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cutting through complexity

Corporate Lending

A new investment option for funds

New development

Since October 2014, QIAIFs - Qualifying Investor Alternative Investment Funds - a form of regulated, alternative fund in Ireland, have been permitted to engage in direct lending.

The initiative has generated considerable interest. Permitting QIAIFs to lend is an innovative development highlighting the Central Bank's proactive approach to policy development and Ireland's expertise in servicing alternative investment funds.

These loan funds are subject to the Alternative Investment Fund Managers Directive ("AIFMD") as well as additional new requirements, set out in the AIF Rulebook, which have been designed to ensure investor protection and financial stability. Loan originating QIAIFs established in Ireland can avail of the benefits of the AIFMD marketing passport, meaning that the Irish loan fund structure can be marketed to professional investors throughout Europe.

Currently only two European countries, Ireland and Luxembourg, have bespoke frameworks to regulate loan funds. Other countries in Europe either expressly prohibit non-banks from lending altogether, or allow lending by non-banks by default. As a result it is unclear how much activity is actually going on and how controlled it is.

Following an extensive consultation period, including consultation with the European Systemic Risk Board, the Central Bank amended the AIF Rulebook to permit a derogation from the general prohibition on lending. This derogation is subject to specific investor protection measures and risk management safeguards including credit assessment, due diligence, diversification, stress testing, liquidity, leverage and disclosure.

A valuable source of alternative funding for corporates

This bespoke Irish regulatory regime allows funds to engage in corporate lending - an activity currently dominated by banks. The demand for reliable funding channels to supplement bank lending has increased because of the financial crisis. The activity of loan funds is niche and specialised and provides corporate entities, in particular, small and medium enterprises, with a valuable source of alternative funding. QIAIFs are not permitted to lend to individuals, AIFMs or related entities, other funds, financial institutions except for the purpose of treasury management, and to investors in certain financial instruments.

Loan originating QIAIFs must engage in the single, investment strategy of lending. This includes issuing loans, participating in loans, participations in lending, and to any operations arising from these activities e.g. dealing with security. Questions have arisen as to why multiple investment strategies are not allowed. The Central Bank has stated that it believes that the substance of the lending operation is critical to the fund manager's operations and that there is a risk of diluting this by allowing multiple strategies to be operated in a single fund. However a loan originating QIAIF which wishes to pursue investment strategies other than lending could establish as an umbrella fund and establish a separate sub-fund for non-loan investments.

New rules require effective credit assessment and management

The new rules require that, similar to credit institutions, loan originating QIAIFs must have an effective credit assessment and management process, including having a risk appetite statement and established policies in a number of key areas. The general consensus is that these rules reflect best practice for asset managers and are not onerous for a loan originating QIAIF to comply with.

That being said, reservation has been expressed about the requirement to comply with the Code of Conduct for Business Lending to Small and Medium Enterprises. It is felt that this particular code on lending to SME's is onerous and contradictory from a funds point of view, and it could lead to a conflict between investors and borrowers. The Central Bank has ruled out, for the time being anyway, amending the code as it believes it is a code of conduct to govern all business lending by all regulated entities.

Diversification limits

Rules in respect of the diversification of the loan portfolio to avoid concentration have also been imposed. Loan originating QIAIFs must aim to limit exposure to any one issuer or group to 25 percent of the fund's net assets. The period of time necessary to achieve this minimum diversification limit can be established by the QIAIF in its prospectus. If this limit is not achievable, the QIAIF can get approval from unit-holders to continue at the diversification level it manages to achieve.

Where a loan originating QIAIF purchases a loan on an arm's length basis, there is no need for the vendor to retain five percent of the loan but where a loan is acquired on a bilateral basis the five percent retention rule does apply.

Despite these restrictions, the diversification rules are not proving problematic and prospective loan originating QIAIFs are satisfied they will be able to able to operate within these parameters.

Transparency for investors

Disclosures under the AIFMD framework are detailed, and even further disclosures to investors are required on a periodic basis under the new rules in the AIF Rulebook, particularly in relation to reporting on a loan-by-loan basis. The Central Bank has clarified that disclosures on non-performing loans and loans under forbearance can be disclosed on an aggregate basis, provided each individual exposure is reported to the Central Bank, in a template which has yet to be finalised. Details of any undrawn committed credit lines will also have to be submitted to the Central Bank in this return.

Additional disclosure, in relation to, the risks involved in investing in the loan fund are also required in the fund's prospectus and marketing material. Prospective loan originating QIAIFs are confident that they can met these requirements and they are not proving to be a stumbling block.

Loan originating QIAIFs must be closed-ended

Loan originating QIAIFs must be closed-ended, must be established for a finite period and must have pre-determined redemption dates, in order to mitigate the risk of an investor run on the fund in the event of a loss of investor confidence. Distributions or redemptions are only permitted from liquid assets. If the assets of the loan originating QIAF are not valued on a mark-to-market basis, then each redemption can only be made with the approval of investors. This approach to liquidity is broadly in line with that in place for other global loan fund structures.

Additional stress testing

Issues which are proving to be a bit more challenging are the stress testing measures in place and also the new leverage limit.

The AIFMD imposes stress testing requirements on alternative investment funds and further requirements are imposed on loan originating QIAIFs in the AIF Rulebook. These inter alia, require loan originating QIAIFs to conduct monthly stressing of market and credit risk and quarterly multifactor stress testing, focussing on market and liquidity events.

Severe restrictions on leverage

A leverage limit for loan originating QIAIFs is set out by the Central Bank in the AIF Rulebook in order to mitigate against pro-cyclical vulnerability. This is in contrast to other QIAIFs, where the AIFM has the discretion to set a maximum level of leverage which is then disclosed to investors. The leverage limit imposes a total asset coverage limit of 200 percent which equates to a ratio of 1:1. This means that a loan originating QIAIF with, for example, assets of €100 may borrow a further €100.

The limit has to be actively monitored so that if the value of the assets declines, leverage must be adjusted accordingly. If the limit is breached, a formal plan must be put in place to bring the fund back into compliance with the limit. The Central Bank retains the power to increase the limit on a case by case basis where it thinks this is necessary. There is a feeling among industry participants that this limit is restrictive and not risk sensitive enough, leading to concerns that the limit may impact on lending to lower risk projects such as infrastructure projects.

Clarifications from the Central Bank

In response to some initial queries by promoters, the Central Bank clarified aspects of the new rules in a recent AIFMD Q&A.;

- A loan originating QIAIF can invest in different levels of debt for example, tranched or mezzanine or subordinated debt;
- Where an intermediary introduces a borrower to a loan originating QIAIF which subsequently lends to that borrower, the QIAIF will still be regarded as the originator of the loan, not the intermediary
- A loan originating QIAIF may hold debt securities where these are used solely for treasury management and hedging purposes
- A loan originating QIAIF may hold equity assets where these securities have been received as a result of a distressed loan workout. There is no particular timeline within which the QIAIF must dispose of these securities, however, the QIAIF should primarily take into account the best interests of its investors
- The activities of a loan originating QIAIF may be subject to the requirements of the Credit Reporting Act 2013 (i.e. the mandatory credit reporting database for the provision of credit to Irish resident borrowers and where the credit agreement is governed by Irish law). Therefore, QIAIFs should consider whether the Credit Reporting Act 2013 applies to their lending activities
- Loan originating QIAIFs are permitted to lend to their own wholly-owned subsidiaries
- No additional rules have been applied to depositaries of loan origination QIAIFs.

Promoters and investment managers are still evaluating the bespoke regulatory regime which has been put in place in Ireland to permit loan origination by funds. Whilst the framework is still very much at an embryonic stage and issues are still being identified and worked though, there is no doubt that this is an attractive proposition for funds looking for alternative investment strategies, for corporates seeking alternative funding and for investors seeking investment opportunities in a well regulated product.

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