Loan originating funds
10 key features

From 1 October 2014, the Central Bank of Ireland (CBI) has permitted certain Qualifying Investor Alternative Investment Funds (QIAIFs) to originate loans (LOQIAIFs). The LOQIAIF was introduced via a new chapter in the QIAIF section of the AIF Rulebook.

The launch of the LOQIAIF follows a consultation process by the CBI over the past year. When issuing the new AIF Rulebook, the CBI also issued a Feedback Statement on this consultation which provides interesting insights on the rationale for the current structure of the LOQIAIF.

The ten key features of the new LOQIAIF are discussed below.

Leading business advisers

1. Who can a LOQIAIF issue loans to?

The intended loan recipients are predominantly non-financial enterprises in Ireland or overseas.

LOQIAIFs are prohibited from issuing loans to natural persons; investment funds; to related parties of the LOQIAIF including its manager or depositary or parties related to them; to financial institutions or to their related companies (unless there is a bona fide treasury management purpose ancillary to the primary objective of the LOQIAIF); or to persons intending to invest in equities or other traded investments or commodities.

2. Can a LOQIAIF do more than originate loans?

Yes, in addition to originating loans, the LOQIAIF is also permitted to participate in loans, to acquire loans in the secondary market, and to seek exposure to loans by way of sub-participations. It is also permitted to engage in operations resulting directly from those activities such as handling any collateral which is used as security for the loans, and to engage in treasury management and the use of derivatives for hedging purposes.

LOQIAIFs are permitted to buy loans from a credit institution where the sale is on an arm's length basis following an offering to multiple parties. Where the sale is on a bi-lateral basis, the LOQIAIF may purchase the loan if the credit institution retains a net economic interest of 5% of the nominal value of the loan as measured at origination.

LOQIAIFs are prohibited from engaging in other types of commercial business; the sole activity of the fund must be dealing with loans. However, a LOQIAIF may be established as a sub-fund within an umbrella fund, where other sub-funds invest in other asset classes. LOQIAIFs are also prohibited from investing in other investment funds, including those that follow loan strategies.

3. Can a LOQIAIF be a UCITS fund?

No, the LOQIAIF can only be established an alternative investment fund governed by AIFMD and the AIF rulebook. The latter clarifies that the LOQIAIF must have a fully authorised manager rather than a registered manager under AIFMD. As a result, the LOQIAIF must be fully within the scope of AIFMD.

4. Are any liquidity restrictions required?

LOQIAIFs must be closed-ended. However, it is permitted at authorisation to specify interim redemption dates within the fund's life-cycle. Distributions and redemptions are permitted if liquid assets are available and there is no risk of jeopardising the regulatory compliance or liquidity obligations of the LOQIAIF. The rules allow the LOQIAIF to make redemptions subject to investor approval, while distributions may be made throughout the LOQIAIF's life-cycle.

The rationale for not permitting an open-ended fund is to avoid situations where a loss in investor confidence could lead to investor runs, which in turn could lead to loans being recalled or sold onwards.

5. Who can invest in a LOQIAIF?

As a QIAIF with an authorised AIFM, the LOQIAIF can be passported to 'professional investors' across Europe under the AIFMD passporting regime. The minimum investment in QIAIFs is €100,000. 'Professional investors' can be either 'per se professional investors' or 'elective professional investors'.

'Per se professional investors' include regulated financial institutions, institutional investors, entities who exceed minimum balance sheet and turnover requirements, national or regional governments or bodies that manage public debt. An investor can become an 'elective professional investor' after it (i) elects in writing to become one, (ii) the LOQIAIF assesses the investor's expertise and (iii) the investor has proof of having worked in that industry or has a portfolio of financial instruments over EUR500,000.

6. How might LOQIAIFs affect the banking sector?

It is envisaged that the introduction of the LOQIAIF will increase competition in the market place for credit lines to small and medium businesses both in Ireland and internationally. Increased competition could eventually reduce the loan interest rates on offer to companies.

Loan origination by investment funds could increase regulatory arbitrage opportunities between the banking and non-banking lending sectors. In its Feedback Statement, the CBI anticipates that managers of LOQIAIFs and banks are likely to form mutually beneficial partnerships, where the LOQIAIF will leverage off the bank's expertise with regard to credit analysis, risk management and the structuring and servicing of loans and to access the bank's client base. It also anticipates banks on the other hand might potentially jointly issue loans with the LOQIAIFs for risk sharing purposes, or refer clients to the LOQIAIF which the bank is not in a position to take on its own balance sheet.

The CBI requires LOQIAIFs to periodically update it with details of undrawn and drawn lines of credit so that it can monitor systemic risk and the relationship between the banks and LOQIAIFs.

7. What protection is in place for investors in LOQIAIFs?

Due to its unique nature and inherent risks, the CBI incorporated several features to ensure the protection of investors. These are in addition to the already robust mechanisms provided for funds under the AIF Rulebook, AIFMD and the Corporate Governance Code for Collective Investment Schemes issued by the Irish Fund Industry Association (IFIA). This latter code is currently under review by the CBI; it will be interesting to see whether the CBI or the IFIA issue a revised code following this review, and whether any revised code includes provisions specific to the LOQIAIF. In addition, LOQIAIFs must abide by the CBI's Code of Conduct for Business Lending to Small and Medium Enterprises.

The investor protection features which drew the most comment during the consultation process were the liquidity and leverage requirements, as summarised below. A full list of the investor protection and market stability features is available in the table on page 6.

Leverage: unlike other AIFs which can set their own leverage limits, the LOQIAIF must limit the debt to equity ratio to 1:1, in other words, its gross assets must not exceed 200% of net asset value

Liquidity: Distributions and redemptions are permitted if liquid assets are available and there is no risk of jeopardising the regulatory compliance or liquidity obligations of the LOQIAIF.

The CBI has confirmed that depositaries will not be required to undertake any additional checks on LOQIAIFs. It appears therefore that the CBI considers that its investor protection features are robust enough to do without this extra layer of oversight.

8. How must a LOQIAIF value its loan investments?

The LOQIAIF rules do not impose any valuation requirements in addition to the valuation rules in AIFMD. These valuation requirements already oblige the AIFM to ensure that the valuation methods are fair, appropriate and transparent and that they are disclosed to investors. AIFMD does not require assets to be valued according to market prices and recognises that such prices are not always available. The CBI notes that AIFMD already has inbuilt mitigants to address risks arising where market prices are not available. Examples include the appointment of an independent valuer, and the inclusion in the valuation procedures of a review process, particularly where a material risk of an inappropriate valuation exists.

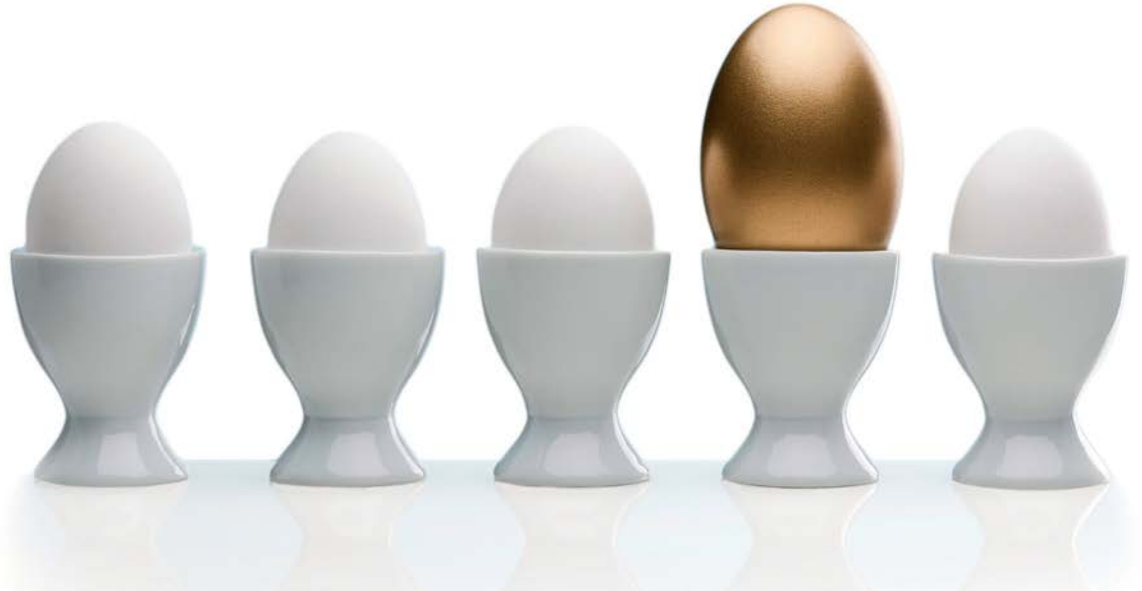
9. Is the LOQIAIF the only regulated European-domiciled loan fund available?

The European Parliament is negotiating the terms of the "European Long Term Investment Fund" (ELTIF). This will be a regulated fund which can issue loans or make other investments. The table on page 7 compares the main features of LOQIAIFs and ELTIFs. Notably, the ELTIF can currently only issue loans to a limited category of entities, while LOQIAIF on the other hand has much wider scope to issue loans. As it is anticipated that the ELTIF will be available to retail investors, its profile is more risk averse than the LOQIAIF, for example, the ELTIF permits leverage of only 30% while the LOQIAIF permits 200%. It is likely that unregulated loan funds will continue to be established where more highly geared structures are required.

10. What are the Tax Considerations of the LOQIAIF

From a direct tax perspective, obtaining treaty access for LOQIAIFs will be key in minimizing any tax leakage both in terms of withholding tax suffered on income into the fund and payments out of the fund. Ireland has double taxation agreements with 71 countries, of which 68 are currently in effect. The Irish Revenue's willingness to issue certificates of tax residence for Irish funds has led to a lot of success in the past in obtaining treaty benefits. It is therefore important that at all times, both for the domestic Irish tax treatment of the fund and from a tax treaty perspective, care and attention is given to maintaining Irish tax residency.

One of the fifteen actions recently identified by the OECD to address Base Erosion and Profit Shifting (BEPS) was Action 6 which aims to develop model treaty provisions and recommendations to prevent treaty abuse. The OECD have recommended the inclusion of a limitation of benefits (LOB) clause and general anti-abuse rules in all international tax treaties. However, the OECD have recognised the importance of achieving a solution which recognises the specific challenges funds face. It is hoped that a practical solution will be reached to ensure funds can continue to benefit from access to international tax treaties.



Conclusion:

As both Irish and overseas entities are permitted to borrow funds from the LOQIAIF, we anticipate that there will be strong interest internationally in the LOQIAIF as an alternative source of financing to venture capital or banking sources.

How we can help:

Our teams of banking, valuation and tax experts can assist you with:

» Transaction support and transaction structuring;

» Valuation of loans and collateral;

» Advising on the transfer of loans from financial institutions to LOQIAIFs;

» Advising on the tax implications of purchasing and originating loans on a global basis, or any tax consequences of dealing with any realised collateral;

» Advising on the tax structuring of a LOQIAIF.

If you would like to discuss any of the matters above please contact any member of the Deloitte team.

Investor protection features of the LOQIAIF

- Implementing policies and procedures: regarding assessing, pricing, and granting of credit; a risk appetite statement; monitoring, renewing and refinancing credit; managing collateral, managing concentration risk, and valuation both of loans and collateral.
- Complying with the CBI's Code of Conduct for Business Lending to Small and Medium Enterprises.
  The Code sets out the processes that lenders are required to adopt in facilitating access to credit. It also promotes fairness and transparency of the treatment of borrowers and includes a clear framework for dealing with borrowers in financial difficulty allowing borrowers and lenders to work together to address existing or emerging difficulties.
- Due diligence: where an AIFM intends to provide access to its records/staff to any potential investor, it must ensure that such access (if provided) is available to all unitholders on a non-discriminatory basis.
- Diversification: the LOQIAIF's portfolio must be diversified. Exposure to one issuer or group is limited to 25% of net assets within a certain time frame. These limits do not apply when the LOQIAIF is building its portfolio at the start of its lifecycle or when closing out its positions at the end of its lifecycle.
- Stress testing: the LOQIAIF must implement a comprehensive stress testing programme, and report the results to the board of the AIFM at least quarterly. The CBI's rationale for imposing these requirements is that the potential systemic risks arising from excessive credit growth and leverage are equally possible to arise from lending by an investment fund as they are in the context of lending by banks.
- Liquidity: Distributions and redemptions are permitted if liquid assets are available and there is no risk of jeopardising the regulatory compliance or liquidity obligations of the LOQIAIF.
- Leverage: contrary to the rules applicable to other AIFs which can set their own leverage limits, the LOQIAIF has a debt to equity ratio of 1:1, in other words, its gross assets must not exceed 200% of net asset value. For example, an AIF with assets of 100 may borrow 100. The requirement for total asset coverage of at least 200% means that a reduction in the value of the assets must be matched by a corresponding reduction in the leverage.
- Disclosures: the CBI acknowledges that the level of disclosures required by AIFs under AIFMD is already detailed. However, it states that the unique nature of the LOQIAIF requires supplementary disclosures, both pre-investment and periodically at each net asset value calculation point. The CBI reasons that LOQIAIFs should apply the same criteria as banks to distressed loans so that investors can have some assurances that appropriate categorisation is applied. Information to be disclosed to unitholders includes details of the fund's loan book. The LOQIAIF must also submit a list of any undrawn committed credit lines to the CBI.

Comparison between the ELTIF and the LOQIAIF

	ELTIF	LOQIAIF
UCITS or AIF?	AIF only	AIF only
Marketing passport	ü	ü
Authorised or Registered AIFM	Authorised only	Authorised only
Regulated?	ü	ü
Retail/Professional investors	Retail & professional	Professional only
Open/closed ended	Closed ended, may allow for limited redemption	Closed ended, with pre-determined redemption dates throughout the life of the fund
Diversity requirements	Max 10% of capital in assets of a single issuer or single asset	Max 25% in a single issuer during a specific time-frame
Eligible assets	70% may be invested in equity/ debt/loans or infra-structure projects. This limit is disapplied during a start-up period of 5 years to build up this portfolio, and also during the end of the life of the fund when positions are being closed Up to 30% can be invested in UCITS compliant liquid assets	Loans only. The rules require that a loan fund cannot engage in other businesses. However, the loan fund can be structured as a sub-fund within an umbrella fund, where the other sub-funds invest in loan-loan assets, eg, equities, etc.
Loans available to whom?	» non-financial unlisted entities established to invest in infrastructure, property, ships, aircraft, rolling stock » listed small and medium enterprises » other ELTIFs » European Social Entrepreneurship Fund	Businesses (non-financial)
Leverage?	Cannot be used to finance loans	Gross assets must not exceed 200% of the net asset value
Legal structure	Cannot be a partnership	Any
Can investors transfer their interests?	Yes, they can sell their interests in the secondary market	No restrictions on transfer

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