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Irish Loan Origination Funds

In Europe, Alternative Investment Funds ("**AIFs**") are the only type of investment fund that can originate loans, given that the UCITS Directive[1] prohibits UCITS from doing so. Loan origination is possible in the context of the EU's existing EuVECA[2], EuSEF[3] and ELTIF[4] Regulations, however, these are very restrictive. While there may be some harmonisation of loan fund rules across Europe in the future there are currently no other common EU frameworks for loan origination by European AIFs.[5]

Ireland was one of the first EU member states to introduce a specific domestic regulatory framework for loan originating investment funds. The Irish Qualifying Investor Alternative Investment Fund ("**QIAIF**") is allowed to originate loans subject to the requirements summarised below. The Central Bank of Ireland devised these rules in 2014 and most recently updated them in December 2016.

Key Features of Qualifying Investor Alternative Investment Funds

General features

- A QIAIF is categorised under the AIFMD Directive as an EU AIF and, as such, if it appoints an EU authorised AIFM, can be freely marketed subject only to a simple notification procedure,

[1] Article 88
[2] Regulation (EU) No 345/2013 of 17 April, 2013 on European venture capital funds
[3] Regulation (EU) No 346/2013 of 17 April 2013 on European social entrepreneurship funds
[4] Regulation (EU) No 760/2015 of 29 April, 2015 on European long-term investment funds
[5] ESMA issued an opinion dated 11 April 2016 entitled "Key principles for a European framework on loan origination by funds" where it set out its recommendation for a harmonised EU wide regime on AIF loan origination. Included in its recommendations are several features that appear in the Irish QIAIF regime. In the event of a future harmonised regime, ESMA's opinion would likely form the basis for the regime and it could be expected that Irish funds would be broadly compliant with ESMA's recommendations.

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to professional investors[6] across all of the European Economic Area Member States under AIFMD[7].

- QIAIFs must impose a minimum initial subscription requirement on investors of 100,000 Euro and may be marketed only to “Qualifying Investors”[8].

- QIAIFs generally have no investment or leverage restrictions. The loan origination QIAIF is an exception to that general rule and its investment restrictions are set out below.

- A QIAIF can be established as an ICAV, a PLC, a unit trust, a common contractual fund or an investment limited partnership.

- QIAIFs are subject to authorisation by the Central Bank of Ireland on a self-certified basis and, provided all of the Central Bank’s requirements are adhered to, authorisation occurs within 24 hours.

Tax features

QIAIFs are tax resident in Ireland but no Irish taxes on its income or gains apply to them. There are generally no Irish withholding taxes on distributions to or redemptions by non-Irish investors and certain categories of Irish investors provided that a relevant investor tax declaration has been obtained[9]. There are no Irish transfer taxes on the issue, redemption or transfer of QIAIF shares. There are exemptions from Value Added Tax for many services required by QIAIFs as provided for under EU law.

QIAIFs are treated as residents for the purposes of the Ireland-US double tax treaty and can establish one or more wholly owned acquisition vehicles to facilitate access to treaties where the QIAIF itself cannot get direct access.[10]

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[6] as defined under Annex II of EU Directive 2004/39/EC (MiFID)
[7] EU Directive 2011/61/EU
[8] A Qualifying Investor is:
(a) a professional client within the meaning of Annex II of the MiFID Directive (this can be an “opt-up” professional or a “per se” professional); or
(b) an investor that receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the QIAIF; or
(c) an investor that certifies that it is an informed investor by providing the following:
• Confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or
• Confirmation (in writing) that the investor’s business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the QIAIF.
[9] Withholding taxes may apply to investments in certain Irish real estate assets.
[10] The ability of QIAIFs to obtain the benefit of the Ireland-US Treaty is dependent on the fund’s compliance with the Treaty’s requirements. The vehicles referenced may include Irish companies that qualify for special tax status under section 110 of the Taxes Consolidation Act, 1997 as amended, which are taxable in Ireland but allowed to reduce their Irish taxable profits through the issue of interest bearing debt instruments.

Key Features of Irish Loan Origination Qualifying Investor Alternative Investment Funds

Preliminary

Obviously, not all forms of financing will constitute loan origination for regulatory purposes, so, for example, gaining exposure to loans through secondary market participations, financing involving the acquisition by the fund of an instrument issuer by the debtor such as a bond, a note, preferred stock or similar instruments would not be treated as loan origination. However, once a fund engages in one origination, then the loan origination rules are triggered in their entirety. A loan origination QIAIF's ability to hold non-loan assets is restricted. It cannot hold non-loan assets if they are unconnected with its loan portfolio or are not realised collateral or used for treasury management or hedging purposes. As such, hybrid loan/credit funds will generally not be permitted.

The requirements

The key regulatory requirements for loan origination QIAIFs are set out below.

1. The fund must be closed-ended. The Central Bank has explained that this was a measure intended to avoid the situation which may arise in an open ended fund where sudden losses of investor confidence lead to investor runs which in turn leads to loans having to be recalled or sold on. There is no minimum or maximum term but the term must be stated in the fund's prospectus.

2. The fund must appoint an EU authorised Alternative Investment Fund Manager to act as its AIFM. The actual investment management of the fund may be carried out by an EU or non-EU non-AIFM by way of delegation from the EU AIFM as long as the entity is registered in its home jurisdiction for asset management. So, for example, an SEC registered investment adviser will be eligible to act as investment manager to a QIAIF.

3. A loan origination fund may be established as a sub-fund of an umbrella QIAIF the other sub-funds of which pursue the same or different strategies.

4. The fund must limit its operations to the business of issuing loans, participating in loans, participations in lending and to operations relating thereto, including investing in debt and equity securities of entities or groups to which the loan originating QIAIF lends or which are held for treasury, cash management or hedging purposes. What this means is that the assets of the fund must be restricted to loans (loans originated by the fund, loans acquired in the secondary market, loan sub-participations and so on), debt or equity of the borrowers or their groups acquired as part of a loan package (so for example, equity "kickers" prevalent in the loan middle market are permitted), hedging operations (for example, interest rate and exchange rate derivatives), treasury operations (cash/money market instruments and so on) and assets resulting from the enforcement of security.

5. There is a diversification requirement of 25% per borrower group. This only applies after the ramp up period (which can be of any duration but must be specified in the prospectus of the

fund). Also, these limits will not apply to a loan originating QIAIF which has reached its end of life phase and is closing out positions.

6. Loan origination QIAIFs must establish and implement documented and regularly updated procedures, policies and processes in respect of a number of credit granting, monitoring and management activities, including: a risk appetite statement, assessment, pricing and granting of credit, credit monitoring, renewal and refinancing, collateral management, concentration risk management, valuation, including collateral valuation and impairment, credit monitoring, identification of problem debt management and forbearance. These requirements are similar to those imposed on Irish banking institutions loan origination activities. Loan managers will tend to have similar procedures already in place.

7. The fund cannot lend to any of the following: (1) natural persons, (2) the AIFM, management company, general partner, depositary or delegates or group companies of these, (3) other collective investment schemes, (4) financial institutions or related companies of these, except in the case where there is a bone fide treasury management purpose which is ancillary to the primary objective of the QIAIF.

8. The fund may not have gross assets of more than 200% of the fund's net asset value.

9. The fund's ability to acquire loans (or exposure to loans) from a credit institution where the loan was not offered to multiple parties on an arm's length open market basis is restricted where the credit institution or a member of its group retains an exposure correlated with the performance of the loan or where the credit institution or a member of its group provides an administration, credit assessment or credit monitoring service in relation to the loan, whether on an individual or portfolio basis. The fund cannot acquire such a loan in such circumstances unless (i) the vendor or an entity within the vendor's group retains a net economic interest of at least 5% of the nominal value of the loan (as measured at origination) and the exposure is not subject to any credit risk mitigation techniques and (ii) the QIAIF can monitor net economic exposure of the vendor or its group entity, can value the loan, can monitor the performance of the loan, can stress test the loan independently of the vendor and will have access to all relevant data on the underlying exposures and cash flows and collateral.

10. There is a monthly portfolio level stress testing obligation intended to identify possible events or future changes in economic conditions that could have unfavourable effects on the QIAIF's credit exposure which must provide for: (i) at least monthly exposure stress testing of the principal market risk factors; and (ii) apply at least quarterly multifactor stress testing scenarios.

11. The QIAIF can provide for redemptions and/or distributions during the life of the fund to the extent that there is unencumbered cash or liquid assets available for distribution or redemption purposes. If the loans are valued other than by reference to prevailing market prices, then a redemption of the fund's shares can only be made with the approval of the investors.

12. If the QIAIF lends to Irish borrowers, Irish lending related regulations may apply, such as the Central Bank's code of conduct for business lending to small and medium sized enterprises, but not otherwise.

13. The QIAIF must provide periodic reporting to investors (at least as of each net asset value calculation point) setting out a breakdown of the originated loans between senior secured debt, junior debt and mezzanine and between loans made with an amortising repayment schedule and those made with bullet repayments and a breakdown of the loan to value ratio for each originated loan. Information must also be provided in respect of non-performing exposures and exposures subject to forbearance activities on an aggregated basis. The QIAIF must also provide periodic reporting to the Central Bank of Ireland including on its undrawn committed credit lines and each exposure of the QIAIF subject to forbearance activities.

Conclusion

The QIAIF is a simple and quick to authorise fund vehicle that, as an EU AIF, can be marketed to professional investors across Europe using the AIFMD marketing passport. The Irish loan fund rules are settled and transparent and an increasing number of managers are establishing loan fund QIAIFs each year.

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the authors or your usual contact at Dillon Eustace.

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