Loan Funds

Following high demand in 2014 for the establishment of loan funds in Malta, the MFSA has launched new rules for collective investment schemes authorised to invest through loans.

The approval and licensing of loan funds is regulated by the Investment Services Act which provides for the licensing and regulation of collective investment schemes investing in any type of assets. These Loan Fund Rules apply specifically to loan funds in addition to any laws, regulations or standard licence conditions that are already applicable to Alternative Investment Funds (AIFs) or Professional Investor Funds (PIFs).

The MFSA has taken as a basis the provisions of the Alternative Investment Fund Managers Directive (AIFMD) as transposed into Maltese law in the first half of 2013. The rules also draw on the relevant MFSA Banking Rules to address the specific areas of risk in a manner that ensures consistency with the Banking Act, while retaining the inherent characteristics of collective investment schemes established under the Investment Services Act.

Through the adoption of these Rules, the Authority has sought to address a number of risks that are primarily associated with lending activities. Risks to the stability of the funds are addressed through the inclusion of exposure limits. To mitigate the transmission or acquisition of unwarranted credit risk, loan funds are also required to follow strict credit assessment standards and fund managers must satisfy special competence and remuneration requirements.

To minimise the risk of cross contamination with the banking sector, loan funds are restricted from lending to credit or financial institutions and must carry out credit assessments at the point of acquisition of any loan portfolios, if this is the case. Pricing risk is addressed through the application of a regularly updated variable NAV. In order to reduce liquidity risks, loan funds must be closed-ended or at least make use of appropriate redemption gates. Other liquidity requirements also apply and leverage is not allowed.
Key Features of the New Regime

**General Requirements**

- Fund managers will be able to establish loan funds either as PIFs or as AIFs, depending on whether the fund manager is a de minimis AIFM or an AIFM licensed in terms of the Act, respectively.
- Funds are to be structured as closed-ended scheme (SICAVs with closed ended features), and will be able to invest through loans solely and exclusively to unlisted companies including SMEs.
- Financial institutions will not be eligible to receive financing from these Schemes.
- The Rulebook covers direct origination of loans by the Scheme or the acquisition by the Scheme of a portfolio of loans or a direct interest in loans which gives rise to a direct legal relationship between the Scheme as lender and the borrower.

**Target Investors**

Units of these collective investment schemes shall only be marketed to:

- professional investors as defined in Section I to Annex II to the Markets in Financial Services Directive (MiFID) and/or
- investors who, on request, elect to be treated as professional clients as per Section II of Annex II to the MiFID and who commit to investing a minimum of €100,000

**Required Service Providers**

Fund manager, custodian, auditor, compliance officer and money laundering reporting officer:

- The Scheme will also have to make arrangements for the valuation function. In particular, the fund manager must have sufficient financial resources and liquidity available to enable it to conduct business, and such organisation, systems, experience and expertise deemed necessary by the MFSA for it to provide management services to these funds.
- The fund manager must also possess the required skills and expertise to ensure that any lending decisions are made with due consideration and will also have proven experience in the area of granting of loans including credit assessment, credit provisioning monitoring and control of exposures.

The Rules also provide for the appointment of a single custodian for each Scheme, either as a Category 4a or Category 4b Investment Services Licence Holder. A Category 4a Investment Services Licence Holder is eligible to act as custodian to all categories of collective investment schemes. On the other hand, a Category 4b Investment Services Licence Holder (‘depositary lite’) can act as custodian of schemes which:

- have no redemption rights exercisable during the period of 5 years from the date of the initial investments; and
- in accordance with their core investment policy, generally do not invest in assets that must be held in custody; or
- generally invest in issuers or non-listed companies in order to potentially acquire control over such companies.

**Investment Restrictions**

The fund manager must comply with the investment objectives, policies and restrictions of the scheme as outlined in the Offering Document, particularly with regards to eligible investments, the risk profile of the fund and other terms of the offer. The use of leverage and the reuse of collateral by the Scheme are not permitted.

**Credit Risk**

- The fund manager is required to establish and implement a credit risk strategy and related policies in proportion with the scope and sophistication of the Scheme’s activities. The credit policy will establish the framework for lending and guide the credit granting activities of the Scheme, which must include a risk appetite statement and address items such as target markets, portfolio mix, structuring of credit limits, processing and reporting.
- The fund manager is bound to submit for approval by its governing body, the Scheme’s strategy for the selection of risks and maximising the profits and returns.

**Liquidity Management**

- The manager is required to employ an appropriate liquidity management system and adopt procedures which enable the monitoring of liquidity risk of the scheme and to ensure that the liquidity profile of the investments of the scheme complies with its underlying obligations.
- Whilst this feature is already provided for in the provisions of the AIFMD, the new Rulebook seeks to further build on this requirement using concepts normally applied in the banking sector, such as the liquid-asset proportion.
- Although structured as a closed-ended scheme, the fund manager may on a yearly basis opt to redeem and cancel any shares in accordance with the terms of the offer should the fund have excess liquidity. The Rules also make provision for the application of a variable NAV.

**Disclosure to investors**

Detailed disclosure obligations modelled on the disclosure provisions prescribed in the AIFMD as well as an annual report.