September 2014

Green Light for Loan Originating QIAIFs

The Central Bank of Ireland ("**Central Bank**") has announced that **with effect from October 1, 2014** it will accept applications for authorisation of Irish domiciled qualifying investor alternative investment funds ("**QIAIFs**") which can engage in direct loan origination. Readers will be aware[1] that earlier this year the Central Bank issued a Consultation Paper (CP 85) indicating its intention to allow the establishment of such funds.

That consultation closed on August 25. The Central Bank has now issued its Feedback Statement[2] and has simultaneously issued its revised AIF Rulebook incorporating the final rules for loan originating QIAIFs. The relevant section from the AIF Rulebook is repeated in the Appendix to this briefing paper.

Ireland now has a new product offering, within a regulated structure, designed to address market needs and at the same time systemic risk concerns of regulators. This is to be welcomed.

Application forms for this new product will be published on the Central Bank website in advance of October 1, 2014 and its key features are explained further below.

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[1] See Dillon Eustace Briefing "Loan Origination QIAIFS – Central Bank Consults" (July 2014)

[2] Central Bank Feedback Statement on CP85 – Consultation on Loan Originating Qualifying Investor AIF (September 18, 2014).

Key Features

The key features of Irish loan originating QIAIFs are as follows:

(i) QIAIFs with authorised AIFM

Loan originating funds will only be permitted under the QIAIF regime and will require an **authorised AIFM**. It will not be possible to avail of the registered QIAIF option.

The QIAIF may be the authorised AIFM itself (as an internally managed vehicle) and may appoint an external credit/portfolio manager or the QIAIF may appoint an external AIFM which either itself carries on the credit management process, or alternatively, appoints a credit/portfolio manager to do so.

(ii) Legal Structure

We think it likely that QIAIF type investment companies or ICAVs (and not unit trusts, CCFs or ILPs) will be the vehicles predominately used for establishment as loan originating funds.

(iii) Limited Activity

A loan originating QIAIF must limit its operations to the *"business of issuing loans, participating in loans, participations in lending and to operations directly arising therefrom, including handling assets which are realised security, to the exclusion of all other commercial business."*

This represents an improvement over what was previously proposed. In response to quite an amount of comment on the previously proposed text, the Central Bank explained that it was never intended to prohibit investment by loan originating QIAIFs in syndications or in loan participations purchased on the secondary market. The Central Bank also made it clear that the handing of assets which are realised security for loans is acceptable and it also clarified that treasury management and the use of derivatives for hedging purposes fall within "*operations directly arising therefrom*".

Readers need to note, however, that **loan originating QIAIFs cannot invest in other funds**. The Central Bank feels that that could confuse the supervisory approach and that investment in other funds could be used to circumvent the requirements applied to the loan originating QIAIF.

In addition**, loan originating QIAIFs cannot invest in other asset classes such as equities, debt securities, etc.** In its Feedback Statement, the Central Bank has said that if a loan originating QIAIF wishes to invest in other assets, the solution is to set up an umbrella structure with a loan originating QIAIF sub-fund and a separate sub-fund for non-loan strategies.

The new rules also apply where a loan originating QIAIF engages in loan origination as part of a syndication or club deal

(iv) Prohibited Loans

Loans cannot be originated to natural persons; to certain related parties (the AIFM, management company, GP, depositary or to delegates or group companies of these); to other funds; to financial institutions or to their related companies (save in the case where there is a bona fide treasury management purpose which is ancillary to primary objective of the loan originating QIAIF); nor to persons intending to invest in equities or other traded investments or commodities.

(v) Acquiring loans from credit institutions

The 5% "skin in the game" requirement for bank vendors remains but has been tempered somewhat as the Central Bank has taken on board comments received during the consultation process. As explained in its Feedback Statement, it has now "*modified the rule to apply it only where the loan acquired from a credit institution is a bilateral arrangement. Accordingly the retention rule does not apply if the loan purchased has been offered to multiple parties and is acquired on an arm's length open market basis".*

Otherwise, a loan originating QIAIF shall not "acquire a loan"[3] from a credit institution under arrangements which involve:

- the retention by the credit institution or a member of its group of an exposure correlated with the performance of the loan;

- the provision of an administration, credit assessment or credit monitoring service in relation to the loan whether on an individual or portfolio basis, by the credit institution or a member of its group,

unless the loan originating QIAIF is satisfied that it has in place and implements particular policies and procedures (including as to valuation, performance, monitoring, stress testing, etc.) and has received from the vendor warranties that:

- the vendor (or, where within scope of banking consolidated supervision, an entity within its group) will retain, on an on-going basis, **a material net economic interest of at least 5% of the nominal value of the loan as measured at origination**;

- the exposure will not be subject to any credit risk mitigation techniques; and

[3] For the purpose of this paragraph, "acquire a loan" means any of : to purchase; take transfer of; take credit risk or part of credit risk attaching to; take other exposures to, a loan.

- the loan originating QIAIF will have readily available access to all materially relevant data on the credit quality and performance of the underlying exposures and on cash flows relating to and collateral supporting the exposures so as to be able to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the exposures.

(vi) Portfolio Diversification

Exposure to any one issuer or group cannot exceed 25% of net assets. The QIAIF has to set out its risk diversification strategy in its prospectus, designed to achieve a portfolio of loans which is diversified and which will limit exposure to any one issuer or group to 25% of net assets within a specified time-frame. The loan originating QIAIF must not intentionally breach its risk diversification strategy and, in the event that it is not able to achieve that strategy within the time-frame set out in its prospectus, it must seek investor approval to continue with the actual level of diversification.

Diversification limits will not apply to a loan originating QIAIF which has reached its end of life phase and is closing out positions. Otherwise, the normal QIAIF rules regarding breaches of investment limits will apply - if the limits are exceeded for reasons beyond the control of the QIAIF, the QIAIF must record such matters and adopt as a priority objective the remedying of that situation, taking due account of the interests of its investors.

(vii) Leverage

The Central Bank has decided to retain its leverage limit for loan originating QIAIFs, albeit described slightly differently. The limit is that the loan originating QIAIF must not have gross assets of more than 200% of net asset value (or such other 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 QIAIFs). In other words, the ratio of debt to equity is still set at 1:1.

If the limit is breached, the QIAIF is required within 30 days (or such longer period as the Central Bank may specify) to obtain approval for a formal plan to bring it back into compliance with the leverage ratio.

(viii) Liquidity and Distributions

Having taken on board several of the comments received during the consultation process, the Central Bank's position in relation to liquidity and distributions for loan originating QIAIFs is now that loan originating funds must be **closed-ended** and must be established for a finite period. However, they can have discretion to invite, at dates determined at the authorisation date or such other dates as may be approved by the Board of the AIFM / Investment Company / Management Company / General Partner, without commitment and on a non-preferred basis, requests for redemption of holdings from investors.

Distributions to or redemptions of investors holdings can only be effected during the life of the loan originating QIAIF to extent that there is unencumbered cash or liquid assets available for such purposes and will not endanger regulatory compliance or liquidity regulated obligations of the QIAIF.

In addition, unless the assets can be valued by reference to prevailing market prices, a redemption cannot be made without the approval of the investors in accordance with the approval process set out in the QIAIF's constitutional document on each occasion.

(ix) Credit Granting, Monitoring and Management

Loan originating QIAIFs must establish and implement a variety of documented and regularly updated procedures, policies and processes in respect of a variety of credit granting, monitoring and management activities, including:

- the setting of a risk appetite statement;
- the assessment, pricing and granting of credit as well as the monitoring of credit and its renewal and refinancing (including, in both cases, criteria, governance and decision making and committee structures);
- collateral management policy;
- concentration risk management policy;
- valuation, including collateral valuation and impairment;
- credit monitoring;
- identification of problem debt management;
- forbearance;
- delegated authority;
- documentation and security.

The new Chapter to the AIF Rulebook sets out a variety of additional controls and restrictions around the credit granting, renewal and refinancing processes; the credit risk assessment process; and processes for value adjustments and provisions (including the requirement for effective systems) and adequacy of credit position diversification (See the Appendix to this briefing paper).

Loan originating QIAIFs will also be subject to the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises when lending to Irish SMEs.

(x) Due Diligence by Investors

Where an AIFM intends to provide access to its records/staff to any investor for the purposes of the investor carrying out due diligence on the AIFM, the AIFM must ensure that such access is made available on a non-discriminatory basis to all investors and not be structured so to materially mis-represent the business of the loan originating QIF.

In response to comments received on this provision during the consultation process, the Central Bank has clarified its position by explaining that "*Once a loan originating Qualifying Investor AIF decides to provide access to its records or staff, this facility must be transparently available so that any unit holder will have been aware of the due diligence possibility. The onus is on the unitholders to pursue this opportunity. It may arise therefore that some unitholders will have put resources into due diligence processes while others have chosen not to.*"

"*The AIFM shall not intentionally or negligently conceal or fail to disclose information that a reasonable person would be likely to have considered important in considering an investment in the loan originating QIAIF.*"

The AIFM is required to ensure that a single person within senior management is designated with responsibility to ensure that the access given has been non-discriminatory and that person must be satisfied that a reasonable person relying on the access provided would not be influenced to invest in the loan originating QIAIF because of lack of access to information. The rule also makes it clear that the AIFM must not intentionally or negligently conceal or fail to disclose information that a reasonable person would be likely to have considered important in considering an investment in the loan originating QIAIF.

(xi) Stress Testing

The QIAIF must have a comprehensive stress testing programme which includes a variety of specific requirements including a programme which identifies possible events or future changes in economic conditions that could have unfavourable effects on the fund's credit exposures. It also requires an assessment of the fund's ability to withstand such changes.

Transactions and aggregate exposures across all forms of counterparty credit risk at the level of specific counterparties must be comprehensively captured in a sufficient timeframe to conduct the regular stress testing, with a minimum monthly frequency for exposure stress testing of principal market risk factors such as interest rate, FX and credit spreads for all counterparties.

At least quarterly multifactor stress testing requirements are imposed as are minimum scenarios which must be addressed. Reporting of stress testing results to senior management must occur at least quarterly basis.

The Central Bank has also indicated that it intends to put in place similar reporting on individual loans as is provided by the banking sector and that its requirements in that regard will evolve with developments in banking.

(xii) Disclosure to Investors

Certain minimum information must be included in the QIAIF's prospectus including information on risk and reward profile, on levels of concentration, geographical location and sectors as well as risks arising from the proposed concentration. Details of the credit assessment monitoring process and information on whether the AIFM would provide investors with access to records and staff for the purpose of due diligence must also be disclosed.

A prominent risk warning must appear in the prospectus and sales material drawing attention to the unique risks which arise from loan origination and how investment in a loan originating investment fund is not guaranteed and is subject to the possibility of investment losses and illiquidity. Similarly, that the Central Bank has the capacity to tighten lending standards and leverage limits and the impact that may have on the QIAIF in following its investment strategy. Also required is a risk warning drawing attention to the potential implications from the application of the Central Bank's Code of Conduct for business lending to SMEs (where loans are issued to SMEs operating within Ireland).

Requirements as to the minimum content of periodic reports are also imposed including, for example, the breakdown of the originated loans between senior secure debt, junior debt and mezzanine debt etc.

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APPENDIX[4]

LOAN ORIGINATING QUALIFYING INVESTOR AIF

i. General Requirements

1. The loan originating Qualifying Investor AIF is not subject to the prohibition on the granting of loans set out in paragraph 7, Section 1, sub-section i in Part 1 of this Chapter

2. The loan originating Qualifying Investor AIF shall limit its operations to the business of issuing loans, participating in loans, participations in lending and to operations directly arising therefrom, including handling assets which are realised security, to the exclusion of all other commercial business

3. The loan originating Qualifying Investor AIF is subject to the rules set out in this section in addition to the general rules for all Qualifying Investor AIFs. The rules in this section also apply where a loan originating Qualifying Investor AIF engages in loan origination as part of a syndication or club deal

4. The loan originating Qualifying Investor AIF must have an authorised AIFM which may be the loan originating Qualifying Investor AIF.

ii. Credit Granting, monitoring and management

1. The loan originating Qualifying Investor AIF shall establish and implement appropriate, documented and regularly updated procedures, policies and processes for each of the following:

   - Risk appetite statement;
   - The assessment, pricing and granting of credit (including criteria, governance and decision making, committee structures);
   - Credit monitoring, renewal and refinancing (including criteria, governance and decision making committee structures);
   - Collateral management policy;
   - Concentration risk management policy;
   - Valuation, including collateral valuation and impairment;
   - Credit monitoring;
   - Identification of problem debt management
   - Forbearance;
   - Delegated authority;
   - Documentation and security

[4] This Appendix repeats Section 4, Chapter 2 – qualifying investor AIF requirements, AIF Rulebook

2. The loan originating Qualifying Investor AIF shall ensure that:

   (a) credit-granting is based on sound and well-defined criteria and that the process for a approving, amending, renewing and re-financing credits is clearly established;

   (b) subject to paragraph 3 of this section, the loan originating Qualifying Investor AIF has internal methodologies that enable the loan originating Qualifying Investor AIF to assess the credit risk of exposures to individual obligors, securities or securitisation positions and credit risk at the portfolio level;

   (c) the ongoing administration and monitoring of the various credit risk bearing portfolio positions and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, is operated through effective systems; and

   (d) diversification of credit positions is adequate having regard to the target markets and overall credit strategy of the loan originating Qualifying Investor AIF

3. Internal methodologies referred to in paragraph 2(ii) above shall, in particular, not rely solely or mechanistically on external credit ratings.

4. The loan originating Qualifying Investor AIF shall address and control the risk that credit risk mitigation techniques used by them may prove less effective than expected

5. The loan originating Qualifying Investor AIF shall ensure that:

   (a) the concentration risk arising from exposures to each counterparty, including

      (i) central counterparties;
      (ii) groups of connected counterparties; and
      (iii) counterparties in the same economic sector, geographic region or from the same activity or commodity;

   is addressed; and

   (b) the application of credit risk mitigation techniques and, in particular risks associated with large indirect credit exposures such as a single collateral issuer, is addressed and controlled including through the establishment and implementation of written policies and procedures

iii. Due Diligence by investors

1. Where the AIFM intends to provide access to its records / staff to any investor for the purposes of a due diligence process, it must ensure that such access has been made

available on a non-discriminatory basis to all unitholders. Such access must not be structured so as to materially misrepresent the business of the loan originating Qualifying Investor AIF. The AIFM shall ensure that a single person within senior management is designated with responsibility to ensure that the access given has been non-discriminatory. This person must be satisfied that a reasonable person relying on the access provided would not be influenced to invest in the loan originating Qualifying Investor AIF because of lack of access to information. The AIFM shall not intentionally or negligently conceal or fail to disclose information that a reasonable person would be likely to have considered material in considering an investment in the loan originating Qualifying Investor AIF

iv. Diversification/eligible investments

1. The loan originating Qualifying Investor AIF shall, in its prospectus, set out a risk diversification strategy which will achieve a portfolio of loans which is diversified and which will limit exposure to any one issuer or group to 25% of net assets within a specified time-frame. The loan originating Qualifying Investor AIF shall not intentionally breach this risk diversification strategy. In the event that the loan originating Qualifying Investor AIF is not able to achieve its risk diversification strategy within the time-frame set out in its prospectus, for reasons beyond its control, the loan originating Qualifying Investor AIF must seek approval from the unitholders, in accordance with the procedures set out in the constitutional document, to continue to operate at the level of diversification which has been achieved. In the event that unitholders do not approve the proposal the loan originating Qualifying Investor AIF must terminate. The proposal to investors must be made within 30 days of the end of the time specified in the prospectus for meeting the risk diversification strategy

2. The loan originating Qualifying Investor AIF shall not originate loans to any of the following:

   (a) natural persons;

   (b) the AIFM, management company, general partner, depositary, or to delegates or group companies of these;

   (c) other collective investment undertakings;

   (d) 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 loan originating Qualifying Investor AIF;

   (e) persons intending to invest in equities or other traded investments or commodities

3. Unless a loan is purchased following an offering to multiple parties and is acquired on an arm's length basis, the loan originating Qualifying Investor AIF shall not acquire a loan from a credit institution under arrangements which involve:

(a) The retention by the credit institution or a member of its group of an exposure correlated with the performance of the loan;

(b) The provision of an administration, credit assessment or credit monitoring service in relation to the loan, whether on an individual or portfolio basis, by the credit institution or a member of its group

unless the loan originating Qualifying Investor AIF is satisfied that the requirements set out in paragraph 4 below have been fulfilled.

For the purposes of this paragraph, "acquire a loan" means any of: to purchase; take transfer of; take credit risk or part of credit risk attaching to; take other exposures to, a loan.

4. Prior to acquiring a loan to which paragraph 3 of this section applies, a loan originating Qualifying Investor AIF must:

(a) have in place and implement policies and procedures to:

(i) monitor the net economic interest26 of the vendor over the lifetime of the loan;
(ii) value the loan where the loan is not purchased at face value;
(iii) prudently monitor the performance of the loan; and
(iv) stress test the loan independently of the vendor on a regular basis and at least annually, having regard to the changing risk profile of the exposure.

(b) have received from the vendor warranties that:

(i) the vendor, or, where within scope of banking consolidated supervision, an entity within its group, will retain, on an on-going basis, a material net economic interest of at least 5% of the nominal value of the loan as measured at origination;
(ii) the exposure will not be subject to any credit risk mitigation techniques; and
(iii) the loan originating Qualifying Investor AIF will have readily available access to all materially relevant data on the credit quality and performance of the underlying exposures and on cash flows relating to and collateral supporting the exposures so as to be able to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the exposures.

5. Without prejudice to the generality of the requirements set out in section viii, Section 1 of Part I of this Chapter, any agent of, intermediary for or introducer to a loan originating Qualifying Investor AIF, or an entity which is a member of group of which those entities are a part, shall be regarded as a connected party to whom section viii shall apply in the event that such an entity sells loans to a loan originating Qualifying Investor Fund or formulates the terms and conditions of a loan to be issued by a loan originating Qualifying Investor Fund.

v. Stress Testing

The loan originating Qualifying Investor AIF shall have a comprehensive stress testing programme which shall include the following:

(a) it shall identify possible events or future changes in economic conditions that could have unfavourable effects on the loan originating Qualifying Investor AIF's credit exposures and assess the loan originating Qualifying Investor AIF's ability to withstand such changes;

(b) the stress measures under the programme shall be compared against internal risk limits;

(c) the programme shall comprehensively capture transactions and aggregate exposures across all forms of counterparty credit risk at the level of specific counterparties in a sufficient time frame to conduct regular stress testing;

(d) the programme shall provide for at least monthly exposure stress testing of principal market risk factors such as interest rates, FX and credit spreads for all counterparties of the loan originating Qualifying Investor AIF in order to identify and enable the loan originating Qualifying Investor AIF when necessary to reduce outsized concentrations in specific directional risks;

(e) the programme shall apply at least quarterly multifactor stress testing scenarios and assess material non-directional risks including yield curve exposure and basis risks. Multiple-factor stress tests shall, at a minimum, address the following scenarios in which the following occurs:

  (i) severe economic or market events have occurred;
  (ii) broad market liquidity has decreased significantly;
  (ii) a large financial intermediary is liquidating positions.

The results of the stress testing under the programme shall be reported regularly, at least on a quarterly basis, to the board of the AIFM/investment company/management company/general partner.

vi. Liquidity and distributions

1. A loan originating Qualifying Investor AIF shall be closed-ended and shall be established for a finite period except that, the loan originating Qualifying Investor AIF may have discretion to invite, at dates determined at the authorisation date, or such other dates as may be approved by the board of the AIFM/investment company/management company/general partner,

without commitment and on a non-preferred basis, requests for redemption of holdings from unitholders.

2. The loan originating Qualifying Investor AIF shall only make distributions or provide for redemptions of unitholders holdings during the life of the loan originating Qualifying Investor AIF to the extent that there is unencumbered cash or liquid assets available for distribution or redemption purposes and that such distributions or redemptions will not endanger the regulatory compliance or liquidity related obligations of the loan originating Qualifying Investor AIF. Unless the assets of the loan originating Qualifying Investor AIF are valued by reference to prevailing market prices, a redemption of unitholder holdings cannot be made without the approval of the unitholders, in accordance with the procedures set out in the constitutional document, on each occasion.

vii. Leverage

1. The loan originating Qualifying Investor AIF must not have gross assets of more than 200% of net asset value, or such other limit as may be set by the Central Bank from time to time for loan originating AIF or for one or more class of loan originating AIF.

2. In the event that the loan originating Qualifying Investor AIF breaches the limit set out in paragraph 1 of this section, the loan originating Qualifying Investor AIF must, within 30 days or such longer period as the Central Bank may specify, secure the approval of the Central Bank for a formal plan to bring the loan originating Qualifying Investor AIF into compliance with the leverage ratio.

viii. Disclosure

1. The prospectus and all sales material issued or distributed in respect of a loan originating Qualifying Investor AIF must include a prominent risk warning which draws attention to the unique risks which arise from loan origination and how investment in a loan originating investment fund is not guaranteed and is subject to the possibility of investment losses and illiquidity. In addition, the prospectus must include:

   (a) Information on the risk and reward profile to enable investors identify the specific risks linked to a loan origination strategy;

   (b) Information on the extent to which the loan originating Qualifying Investor AIF intends to be concentrated as regards individual entities, geographical locations and sectors and risk arising from the proposed concentrations;

   (c) Details of the credit assessment and monitoring process set out in paragraph 1 of section ii Credit granting, monitoring and management above;

(d) Information on whether the AIFM will provide unitholders or potential unitholders with access to records and staff for the purposes of a due diligence process together with the terms and conditions under which such access will be made available.

2. The prospectus and all sales materials issued or distributed in respect of a loan originating Qualifying Investor AIF must include a risk warning drawing attention to the fact that leverage limits and lending standards may be tightened by the Central Bank which may impact on the ability of the loan originating Qualifying Investor AIF to follow the investment strategy set out in the prospectus.

3. The prospectus and all sales materials issued or distributed in respect of a loan originating Qualifying Investor AIF must include a risk warning drawing attention to the potential implications arising from the application of the Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises where loans are issued to SMEs operating within the State.

4. The periodic reports issued by the loan originating Qualifying Investor AIF must include the following:

(a) A breakdown of the originated loans between senior secured debt, junior debt and mezzanine debt;

(b) A breakdown of the originated loans between loans made with a amortising repayment schedule and loans made with bullet repayments;

(c) A breakdown of the loan to value ratio for each originated loan;

(d) Information in respect of:

- non-performing exposures, as defined in the Implementing Technical Standards adopted under Article 99 of Regulation EU No 575/2013, as amended from time to time; and
- exposures subject to forbearance activities, as defined in the Implementing Technical Standards adopted under Article 99 of Regulation EU No 575/2013, as amended from time to time. This information may be provided on an aggregate basis in periodic reports. It must be provided in relation to each exposure to the Central Bank and submitted with the periodic report and
- Material changes to the credit assessment and monitoring process set out in section ii Credit granting, monitoring and management above.

This information must also be provided to unitholders at each net asset value calculation point.

5. A list of any undrawn committed credit lines must be submitted to the Central Bank with periodic reports. The Central Bank reserves the right to pass this information to national competent authorities of the bank(s) in question, wherever located.