers engaged in loan origination and participation in loan syndications.

UCITS investment funds are prohibited from engaging in loan origination as an investment strategy and, until now, the Central Bank has adopted the same approach in relation to non-UCITS investment funds. Noting that the Alternative Investment Fund Managers Directive (AIFMD) does not prohibit an alternative investment fund (AIF) marketed by an AIFMD-compliant alternative investment fund manager (AIFM) from engaging in loan origination, the Central Bank has indicated its willingness to consider higher risk profile options for Irish authorised AIFs and that loan origination may be one such investment strategy.

The discussion paper considers why non-UCITS have been prohibited from loan origination to date and whether the balance of public interest is best served by continuing this prohibition and the extent to which this activity could raise shadow banking concerns. In considering these issues the discussion paper acknowledges the body of empirical evidence which suggests that the development of non-bank sources of credit may assist in the evolution of the European economy at a time when the need for alternative funding options has been brought into focus following the global financial crisis. The Central Bank notes that while loan origination by investment funds would be captured by the FSB definition of shadow banking, it recognises that non-bank credit intermediation, appropriately conducted, provides a valuable alternative to bank funding and one that supports real economic activity.

The discussion paper identifies risks which the Central Bank anticipates may arise in the context in an investment fund originating loans, which include:

1. Concentration risk, including where funds may be exposed to a certain sector or collection of borrowers with similar economic characteristics, where a portfolio contains few loans or where a portfolio may be dominated by a small number of positions on account of the time taken to build the portfolio;
2. Private lending is intrinsically illiquid;
3. Vulnerability of investment funds to investor runs where there is a mismatch between liquidity and maturity of assets and liabilities;
4. Risks associated with leverage including the encumbrance of the loan portfolio or rights which might be conferred on lenders in respect of the portfolio;
5. Risk of information asymmetry when investors own an investment fund for long periods in the absence of specific new information on the performance of the investment fund; and
6. Risk of the mispricing of credit due to the lack of incentive alignment where the loan pricing is provided by the investment manager or an external specialist on the basis of transactional fees which may not be affected by the performance of the loans.

In order to mitigate these risks Central Bank has identified a list of possible measures, including:

1. Diversification requirements, either in the form of a minimum number of loans or a maximum percentage of assets exposed to a single borrower;
2. Limits on the types of loans which may be originated, including the extent to which funds should be permitted to engage in mezzanine/unsecured lending or restrictions on the length of loan terms;
3. Restrictions designed to avoid mismatches between maturity or liquidity of assets and liabilities by limiting loan originations to closed-ended fund structures or otherwise require specific redemption management techniques to be in place to manage redemptions in times of market stress;
4. Constraints on the level of leverage which may be incurred;
5. “Skin in the game” type co-investment requirements to align the incentives for fund managers and investors;
6. Requirements for fund managers to demonstrate requisite expertise, experience and track record;
7. Constraints on the type of investor;
8. Introduction of credit assessment requirements; and

The discussion paper raises a number of key questions which can be summarised as follows:

1. Is there a public good which could be served by relaxing the current regulatory constraint whereby investment funds are prohibited from originating loans?
2. What are the “shadow banking” risks raised by the relaxation of the current policy?
3. In what way could these risks be mitigated such that the loan origination by investment funds could be a viable credit alternative?
4. Does the alternative current investment fund rulebook (AIF Rulebook) provide sufficient protection for investors in the case where investment funds were allowed to originate loans?
There has been much interest from investment managers seeking to establish funds which can engage in direct lending in addition to acquiring loans or loan participations and consequently there was significant engagement with the discussion by industry participants. The closing date for the responses to the discussion paper has passed and we await the Central Bank’s feedback statement.

The contents of this note are necessarily expressed in broad terms and limited to general information rather than detailed analyses or legal advice. Specialist professional advice should always be obtained to address legal and other issues arising in specific contexts.

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