

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

STANDARD LICENCE CONDITIONS APPLICABLE

TO

COLLECTIVE INVESTMENT SCHEMES

AUTHORISED TO INVEST THROUGH LOANS

FREQUENTLY ASKED QUESTIONS

Preliminary Remarks

This FAQ aims to provide answers to questions that the Authority has been receiving with regards to the application of the Standard Licence Conditions applicable to Collective Investment Schemes authorised to invest through loans [the “Rulebook”].

The contents will be updated from time to time to include further information as deemed appropriate by the Authority.

The answers provided in this document are not necessarily definitive and are not intended to replace or substitute legal or professional advice. Anyone wishing to clarify any matter relating to the content of this document may contact the Authority through the normal channels.

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- Q3) What types of loans may be originated by Loan Funds?**

A. SCOPE

Q1) Which Funds fall within the scope of these Rules?

- A1) These Rules apply to collective investment schemes (including their sub-funds) (“**Funds**”) that are “established to carry out investments through loans”.

Accordingly, the Rules apply to any funds which as a significant part of their investment objective or strategy, aim to, directly or indirectly through SPVs:

- (a) grant or issue loans to borrowers as lender of record (“**Loan Origination**”); or
- (b) acquire one or more loans or portfolios of loans under arrangements where the Fund (or its SPV) becomes the new lender of record (“**Acquiring Loans**”).

(Loan Origination and Acquiring Loans are collectively referred to as “**Lending**”).

Q2) What does the expression “significant” part of their investment objective or strategy mean?

- A2) The Rules are designed to apply to funds whose investment objective or strategies include direct lending or the acquisition and subsequent management of loans or portfolios of loans as a means of generating an investment return or gain for the Fund and its investors.

As a general rule, any amount of lending carried out by a fund in accordance with its investment objective and strategy could potentially mean that the fund is subject to the Rules.

However, where a Fund’s:

- (a) investment objective and strategy is not primarily concerned with obtaining exposure to loans and
- (b) its Constitutional Document or Offering Document contains an express investment restriction that prohibits the fund from investing more than 15% of its net asset value through lending,

such fund could benefit from a full or partial derogation from the Rules. Such derogation shall not be automatically applicable and will require the Authority’s determination in writing as to the availability of such derogation for the fund.

For the avoidance of doubt, **investing in or acquiring transferable securities** (as defined under the Investment Services Act) is not lending. Similarly, **efficient portfolio management or treasury management techniques** such as securities lending, repo and reverse repo activities are not considered lending.

Q2.1) Are funds with venture capital or private equity objectives and strategies subject to the Rules?

A2.1) Venture capital, private equity funds and other funds having specific investment objectives and strategies that only engage in lending as an ancillary activity in furtherance of their investment strategy do not fall within the scope of these Rules. Granting or issuing shareholder loans, venture or risk capital or other private equity financing techniques are examples of such ancillary activity in furtherance of their investment strategy.

Q2.2) Are Funds involved in distressed debt strategies subject to the Rules?

A2.2) Funds pursuing clearly defined distressed debt strategies may be considered to fall outside the scope of the Rules. Due to the uncertainties that may arise on the application of the Rules in certain situations, particularly if loan origination is or may be involved, funds engaging in distressed debt strategies are encouraged to clarify their position with the Authority.

In carrying out its assessment of the particular strategy concerned, the Authority will primarily focus on the extent to which the fund is permitted to engage in lending. Although these investing techniques may form an integral part of the distressed debt strategy followed by the fund (e.g. temporary credit lines to target companies), the Authority will need to be assured that such funds will not be pursuing an investment strategy that is more akin to that of a loan fund as envisaged by the Rules.

Subject to the above, the Authority may not consider the acquisition on an arm's length basis of loans or portfolios of loans which are or consist of foreclosed or distressed loans as the activity of acquiring loans. Alternatively, the Authority may specify which conditions shall apply in the circumstances of the case.

Q3) What does Loan Origination mean?

A3) The Authority interprets the activity of loan origination as consisting in the granting or issuing of a loan or credit as lender or co-lender to a third party as borrower.

Subject to the clarifications provided in this Q&A, the Authority considers this as analogous to the activity of "lending" under the First Schedule to the Financial Institutions Act¹ (the "FI Act").

For the avoidance of doubt, the acquisition by a fund of transferable securities issued by:

¹ Cap. 376 - Laws of Malta

- (a) credit institutions or financial institutions authorised and regulated in a recognised jurisdiction to carry out loan origination; or
- (b) securitisation vehicles that do not belong to the fund (see answer to Q. 11 below though),

would not be considered as engaging in indirect lending.

Q3.1) Is participating in syndicated loans considered as loan origination?

A3.1) In the case of syndicated loans, a fund is considered to fall outside the scope of Rules if its exposure to a borrower is exclusively as co-lender in a loan syndicate where the lead arranger and lender is a credit institution or other financial institution that is authorised and regulated to undertake lending activity.

Q3.2) Are mezzanine finance and hybrid securities considered to be loans?

A3.2) Various legal aspects and market practices must be taken into consideration prior to determining the exact nature of these funds.

The investment rationale in a mezzanine finance / hybrid security investment differs from the rationale associated with normal lending activity, although loan-type instruments are frequently used to achieve this.

In view of this, the MFSA would need to assess the nature and objectives of the fund and the composition of the portfolio in order to determine the extent to which it may fall within the letter and spirit of the Rules and may consider waiving certain provisions and or adding special conditions as may be appropriate (such as setting specific thresholds for standard loans offered alongside mezzanine instruments).

Q3.3) Is factoring considered to be Lending for the purposes of the Rules?

A3.3) In its pure form, factoring is the outright purchase of the invoices of a company by the factoring institution. By buying the invoice, the factor may either assume the risk of default (without recourse factoring) or retain the right to obtain reimbursement from the vendor (with recourse factoring).

The Authority considers that a fund engaging in factoring exclusively without recourse would not be engaging in loan origination.

Recourse factoring and accounts receivable financing are essentially the extension of a credit line to the supplier by the factoring/financing entity (in this case the Loan Fund). Depending on the circumstances of the particular case, the Authority generally considers that a fund engaging in recourse factoring will be engaged in lending since the Fund's counterparty remains responsible for any bad debt on the receivables 'pledged' or 'acquired' under a factoring arrangement.

Q3.4) Is forfeiting or other forms of trade finance considered to be Lending?

A3.4) Trade finance including forfeiting is considered to be an extension of credit. The short term nature of this lending however mitigates the liquidity risk, but is still considered as a form of lending activity.

Certain provisions in the Rules may not be relevant or proportionate to funds engaging in this type of activity and the Authority could consider allowing a derogation from some of the said provisions should a proper case be made for this by the promoters.

Q4) What does ‘Acquiring Loans’ mean?

A4) The Authority interprets the activity of “acquiring loans” as the acquisition (whether by novation or assignment) of one or more loans or portfolios of loans (whether from an originator or on the secondary markets) which gives rise to a direct legal relationship between on the one hand the Fund as lender and on the other hand the borrower or borrowers.

Arrangements entered into on an arm’s length basis where the fund may have economic exposure to loans but has no direct recourse against the underlying borrowers (such as participating notes, swaps or similar instruments) are not considered as acquiring loans.

Q5) What is the Authority’s approach to lending through SPVs or master funds? Would these fall within the scope of the Rules?

A5) If the fund’s SPVs or master fund were to engage in lending to third party operators, the MFSA would adopt a look through approach and require the fund to amend its investment objectives to cover ‘investment through lending’. In such a case the Rules will apply.

Where the fund is investing in securities issued by or is lending to its SPVs or master fund, however, one must evaluate whether this investment or lending is intended to finance the origination of loans (or acquisition of loan portfolios) at the level of the SPV or master fund or whether the lending is linked to the attainment of the wider investment objectives of the fund (*see answer to question 2*).

Q5.1) Would the securitisation of loan portfolios require the securitisation vehicle to be licensed as a loan fund?

A5.1) Different scenarios must be taken into consideration:

- a. The setting up of a securitisation vehicle in accordance with the provisions of the Securitisation Act, would not require a Collective Investment Scheme

licence unless otherwise required by the said Act, even if the assets being securitised are loan instruments or income flows arising from loans.

- b. A securitisation vehicle set up through a fund under the Securitisation Act (or other comparable legislation in a recognised jurisdiction) in order to acquire and securitise loan assets would likewise not subject the fund or the securitisation vehicle to the Rules.
- c. A Fund investing in financial instruments issued by a securitisation vehicle that does not belong to the Fund is not considered to be a loan fund.
- d. An SPV of a Fund set up to originate loans, or acquire loan assets without issuing any financial instruments, would not be considered as a securitisation vehicle and would render the fund subject to the Loan Fund Rules.

Q6) What is the interplay between the Rules and the Financial Institutions Act?

A6) The FI Act regulates the carrying on of business of a financial institution (which includes regularly or habitually lending) in or from Malta. Under Article 3(6) of the FI Act:

“Where a person is already licensed under the Banking Act or the Investment Services Act to carry out an activity listed in the First Schedule, such person shall not require a licence for such an activity under this Act.”

For the purposes of this Article, unless either:

- (i) a Fund is authorised under the Rules as a Lending Fund or
- (ii) the Authority determines that the relevant type of activity (including in these Q&A) does not constitute Lending, and
- (iii) all relevant lending activities proposed to be carried out by the Fund are clearly disclosed in its Offering Documents,

a Fund is not, through the issuance of a collective investment scheme licence under the Investment Services Act, deemed licensed to carry out the activity of lending under the Investment Services Act.

B. OTHER

Q1) Do the Rules apply in full where a Fund exclusively Acquires Loans?

A1) The Authority recognises that there is a difference in the approach and expertise required in the acquisition of a portfolio of loans, as opposed to the origination of loans, although there is a strong element of convergence with loan origination once a portfolio of loans has been acquired and is under management.

This difference in approach is recognised in SLC 4.21 of the Rules which specifies the nature of the assessments that the manager needs to carry out at the acquisition stage as well as the manner in which the Rules need to apply once the said asset/s have been so acquired.

Q2) The Loan Fund Rules define a closed ended fund as one which, among other things, does not raise capital though the continuous sale of units or shares (Rule 1.03). What should the Fund do should it wish to accept new capital in the course of its duration, or at least in a couple of instances?

A2) Any intention to raise additional capital on a one-off basis should be indicated to the Authority at the outset and should be disclosed in the fund's Constitutional Documents and Offering Documents. The MFSA will consider the circumstances of each case, including the objectives and policies of the Fund. A Loan Fund is, however, required to abide by the liquidity provisions stipulated in the Loan Fund Rules. It is not allowed to raise capital in order to effect a redemption of units. In any authorised fresh call for capital, the fund shall ensure that the offer to raise capital is first made to existing shareholders pro rata to their existing holding in the fund as this will ensure that pre-emption rights are duly protected. If any existing unit holder does not take this offer, the fund can raise capital from other unit holders and/or other investors as the case may be.

Q3) What types of loans may be originated by Loan Funds?

A3) These types of Schemes may issue loans solely and exclusively to unlisted companies and SMEs. Financial undertakings as defined in the Rules shall however not be eligible to receive financing from these Schemes.

The Loan Fund Rules further specify that a Collective Investment Scheme may not originate loans to households or individuals. However, loans to households or individuals that have been originated by credit institutions may be acquired by a Loan Fund under the applicable conditions established by the Loan Fund Rules.