



Irish Loan Originating Funds - An Introduction

In 2015 the Central Bank of Ireland (Central Bank) introduced one of Europe's first tailored regulatory regimes for loan originating funds. This development was viewed as particularly timely, not least because of the evident need to provide for alternative sources of funding to the real economy across Europe and thereby reduce the concentration of credit risk within the European banking sector.

In Ireland, loan originating funds must be established as Qualifying Investor Alternative Investment Funds (QIAIFs). QIAIFs must have a minimum initial subscription of €100,000 (or its equivalent in another currency) or greater and can be marketed solely to "Qualifying Investors". Owing to their professional/ sophisticated nature, QIAIFs benefit from a fast-track approval process, provided that all parties to the fund are already regulated/approved by the Central Bank. This means that a QIAIF can be authorised by the Central Bank in 24 hours.

Loan originating QIAIFs (L-QIAIFs) fall under the Central Bank's AIF Rulebook and are subject to the provisions of the EU's Alternative Investment Fund Managers Directive (AIFMD). AIFMD permits AIFMs authorised in the EU to manage and/or market their products on a pan-European basis. This passport regime applies equally to L-QIAIFs as it does to any other type of QIAIF, meaning that an L-QIAIF established in Ireland could be marketed right across the EU.

An L-QIAIF may be established as either a standalone investment fund or as part of an umbrella investment fund structure with multiple sub-funds catering, at sub-fund level, for both loan originating strategies and non-loan originating strategies.

A significant advantage of the QIAIF product in terms of speed to market is that it is subject to a filing only authorisation process (as opposed to a prior full review process) by the Central Bank.

L-QIAIF Structure

L-QIAIFs can be established as an ICAV, an investment company, a unit trust, a common contractual fund or an investment limited partnership. An L-QIAIF must be closed-ended but may accept a redemption request: (a) at dates determined at the date of authorisation of the L-QIAIF by the Central Bank; or (b) at such dates as may be approved by the Board of the AIFM or L-QIAIF.

Choice of Structure

The most popular structure for new L-QIAIFs is the Irish Collective Asset Management Vehicle or "ICAV", the ICAV is a corporate structure introduced in 2015 that is specifically designed for investment funds. The ICAV has certain advantages when compared against the other product types available in Ireland, such as the investment company. An umbrella ICAV can publish audited financial statements on a sub-fund by sub-fund

basis and can dispense with the requirement to hold an annual general meeting of shareholders. The ICAV also has the ability to “check the box” to be treated as a transparent entity for U.S. federal income tax purposes. As a result of these advantages, the ICAV has become the corporate vehicle of choice for newly established investment funds.

Umbrella Funds - Segregated Liability

All L-QIAIFs, irrespective of their legal form, may be structured as an umbrella fund i.e. a structure with more than one sub-fund or portfolio, with segregated liability between the sub-funds. This means that as far as Irish law is concerned, automatic ring fencing of liabilities exists between one sub-fund and the other sub-funds in the umbrella such that there is no cross-contamination or “dipping” into the assets of one sub-fund to discharge the liabilities of another.

Permitted Activities

L-QIAIFs may engage in the following:

- issuing loans;
- participating in loans;
- investment in debt/credit instruments;
- participating in lending;
- operations relating to the activities listed above, including investing in equity securities of entities or groups to which the L-QIAIF lends or instruments which are held for treasury, cash management or hedging purposes.

Lending can be structured as an investment in debt securities or as participation in a syndicated lending arrangement. It can also combine lending (whether syndicated or bilateral), debt securities, subordinated debt and equity in a package of related investments. The L-QIAIF can also invest in debt instruments or equity issued by group companies of entities to which the L-QIAIF has lent.

The key requirement is that all such investments must be related to the permitted activities listed in the bullet points above.

Eligible Borrowers

An L-QIAIF may not lend to any of the following:

- Natural persons;
- the AIFM, the Depository or their respective delegates or group companies;
- Other collective investment undertakings;
- Financial institutions or their related companies, except in the case where there is a bona fide treasury management purpose which is ancillary to the primary investment objective of the L-QIAIF;
- Persons intending to invest in equities or other traded investments or commodities.

Leverage

The L-QIAIF must not have gross assets of more than 200% of its net asset value (that is, if, for example, an L-QIAIF has assets of \$100m, the L-QIAIF may have leverage of an additional \$100m.)

In the event that an L-QIAIF breaches the leverage limit, the L-QIAIF 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 L-QIAIF into compliance with the leverage limit.

Diversification

An L-QIAIF must have a risk diversification strategy, which will achieve a portfolio of loans that is diversified and which limits exposure to any one issuer or group to 25% of the net assets of the L-QIAIF within a specified timeframe. An L-QIAIF may not intentionally breach this risk diversification strategy. If, for reasons beyond its control, an L-QIAIF is unable to achieve its risk diversification strategy within the time-frame set out in its Prospectus, shareholder approval must be sought to continue to operate at the level of diversification that has been achieved. 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. In the absence of such shareholder approval, the L-QIAIF must terminate.

Policies and Procedures

An L-QIAIF must establish and implement appropriate, documented and regularly updated procedures, policies and processes for lending, credit monitoring and credit management, such as:

- A 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; and
- Documentation and security.

Stress Testing

An L-QIAIF must have a comprehensive stress testing programme, which should include the following elements:

- It must identify possible events or future changes in economic conditions that could have unfavourable effects on an L-QIAIF's credit exposures and assess the L-QIAIF's ability to withstand such changes;
- The stress measures under the programme must be compared against internal risk limits;
- It must 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;
- The programme must 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 an L-QIAIF in order to identify and enable the L-QIAIF when necessary to reduce outsized concentrations in specific directional risks; and
- The programme must apply at least quarterly multifactor stress testing scenarios and assess material non-directional risks including yield curve exposure and basis risks.

The results of the stress testing under the programme must be reported regularly, at least on a quarterly basis, to the boards of AIFM and the L-QIAIF, respectively.

Regarding the assessment of risk, the Central Bank places particular importance on the requirement that L-QIAIFs should not rely solely or mechanically on external credit ratings.

Due Diligence by Investors

If the L-QIAIF or its AIFM provides 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 shareholders.

Closed-ended

An L-QIAIF must be closed-ended and must be established for a finite period. However, the L-QIAIF will 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 and the L-QIAIF, without commitment and on a non-preferred basis, requests for redemption of holdings from shareholders in an L-QIAIF.

The L-QIAIF may only make distributions or provide for redemptions of shareholders during the life of an L-QIAIF 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 L-QIAIF. Unless the assets of an L-QIAIF are valued by reference to prevailing market prices, a redemption cannot be made without the approval of the shareholders.

Qualifying Investors

Investors in an L-QIAIF are required to be either sophisticated investors or institutional investors. In order to avoid an obligation to produce certain onerous pre-contractual documents, it is recommended that an L-QIAIF only take subscriptions from an investor who is a professional client within the meaning of Annex II of MiFID II, which is defined as a client who possesses the experience, knowledge and expertise to make its own investment decisions.

There are a number of entities which are automatically regarded as a professional client such as:

- Entities that are required to be authorised or regulated to operate in financial markets (investment firms, collective investment schemes and management companies of those schemes etc);
- National and regional governments, public bodies that manage debt, central banks and international institutions such as the IMF and the ECB;
- Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

There is also a procedure whereby investors other than those mentioned above can elect to be treated as a professional client. This involves waiving some of the protections afforded by the MiFID II conduct of business rules.

Conditions applicable to Subscription

The minimum initial subscription for an investor in an L-QIAIF must normally be the equivalent of €100,000. An L-QIAIF may not accept subscriptions from persons that group amounts of less than €100,000 for individual investors. The L-QIAIF may grant an exception to these requirements for certain investors, such as the AIFM or the investment manager.

The initial offer period of an L-QIAIF may extend up to two years and six months, provided that the terms of the initial offer ensure that early shareholders are not prejudiced by the arrangements.

As L-QIAIFs do not have to be actively marketed to the public, most L-QIAIFs have a very small number of investors. However, L-QIAIFs must be open to subscription by the public.

Prospectus

The Prospectus of an L-QIAIF must include:

- Information on the risk and reward profile to enable investors identify the specific risks linked to a loan origination strategy;
- Information on the extent to which the L-QIAIF intends to be concentrated as regards individual entities, geographical locations and sectors;
- Information on the risk arising from the loan origination concentrations;
- Details of the credit assessment and monitoring process set out above;
- A risk diversification strategy which will achieve a portfolio of loans that is diversified and limits exposure to any one issuer or group to 25% of the net assets of the L-QIAIF within a specified timeframe.

In addition, the Prospectus **and all sales materials issued or distributed** in respect of an L-QIAIF must include risk warnings 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 L-QIAIF to follow the investment strategy set out in the Prospectus.

Authorisation Process

A key advantage of establishing an L-QIAIF in Ireland is the speed of the authorisation process, with the Central Bank providing regulatory approval within 24 hours of application. In practice, the authorisation process for an L-QIAIF generally takes eight weeks, to allow for the various service provider contracts to be negotiated and the prospectus and other L-QIAIF documentation (such as the procedures, policies and processes regarding credit granting, monitoring and management) to be agreed.

Ireland as a Loan Servicing Centre of Excellence

Ireland has developed a deep level of expertise in loan servicing for a broad range of products, including L-QIAIF funds, which has helped establish it as one of the main global loan servicing centres. Irish fund service providers also have highly advanced and scalable servicing capabilities, built on global models and advanced technical solutions, supported by local expertise.

Taxation

An L-QIAIF is not subject to any tax in Ireland on interest or principal repayments on loans (foreign taxes may apply however). In addition, no Irish withholding tax applies to income distributions or redemption payments made by L-QIAIFs to non-Irish resident investors regardless of where they are resident.

L-QIAIFs are exempt from Irish income tax and Irish corporation tax and are not subject to tax on their net asset value. Additionally there is no stamp duty payable on the transfer of shares in an L-QIAIF. An “exit tax” may arise for investors who are resident in Ireland for tax purposes (or ordinarily resident) on a “chargeable event” (distributions, redemptions, repurchases, transfers and cancellation of units or on every 8 year anniversary). Funds set up as common contractual funds, however, are treated as tax transparent by the authorities and the income and gains of such funds are treated as though they accrue to the investors directly.

Funds in Ireland are not required to charge VAT as financial services are exempt, however, funds may be

required to register and self-account for VAT if they receive certain taxable services from suppliers outside of Ireland, including legal advisory services, tax advisory services or advertising services.

It is also of note that Ireland has a wide Double Taxation Treaty network available to it with approximately 80 agreements. However, each jurisdiction should be considered on a case by case basis to determine whether an agreement can be availed of by an L-QIAIF and its shareholders.

Joint Ventures

Given the regulated nature of an L-QIAIF, it can be difficult to enshrine common joint venture terms (ROFR, Pre-emption, Veto etc) into fund documentation. There are various solutions to this in circumstances where joint venture partners wish to operate an L-QIAIF in a more conventional JV partnership manner. These include inserting a partnership below the L-QIAIF where the L-QIAIF holds only a limited partnership interest and the limited partnership, through its general partner, holds the asset. Tax advice is a key factor in this and we are happy to engage on this in relation to the JV partners both individually and jointly in terms of agreeing the best structure.

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