

10 November 2020

## Circular on the Restructuring of the MFSA Loan Funds Regime

### 1. Purpose

The Authority is today publishing a revised version of the Loan Funds Rules reflecting the restructuring of the MFSA Loan Funds regime.

The purpose of this Circular is to inform the industry about the key changes being implemented in respect of this framework, presenting the revised Loan Fund Rules, as well to provide a background that has led to these amendments.

### 2. Background to the revised framework

As communicated in the [MFSA Circular](#) dated 2 April 2014, the Authority had, at the time, set out that the MFSA shall monitor developments both at European and international level and in particular, to update the MFSA Loan Fund Rules, should circumstances so merit.

In this respect, an assessment of the MFSA Loan Fund Rules has been carried out by the Authority in view of market developments, the current economic scenario, having however also regard to the direction being taken at EU level with regards to loan origination by funds, including associated risks.

Furthermore, consideration was given to the industry's feedback provided to the Authority since the framework was setup, on how aspects of the regime may be enhanced, in order to make such framework easier to operate with.

As part of the framework's restructuring, the objective was in fact for the Authority to re-evaluate our regulatory approach to this market and achieve a better balance between the need for a sound regulatory framework and that to make such regime more pragmatic and accessible to the fund industry, particularly in view of the considerations, as indicated below.

Besides undertaking an assessment of the current applicable requirements of the MFSA Loan fund regime, attention was given by the Authority to the relevant EU regulatory developments and, in particular, the focus being placed on the area of non-bank financing by the European Commission, within the wider context of the Capital Markets Union ('CMU'). Bank financing is an important external source of funding for businesses, but with changes in regulatory frameworks applicable to banks, it is also increasingly raising barriers to bank lending to certain small and medium sized enterprises ('SMEs').

In order to ensure that SMEs in particular, have access to adequate financing and can further diversify their funding sources, the CMU is aiming to make it easier for such firms to be able to tap into alternative sources of funding and consequently, reduce their over-reliance on bank financing. In this regard, the Authority is cognisant that the availability of loan funds in general is increasingly becoming a common part of the funding ecosystem for businesses seeking alternative source of financing to traditional banking.

Further to the above, the need to make loan funds more accessible, was also driven by the need to continue supporting financial innovation. In overcoming the financing challenges, alternative non-bank finance is playing a key role in helping businesses, in providing financing needs to be able to grow and contribute to the economy. The Authority accordingly deems that making available an alternative finance solution to such businesses involved in the facilitation of innovative new finance may also hence, be considered an important element in fostering the financing of innovation element throughout Europe.

The need for enhancing the MFSA loan fund regime has become even more pronounced in the current economic scenario, where certain businesses (particularly, those who are experiencing weakness in their financial situation) may be finding it increasingly difficult to gain access to capital through traditional lending sources. At the same time, fund managers may be after acquiring a riskier investment, to be targeted to adequately informed investors, which although being of a greater illiquid nature, would be able to create higher returns and with a different risk profile.

In addition, the aim for revisiting this regime was to achieve a more accessible framework for Professional Investor Funds (established as loan funds) managed by *de minimis* AIFMs. This is in view that the current Loan Fund Rules do not differentiate between Alternative Investment Funds managed by full AIFMs and Professional Investor Funds managed by *de minimis* AIFMs. As a result, in terms of the current Loan Fund Rules, the same onerous requirements apply to both type of fund structures, making it less accessible for smaller sized asset managers to set up these funds.

Furthermore, the objective was also to remove, or otherwise amend accordingly, the current Standard Licence Conditions applicable to collective investment schemes (qualifying as loan funds) established in terms of the MFSA's Alternative Investment Funds framework, which are essentially replicating certain requirements applicable at the AIFM level (or to self-managed Alternative Investment Funds).

Besides reflecting the above considerations, the revised Rules incorporate the contents of the ["Frequently Asked Questions document on the Standard Licence Conditions applicable to Collective Investment Schemes authorised to invest through loans"](#) (FAQ), published in May 2015. The Authority believes that having one consolidated set of Rules (including contents of the FAQ document) should provide greater clarity for applicants intending to apply for a license in terms of this regime.

On a general note, in considering the amendments to the MFSA Loan Funds Framework and in assessing which features applicable to the current framework are deemed critical to remain applicable, attention was given by the MFSA to the emergence of non-bank financial intermediation matter and the risks typically associated with loan originating funds.

In this respect and as further indicated in the comparative table hereunder, certain features of the framework considered key by the MFSA in view of the particular nature of these funds and the

associated risks, shall remain applicable. As stated above, regard was also given in this respect to the direction that the EU is taking with reference to loan origination funds.

That said, the Authority believes that the restructured framework provides the industry with a more pragmatic, but nonetheless robust regime.

### 3. Comparative Table

The revised Loan Fund Rules are attached as Appendix 1 to this Circular. For ease of reference, the table below provides an overview of the main differences between the current Loan Fund Rules to the revised framework.

FEATURE	CURRENT FRAMEWORK	REVISED FRAMEWORK
APPLICABILITY	The applicability of the MFSA Loan Fund Rules applies for AIFs (excluding Retail AIFs) and Professional Investor Funds	No change.
FUND STRUCTURE	<p>Loan funds must be set up as closed ended (although the fund manager may on a yearly basis opt to redeem and cancel any shares should the fund have excess liquidity).</p> <p>Where the Scheme is licensed under an umbrella structure, all funds in the structure shall be strictly licensed as loan funds.</p>	<p>No change.</p> <p>The requirement of having all sub-funds necessarily classifying as loan funds within the same umbrella structure has been removed.</p>
INVESTMENT STRATEGY	<p>Collective Investment Schemes falling under the Loan Fund Rules are authorised to “invest through loans”, intended as:</p> <p>[i] the direct origination of loans by the Scheme; or</p> <p>[ii] 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.</p>	The revised framework expands the definition of “investing through loans” to include the activities of factoring and/or forfaiting (reflecting MFSA position as per FAQs).
TARGET INVESTORS (allowed to invest in these funds)	Units of these funds may only be marketed to Professional Investors (as defined in MiFID) and/or investors who elect to be treated as such and commit to investing a minimum of EUR 100,000.	No change.

<p>TARGET LOAN RECIPIENTS</p>	<p>The Scheme may issue loans solely and exclusively to unlisted companies and SMEs as defined in the Commission Recommendation of 6 May 2013 concerning the definition of micro, small and medium-sized enterprises.</p> <p>Provided further that financial undertakings shall not be eligible to receive financing from these Schemes.</p> <p>Provided further that households and individuals shall not be eligible to receive any financing from these Schemes.</p>	<p>This has been amended and largely follows the ESMA Opinion on Loan Origination Funds.</p> <p>Loan-originating funds shall not be able to originate loans to the following debtors:</p> <ul style="list-style-type: none"> <li>- Individuals;</li> <li>- Financial undertakings (as defined in the revised Loan Fund Rules);</li> <li>- Collective investment schemes;</li> <li>- The AIFM and related parties (e.g. depositary, general partner, or delegates), including the fund's service providers.</li> </ul>
<p>SERVICE PROVIDERS</p>	<p>A loan fund structured as AIF or PIF is required to appoint a fund manager (unless self-managed), a custodian, an auditor, an external valuer (where applicable), a Compliance Officer and a Money Laundering Reporting Officer.</p>	<p>Current requirements included in the Rulebook applicable to service providers have been amended as follows: -</p> <p>For Alternative Investment Funds – the requirements have been removed because they are currently replicating the already existing requirements emanating either from the AIF Rulebook itself, or the requirements applicable at the AIFM level (in line with the AIFMD).</p> <p>For Professional Investor Funds – the requirements applicable to service providers are removed as the requirements are covered in the PIF Rulebook, with the exception, however, to the <u>valuation</u> arrangements, which shall remain featuring in the revised Rules.</p>
<p>VALUATION</p>	<p>The valuation shall be performed by (i) an independent external valuer; or (ii) the Manager, provided that the valuation task is functionally independent from the portfolio management and the credit granting function.</p>	<p>No change.</p>
<p>CASH BORROWING &amp; LEVERAGE LIMITS</p>	<p><u>Cash Borrowings</u>: The Scheme may borrow cash provided that such borrowing fulfils all of the following conditions:</p>	<p>Borrowing restrictions are being removed and the use of leverage (including borrowing) is allowed up to 200% of the net assets of the Scheme.</p>

	<p>a. it is short-term borrowing to bridge drawdown commitment dates, or it serves the purpose of acquiring units or shares in the Scheme's investments in terms of the Scheme's offering documents; and</p> <p>b. it represents not more than 30% of the capital of the Scheme;</p> <p>c. it is contracted in the same currency as the assets to be acquired with the borrowed cash;</p> <p>d. it does not hinder the realisation of any asset held in the portfolio of the Scheme; and</p> <p>e. it does not encumber the assets held in the portfolio of the Scheme.</p> <p><u>Leverage Limits:</u> The use of leverage and the reuse of collateral by the Scheme are not permitted, while borrowing is allowed under certain conditions.</p>	<p>Short selling and reuse of collateral are not permitted.</p>
<p>EXPOSURE LIMITS</p>	<p>The Scheme may invest:</p> <ul style="list-style-type: none"> <li>- Up to 30% of its assets in liquid securities;</li> <li>- Not more than 10% of its capital in a single undertaking;</li> <li>- Not more than 10% of its capital in another loan fund, provided that this fund operates according to the Loan Fund Rules, provided that the Scheme does not acquire more than 25% of the units or shares of the target loan fund.</li> </ul>	<p>The prescribed investment restrictions are being removed.</p> <p>No fixed diversification requirements or limits to exposures shall apply.</p> <p>However, the fund's manager (or the scheme itself, if it has a self-managed structure) is nonetheless expected to ensure a sufficiently diversified credit portfolio.</p>
<p>RISK MANAGEMENT</p>	<p>Functional and hierarchical separation of the Risk management from the operating units, in accordance with the principle of proportionality.</p> <p>The risk measurement arrangements are subject to ongoing review and to the performance of stress-test, scenario analysis and back-tests.</p> <p>The risk management arrangements requirements for Managers of Maltese loan funds practically reflect those emanating from the AIFMD in this regard; however, further requirements are added with respect to the</p>	<p>The revised Rules have been streamlined to avoid duplication of requirements (already applicable to AIFMs) and also avoid applying the same onerous Rules applicable for full AIFMs to <i>de minimis</i> AIFMs.</p> <p>The separation between the Risk Management function and the operating units will still constitute a requirement, subject to the principle of proportionality.</p>

	<p>management of the credit and liquidity risks.</p> <p>CREDIT RISK: the Fund Manager is required to establish a credit risk strategy setting out the organisation of the credit-granting function, as well as a credit risk policy establishing the framework for the lending activity.</p> <p>The Rules include prescriptive requirements on the criteria to be followed for a sound credit-granting process and/or for the acquisition of existing credits. The credit risk policy shall include a "credit provisioning policy", and the Manager shall further establish a credit administration function, to be functionally independent from the portfolio management and the credit-granting function.</p> <p>LIQUIDITY RISK: quantitative and qualitative limits with respect to the liquidity risk shall be established and abided by, and regular stress tests, which criteria are thoroughly listed, shall be conducted to assess the liquidity risk of the Scheme.</p>	<p>CREDIT RISK: the Fund Manager (or the scheme, if self-managed) is required to establish a Risk Management Policy which also addresses credit risk, by establishing the framework for the lending activity. The policy shall reflect the risk tolerance towards the lending activity and the different criteria to be applied thereto.</p> <p>Whilst retaining most of the principles for a sound credit-granting process as a requirement emanating from the Rules, the revised Rules will be giving the Manager (or the scheme, if self-managed) more flexibility with respect to the organisation of the credit-granting activity, whilst however demonstrating the soundness and adequacy of its arrangements.</p> <p>LIQUIDITY RISK: the same general principles will apply with respect to the measures to be taken by the Manager (or the scheme, if self-managed) to address liquidity risk. The revised Rules specify what needs to be included in the Risk Management policy of the Manager (or the scheme, if self-managed) in this respect.</p>
<p>LIQUIDITY MANAGEMENT</p>	<p>The Manger shall monitor the liquidity profile of the Scheme's portfolio, ensuring that this maintains a minimum liquid-asset proportion: specific criteria are listed to explain how this should be attained.</p> <p>A Variable NAV shall be applied to the Scheme.</p> <p>The Manager is required to keep a Liquidity Maturity Ladder.</p>	<p>The revised Rules reflect general principles with regards to Liquidity Management but do not include prescriptive requirements such as the Liquidity Maturity Ladder (i.e. Asset/Liability Management) requirement, that were included in the previous Loan Fund Rules.</p> <p>The Manager (or the scheme, if self-managed) shall ensure to have well documented liquidity management policies and procedures (including their review and update) and that the investment strategy, liquidity profile and redemption policy, are aligned accordingly.</p>

<p>SELF-MANAGED SCHEMES <u>structured as Professional Investor Funds</u></p>	<p>The initial paid up share capital for the Scheme should not be less than EUR300,000 and the NAV of the Scheme is expected to exceed this amount on an ongoing basis.</p>	<p>The requirement has been removed, and the initial paid up share capital of PIFs investing through loans shall be compliant with the relevant requirements set out in the PIF Rulebook.</p>

#### 4. Applicability of the revised Loan Fund Rules

The revised Loan Fund Rules shall apply as from the date of this Circular onwards. Such Rules shall be applicable to new applicants applying for a collective investment fund licence to be established in terms of the Loan Fund Rules.

Similarly, in view that the contents of the FAQs, have been incorporated in the revised version of the Loan Fund Rules, such FAQs will not apply to new applicants.

The revised Loan Fund Rules are Standard Licence Conditions which apply to collective investment schemes falling within scope of the Loan Fund Rules, licensed as Alternative Investment Funds or Professional Investor Funds. Such Licence Conditions shall apply in addition to any other MFSA Rules applicable to these funds (as indicated in the relevant Rulebook).

#### 5. Way forward for collective investment schemes already licensed in terms of the Loan Fund Rules

The previous version of the Loan Fund Rules shall remain available, for the time being, on the MFSA's website, applicable to current collective investment schemes that have been established in terms of the Loan Fund Rules and licensed up to the date of this Circular.

Such licensed funds opting to amend any of their current applicable requirements in light of the revised Rules, are expected to duly notify investors and to seek regulatory approval, as needed and may be required in terms of their Offering Memorandum, Constitutional Documents and MFSA Rules.

Existing licensed loan funds are expected to undertake an assessment and assess how the revised framework might impact the fund's operations. Any potential issues arising as a result of the revised Loan Fund Rules requiring action by the licensed scheme, need to be addressed by no later than 1 November 2021. Should assistance be required in this regard, licence holders are urged to contact the Securities and Markets Supervision.

If an existing Loan Fund has been granted any derogations by the MFSA in terms of the previous Loan Fund Rules, the licence holder is expected to undertake an assessment of the applicability or otherwise of such derogation and also contact the Securities and Markets Supervision.

With reference to the FAQ document, this shall also remain available on the MFSA's website in the near future but shall only be applicable to collective investment schemes (established in terms of the Loan Fund Rules) licensed up to the 10 November 2020.

## 6. Contact

Any queries regarding the above should be directed, as applicable, to the Authorisation team (e-mail: [ausecurities@mfsa.mt](mailto:ausecurities@mfsa.mt)) or to the Funds Supervision team (e-mail: [funds@mfsa.mt](mailto:funds@mfsa.mt)) within the Securities and Market Supervision function.