Loan funds
Europe's alternative source of business funding

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The financial crisis caused liquidity problems for banks globally, with a knock-on reduction in access to capital for businesses. To address this challenge, regulators in Europe are introducing alternative sources of financing, and in particular, are implementing measures to allow investment funds to issue loans to businesses.

At a European level, the 'European Long-Term Investment Fund' (ELTIF) is being established, while Ireland has recently launched its own 'Loan Originating Qualified Investor Alternative Investment Fund' (referred to below as Irish Loan Fund (ILF). Both measures offer a regulated fund that originates loans to business, and in this article we compare the key features of each.

Note that the ELTIF is not required to be a loan fund—it must invest at least 70% of its assets in eligible assets. These eligible assets can constitute several forms of long-term investment, including loans. In this article, we focus on the ELTIF structured as a loan fund.

Background and current status

The ELTIF originated in 2012 as part of a proposed package of reforms to UCITS funds, dubbed 'UCITS VI'. One proposed reform was the introduction of a long-term investment product for Europe's retail market. Following industry feedback, the European Commission instead issued its proposal for a Regulation on ELTIF in June 2013 as a stand-alone fund product regulated by the Alternative Investment Fund Managers Directive (AIFMD).

Discussing the ELTIF Regulation, the Internal Market and Services Commissioner Michel Barnier explained: *"We need to secure long-term financing for Europe's real economy. Currently, financing is often scarce and where it exists, too focused on short-term goals. The European Long-Term Investment Fund is an investment vehicle that will allow professional investors and individuals to invest long-term in European non-listed companies and in long-term assets such as real estate and infrastructure projects. Making ELTIFs available to all types of investors across the European Union is vital to maximise the pool of capital available to European companies. I hope that creating a new EU investment brand will gain the confidence of investors and companies alike."*

The European Commission adopted a green paper on the long-term financing of the European economy in March 2013. It examined the supply of long-term financing in Europe and confirmed the need for investment funds to aid the improvement and diversification of Europe's long-term investment measures.

On 10 December 2014, the Permanent Representative's Committee on behalf of the Council of the European Union approved the final compromise text of the ELTIF Regulation following provisional agreement reached through trialogue discussion. To achieve a similar purpose, i.e. non-bank financing for businesses, Ireland launched the Irish Loan Fund (ILF) in October 2014.

Structure

The funds have similar structuring requirements—both must be authorised in their home member state, can form part of an umbrella fund, must be closed-ended, and must have an AIFMD authorised investment manager. The rationale for prohibiting open-ended structures 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. Under exceptional circumstances specified within the rules of incorporation, the ELTIF can be structured to allow redemption if this fits the fund's investment strategy and its life cycle can be extended or reduced to allow for more flexibility.

Although ILFs must be closed-ended, they are 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 ILF's regulatory compliance or liquidity obligations. The rules allow the ILF to make redemptions subject to investor approval, while distributions may be made throughout the ILF's lifecycle.

The ILF can be structured as any form of Irish investment vehicle, including a unit trust, an investment limited partnership, an Irish Collective Asset-management Vehicle or a variable capital company.

ELTIFs have an equally broad range of available structures. However, if being marketed to investors, ELTIFs cannot be structured as partnerships. This feature drew criticism as it could create obstacles in jurisdictions where partnerships are the only viable legal structure for funds.

Eligible investments

The defining feature of any fund is its investment strategy, particularly its permitted investments. The key characteristics of a loan fund are the type and balance of loans it can hold in its portfolio, particularly the profile of the permitted loan recipient. The funds have different balancing criteria for their portfolios: the ELTIF has a narrower category of permitted loan recipient than the ILF, while the ILF is required to be a single strategy fund.

Permitted loans—eligible investments

The ELTIF has significant flexibility regarding its portfolio—at least 70% of its capital must be invested in eligible assets, which include loans to 'qualifying portfolio undertakings', with the balance in diversified assets. Qualifying portfolio undertakings are portfolio undertakings (excluding funds, financial undertakings, organised trading facilities and listed entities) and listed Small and Medium Enterprises (SMEs).

Ireland's ILF is obliged to be a single-strategy fund, focusing solely on lending. However, it can exist as a sub-fund within an umbrella fund that follows a wider investment strategy including securities. The Central Bank of Ireland (CBI) has confirmed that in addition to originating loans, the ILF can also participate in loans, acquire loans in the secondary market, and seek exposure to loans by way of sub-participations. It is also permitted to engage in operations resulting directly from activities such as handling any collateral used as security for the loans, and to engage in treasury management and the use of derivatives for hedging purposes.

ILFs 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 bilateral basis, the ILF 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.

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Permitted loan recipient

The goal of the ELTIF is to drive growth in long-term projects across Europe and to contribute to financing the Union's real economy. This is reflected in the permitted recipient of a loan from an ELTIF: non-financial unlisted entities that were established to invest in infrastructure, property, ships, aircraft rolling stock or listed small and medium-sized enterprises; European Social Entrepreneurship Funds; and European Venture Capital Funds.They are also permitted to channel the European Investment Bank Group's European infrastructure or SME financing.

The ILF has a wider goal of providing financing to businesses generally, and so can issue loans to non-financial businesses. It cannot issue loans to financial companies or natural persons.

Marketing—eligible investors

As AIFMD-regulated entities, both funds can be passported across the EU under the AIFMD passport. Given its origins as a proposed reform to the UCITS regime, it is unsurprising that the ELTIF is available to retail investors. Note that even an ELTIF being marketed to retail investors can be passported under AIFMD—this is an interesting development, since under AIFMD only funds marketed to professional investors can generally be passported.

The ELTIF's minimum investment of €10,000 has attracted criticism (including from the UK Government) that this relatively high threshold would remove the ELTIF from the reach of most retail investors. Perhaps the European Commission set this threshold to protect the lower end of the retail spectrum from the perceived higher level of inherent risk in a loan fund?

The ILF is widely available for investment by professional investors for a minimum investment of €100,000.

Leverage

The retail versus professional nature of the funds is illustrated by their respective leverage limits: as a product tailored for retail investors, the ELTIF's profile is more risk averse than the ILF, for example, the ELTIF permits leverage of only 30% while the ILF permits 200%. In addition, to protect against shadow banking, ELTIFs cannot use borrowed cash when issuing loans. Given the relatively low leverage limits of both funds and the ban on ELTIFs using borrowed funds as loan funding, it is likely that unregulated loan funds will continue to be established where more highly geared structures are required.

Transparency requirements

As AIFs regulated by AIFMD, both funds are already subject to detailed levels of disclosure. The CBI acknowledges this, yet explains that the unique nature of the ILF requires supplementary disclosures, both pre-investment and periodically at each net asset value calculation point.

It considers that ILFs should apply the same criteria as banks to distressed loans so that investors can have some assurance that appropriate categorisation is applied. Information to be disclosed to unitholders includes details of the fund's loan book, while the ILF must also submit a list of any undrawn committed credit lines to the CBI to allow it to monitor systemic risk.

An ELTIF marketed to retail investors must publish a KID in accordance with the Regulation on key information documents (or KIDs) for investment products, which introduces a new pan-European pre-contractual product disclosure document for packaged retail investment products.

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Conclusion

The CBI anticipates that managers of ILFs and banks are likely to form mutually beneficial partnerships, where the ILF will leverage the bank's expertise in credit analysis, risk management and the structuring and servicing of loans, and gain access to the bank's client base. It also anticipates that banks, on the other hand, could potentially issue loans jointly with ILFs for risk-sharing purposes, or refer clients that the bank is not in a position to take onto its own balance sheet to the ILF. It will be interesting to see the impact of these funds across Europe: will the increased pool of funding and credit lines to SMEs reduce the loan interest rates on offer to companies?

Will ELTIFs actually issue loans, or will they focus instead on the other assets in which they are permitted to invest, for example real estate or infrastructure projects? Will different countries consider loan funds to be a form of shadow banking, and will they allow them to be marketed to their investors? Following the launch of the ILF, the draft of ELTIF was amended fundamentally to permit redemption in certain circumstances and investment in listed small and medium enterprises – will future amendments to the funds cause them to become polarised or to converge?

Finally, it will also be interesting to see whether the introduction of loan funds and an extra pool of business funding achieves its primary goal of driving growth in the EU economy.

Comparison between the ELTIF and the ILF

	ELTIF	ILF
UCITS or AIF?	AIF only	AIF only
Minimum investment	€10,000	€100,000
Marketing passport	Yes	Yes
Authorised or registered AIFM	Authorised only	Authorised only
Regulated?	Yes	Yes
Retail/professional investors	Retail and professional	Professional only
Open-/closed-ended	Closed-ended, has the option to include redemption rights	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 timeframe
Eligible assets	70% may be invested in equity/debt/loans or infrastructure projects. This limit does not apply for the first five years during construction of the portfolio, or during the end of the life of the fund when positions are being closed. Up to 30% can be invested in diversified 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 assets, e.g. equities, etc.
Loans available to?	• Non-financial unlisted entities established to invest in infrastructure, property, ships, aircraft, rolling stock, listed small and medium enterprises • European Social • Entrepreneurship Fund • European Venture Capital Fund	Businesses (non-financial)
Leverage?	Up to 30% of the capital of the ELTIF, non-recourse and used only to acquire eligible assets	Gross assets must not exceed 200% of the net asset value
Legal structure	Cannot be a partnership	Any
Can investors transfer their interest?	Yes, they can sell their interest in the secondary market	No restrictions on transfer
Transparency requirements	• Details of how the ELTIF's investment objectives and strategy mean the fund qualifies as 'long term' • Prospectus Directive disclosure requirements • AIFMD disclosure requirements • Prominent description of eligible assets • Prominent warning of the illiquid nature of the fund • All costs attached to the fund • KID disclosure requirements (if marketed to retail investors)	• A prominent risk warning highlighting the particular risks inherent in loan origination, i.e. how an investment in a loan originating fund is not guaranteed and is subject to the possibility of investment losses and illiquidity • Information on the fund's risk/reward profile • Anticipated concentration levels • Credit monitoring process • Confirmation of whether the manager will allow access to records and staff for due diligence • A risk warning that the central bank may tighten lending standards and leverage limits • Information that a reasonable investor would deem important when considering an investment in the fund • The implications of the central bank's Code of Conduct for Business Lending to Small and Medium Enterprises where loans are made to SMEs • Details of the fund's loan book must be disclosed periodically

To the **point**:

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- It will be interesting to see the impact of these funds across Europe: will the increased pool of funding and credit lines to SMEs reduce the loan interest rates on offer to companies?
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It will also be interesting to see whether the introduction of loan funds and an extra pool of business funding achieves its primary goal of driving growth in the EU economy