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Loan originating qualifying investor AIF

On 28 July 2014 the Central Bank of Ireland issued Consultation Paper 85 with regards to loan originating Qualifying Investor Alternative Investment Funds ("QIAIFs") which will permit Irish funds to originate loans directly.

This will be the first dedicated regulatory regime in the EU for loan originating funds and will operate under the EU's Alternative Investment Fund Manager's Directive ("AIFMD").

In its consultation paper, the Central Bank is proposing to permit QIAIFs to derogate from its general prohibition on lending subject to specific investor protections and risk management safeguards. These safeguards are being put in place to mitigate the risks that the Central Bank sees as critical to loan originating funds:

- risks of regulatory arbitrage;
- risks of runs in investment funds;
- contagion risk with the banking sector, and
- risks of excessive credit growth and pro-cyclicality.

A new chapter to the Central Bank's AIF Rulebook will also be introduced to provide for loan originating QIAIFs.

Structure

Loan originating funds will only be permitted under the QIAIF regime and will require an authorised AIFM. Its activity must be restricted to the issuance of loans.

It would appear therefore that only QIAIF type companies (as opposed to unit trusts, common contractual funds and / or investment limited partnerships) will be suitable for establishment as loan originating funds.

It may however be possible to launch a loan originating QIAIF as one dedicated sub-fund of a QIAIF umbrella fund which has other non-loan originating sub-funds.

An ICAV, the new Irish corporate vehicle specifically designed for investment funds (with the ability to "check the box" for US tax purposes) may also be considered as a possible structure for a loan originating QIAIF.

Questions for consideration

The Central Bank has asked for stakeholders' views on:

Credit assessment granting and monitoring

Loan originating QIAIFs must have an effective credit assessment and management process with established policies in a number of key areas in line with the requirement for credit institutions.

The Central Bank further confirmed that loan originating QIAIFs will be subject to the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises.

Diversification

Unlike other QIAIFs, loan originating QIAIFs will be subject to portfolio diversification rules. These rules must be noted in the loan originating QIAIFs prospectus and will limit exposure to any one issuer or group to 25% of net assets within a specific time frame.

Liquidity

It is proposed that a loan originating QIAIF must be closed-ended to avoid a situation which may arise in an open ended fund where sudden losses of investor confidence leads to investor runs which in turn leads to a situation where loans may have to be recalled or sold on.

A loan originating QIAIF may 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 purposes and such distribution redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating QIAIF.

Due diligence by investors on the management of a loan originating QIAIF

It was noted by the Central Bank that detailed due diligence by investors in loan funds is a widespread practice. The rule suggests that where such access has been provided it must be made available on a non-discriminatory basis to all unitholders. The access must not be structured so as to materially represent the business of the loan originating QIAIF.

Valuation

AIFMD does not require that the assets of AIFs are valued by reference to market prices and recognises that for certain types of AIF this may not be possible.

The Central Bank is not proposing to include any additional rules in relation to the valuation of the assets of a loan originating QIAIF.

Leverage

Loan originating QIAIFs must ensure that any indebtedness by the loan origination QIAIF must have total asset coverage of at least 200%, or such limit as may be set by the Central Bank from time to time for loan originating QIAIFs or for one or more classes of loan originating QIAFs.

Disclosure

The prospectus of a loan originating QIAIF must include a prominent risk warning which draws attention to the unique risks which arise from loan origination and investments in same.

Certain other minimum information must be included in the QIAIF's prospectus such as information on risk and reward profile, levels of concentration and geographical location and sectors.

Reporting and stress testing

A loan originating QIAIF must have a comprehensive stress testing programme in place which identifies possible future economic changes that could have an unfavourable effect on a loan originating QIAIFs credit exposure.
An assessment of a loan originating QIAFs ability to withstand such change is also expected.

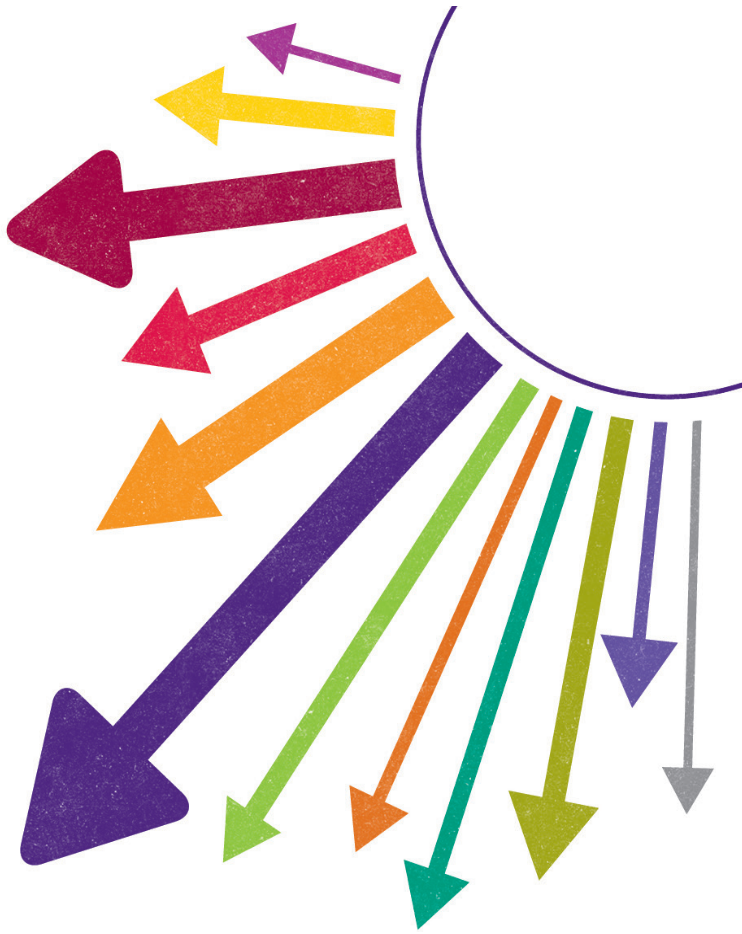
How we see it

We welcome the development that the Central Bank has launched a formal consultation exercise on loan originating QIAIFs. It is clear however that there are areas where stakeholders may feel amendments are required most notably around diversification and leverage which we highlight below.

Loan originating QIAIFs are designed for professional investors with minimum subscriptions of €100,000. It would therefore appears reasonable to assume that investors in loan originating QIAIF's are appropriately knowledgeable (or have access to such knowledge) to ascertain risks such as diversification risk.

No such diversification rule applies to other fund structures such as real estate funds or other QIAIF funds. This restriction may impact on the utilisation of Irish loan originating funds by some managers who feel the 25% diversification risk rule is over restrictive.

A similar issue may arise with regards to leverage limit requirements. The imposed 1:1 leverage limits for example are much more restrictive than those required under AIFMD which considers that leverage is employed on a substantial basis when the exposure exceeds three times the net asset value of the relevant AIF. Leverage thresholds are generally greater in the banking sector to those considered within the Central Bank's consultation paper. This could



impact negatively on a loan originating fund being able to offer genuine alternative product lines.
The Central Bank may also come under market participant pressure to consider:

- whether the defined activity of a loan originating fund is too narrow;
- whether the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises ("SME Code") is appropriately covered by Article 12 of AIFMD or indeed is the application of the SME Code appropriate given that the SME Code was written in the context of bank lending and not lending from investment funds;
- whether requested periodic disclosures required are appropriate from a confidentiality or proprietary prospective; and
- whether the suggested requirement that an arranging bank would be required to provide a warranty to a loan originating QIAIF that it will retain 5% of the nominal value of the loans as measured at origination would put Irish loan originating QIAIFs at a significant disadvantage to other jurisdictions. This "skin the game" requirement would be a significant cost to arranging banks and could deter such banks from working with loan originating QIAIFs.

Closing date

The closing date for responses to CP 85 was 25 August 2014.

Timing for any decision on when loan originating fund's may become available is uncertain.

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