FINDINGS OF THE SURVEY ON LOAN FUNDS

Final Report

The Board

OF THE

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FR03/2017	**FEBRUARY 2017**

Copies of publications are available from:
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BACKGROUND:

The financial crisis in 2007/2008 marked a turning point for the global financial system. In its aftermath, there was a strong demand for more regulation and monitoring. Having initially focused primarily on strengthening the banking sector and significantly increasing prudential requirements, international organisations and regulatory bodies have been working together to address risks that could emanate from the so called global *shadow banking system* and to build a robust, sustainable system of market-based finance. [1] In doing so, special focus has been placed on certain types of entities, among others, loan funds. Loan funds represent a unique type of fund within the area of fund innovation. They are quite different from traditional funds, and have not yet been closely scrutinised.

While still relatively small compared to the global fund industry, loan funds, at present, seem to be increasingly more relevant in some jurisdictions. For instance, one of the driving forces that has led European jurisdictions to consider permitting funds to originate loans was the adoption of the EU regulation on European long-term investment funds (**ELTIF-Regulation**) allowing funds the origination of loans under certain conditions.[2] As a result, many jurisdictions in Europe now allow loan origination for funds.

Against this background, IOSCO considered there was merit in conducting some research in this area. Therefore, IOSCO launched a questionnaire in December 2015 to gather information from the members of its Committee on Investment Management on existing practices and experience as regards Loan Funds (Loan Originating Funds and Loan Participating Funds as defined below).

Based on the results of the survey, this report presents the current state of affairs in each jurisdiction and how the markets have evolved.

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1 The Financial Stability Board defines the shadow banking system as a system of credit intermediation that involves entities and activities outside the regular banking system. IOSCO, including many of its member authorities and market participants prefer to use other terms such as “market-based financing” instead of “shadow banking”. The use of the term “shadow banking” is not intended to cast a pejorative tone on this system of credit intermediation.

2 Regulation (EU) no. 2015/760.

SCOPE:

The scope of this report is Loan Funds in the area of investment funds (**Funds**). It applies to open-ended Funds as well as to closed-ended Funds. It is not limited to retail Funds, but also addresses professional investor Funds. However, it does not cover any type of securitisation position or securitisation special purpose vehicle.

Regardless of any labelling, a loan originating fund (**Loan Originating Fund**) as defined herein refers to any type of Fund that is, according to its investment strategy, allowed to grant and restructure loans (e.g., subsequent amendment of loan conditions such as prolongation or deferral). Therefore it does not matter whether the investment in a loan is only a small part of the Fund's investment strategy or the sole asset in which the Fund can invest.

In contrast, a loan participating fund (**Loan Participating Fund**) is defined herein as a Fund that is allowed to acquire and restructure partially or entirely existing loans originated by banks and other institutions, either directly from the lender or on secondary markets, where such loans are traded. However, according to their investment strategy they are not allowed to grant loans.

To avoid doubt, a Fund whose investment strategy allows it to both grant and acquire loans is also considered to be a Loan Originating Fund. The trigger for falling within the definition of a Loan Originating Fund is solely the ability of the Fund to grant loans on the basis of its investment strategy, notwithstanding any label or other eligible asset.

MAIN FACTS:[3]

Twenty-four jurisdictions participated in the survey.[4]

In total, Loan Originating Funds are allowed in 14 jurisdictions.[5] Loan Participating Funds are allowed in 17 jurisdictions.[6]

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[3] All data in this report derive from the answers given by the participants of the survey on Loan Funds conducted by IOSCO.

[4] Australia, Belgium, Brazil, Canada (Québec and Ontario), China, France, Germany, Hong Kong, India, Ireland, Israel, Italy, Japan, Jersey, Luxembourg, Portugal, Romania, Saudi Arabia, Singapore, Spain, Switzerland, Turkey, UK and US.

[5] Australia, Belgium, France, Germany, Hong Kong, Ireland, Italy, Jersey, Luxembourg, Singapore, Spain, Switzerland, UK and US.

1. Prohibition of Loan Originating Funds

Reasons for prohibiting Loan Originating Funds and, where applicable, Loan Participating Funds vary among jurisdictions.

For instance, in Brazil, Japan, Portugal and Turkey loan origination/participation is not included in the exhaustive list of eligible assets or, like in Saudi Arabia, explicitly prohibited. Israel and India only allow Funds to invest in transferable securities and hence neither in loan origination nor in loan participation.

Canada (Québec and Ontario), which allows Loan Participating Funds but not Loan Originating Funds, has restrictions in place to limit activities which are considered to be inconsistent with the fundamental characteristics of a Fund. A publicly offered Fund must not acquire a mortgage that is not guaranteed or an interest in a loan syndication or participation, if any responsibility for administering the loan is required for the Fund. It also must not lend cash or portfolio assets other than cash. Those investments are viewed to be similar to the engagement in lending business that is generally outside the scope of portfolio management. Investments in loan origination are therefore not allowed. The Fund's primary activity has to be managing an investment portfolio. Contrary to Loan Originating Funds, loan participation is permitted, as long as it is a passive investment that would not require the Fund to administer the loans, since such passive investment is viewed as consistent with the nature of a Fund.

In some jurisdictions there may be upcoming reforms allowing Loan Originating Funds. Saudi Arabia is currently revising its Fund's regulation to allow private Funds to originate loans, subject to the approval of the Central Bank of Saudi Arabia. Romania is also reviewing its regulatory framework with a view to allow Funds marketed to professional investors to invest in loans.

2. Market environment

As for now, the relevance of Loan Originating Funds in the market seems to be quite low. Even in a large market such as the US, which has a long history of permitting Loan Funds, the size of both the Loan Originating Fund market and the Loan Participating Fund market is estimated to be relatively small. According to Lipper, as of October 2016, the gross AuM of all funds that invest primarily in loan participations was approximately USD 218 bn.[7] Some other significant markets for Loan Funds are in Luxembourg and the UK. In Luxembourg, the

[6] Australia, Belgium, Brazil, Canada (Québec and Ontario), France, Germany, Hong Kong, Ireland, Italy, Japan, Jersey, Luxembourg, Singapore, Spain, Switzerland, UK and US.

[7] However the Loan Fund market, as defined and measured, represents a very small fraction of the US mutual fund market. For example, as of year-end 2015, US mutual fund total assets were approximately USD 18.1 trillion. Investment Company Institute, 2016 Investment Company Fact Book at 7.

net AuM of all domestic Loan Funds (i.e., Funds with their primary activity engaged in lending and across various loan activities, encompassing also activities such as microfinance, real estate debt or infrastructure financing) is EUR 37.3 bn, constituting 1% of all domestic Funds. The gross AuM of all Loan Funds in the UK market is GBP 20.7 bn (representing 0.4 % of all domestic Funds). Although the absolute figures of the Loan Funds' AuM are quite high, and could thus give at first sight the impression of greater importance, Loan Funds appear less relevant when compared to the total Fund industry in the relevant market.

In respect of the further development of Loan Funds there are many different views. While in Hong Kong,[8] Singapore and Switzerland a specific demand for Loan Funds has not been identified, in Australia[9] , in contrast, parts of the Loan Fund market is expected to show strong growth. While this segment in Luxembourg remains a niche-market at this stage, there appears to be some room for growth. In France, Germany, Italy and Spain, Loan Originating Funds have only just recently been allowed. Hence it is too early to assess how the markets will develop there. Nevertheless a certain demand is already identified.

Although demand for Loan Funds increased in the US market from the financial crisis of 2008-2009 until mid-2014, it appears to have been driven by a sustained period of low interest rates. Investor demand in the US market may be expected to flatten if and when there is a return to a more normal interest rate environment. Thus, Loan Funds in the US are perceived as a periodic phenomenon, rather than as a persistent change in the markets. In a number of other jurisdictions, Loan Originating Funds are considered as an alternative to banks as traditional providers of financing. [10] They are perceived as a growing source of market-based financing, especially in economic areas which have been dependent on banks, but where banks have recently exited the markets due to new capital requirement.

3. Regulatory aspects

Structure:

In the majority of jurisdictions, Loan Originating Funds can be set up as either open-ended or closed-ended Funds. Only four jurisdictions limit the Fund structure to closed-ended Funds. [11] However, in regards to Loan Participating Funds, all jurisdictions allow Funds to be structured either ways.

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8 Currently none of the publicly offered open-ended Funds in Hong Kong are Loan Funds.

9 While the popularity of mortgage schemes has declined in Australia since the crisis in 2008, peer-to-peer loans are gaining in popularity.

10 Belgium, Germany, Italy, Jersey, Luxembourg, Portugal, Singapore and UK.

11 France, Germany, Ireland and Italy.

Access:
The access to Loan Originating Funds is limited in nine jurisdictions to professional or *qualified* investors. [12] Additionally, Loan Originating Funds are accessible to retail investors, in five jurisdictions only. [13] Regarding Loan Participating Funds, it can be stated that only four jurisdictions limit the access to professional and *qualified* investors.

Investment:
All jurisdictions allow Loan Originating Funds to invest in other assets than loan origination. An Irish Loan Originating Fund must limit its operations to the business of issuing loans, participating in loans, participations in lending and to operations relating thereto including investing in debt and equity securities of entities or groups to which the Loan Originating Fund lends or which are held for treasury, cash management or hedging purposes.

In all jurisdictions, other Funds are allowed to invest in Loan Originating Funds as long as it is in compliance with their investment strategy.

Listing:
In most jurisdictions, the listing of Loan Originating Funds on a stock exchange is not explicitly forbidden if the respective listing requirements are met. Although Loan Originating Funds may be admitted to a stock exchange, they may be prevented from being listed in practice because trading is restricted exclusively to qualified/professional investors.

Requirements/Restrictions:
In terms of requirements or restrictions as regards the Fund's investment management, only six jurisdictions have special provisions for Loan Originating Funds in place. [14] In the other eight jurisdictions, the general rules apply. In Hong Kong, Singapore, Switzerland or the US for instance, loan origination is treated the same way as other fund investments. They are subject to the same investor protection rules and regulations. There are no provisions that apply especially for Loan Funds.

However, the special provisions for Loan Originating Funds in the relevant jurisdictions are summarised below as follows:

- Belgium has a special legislation for Funds that limits investing in or lending to small and medium sized enterprises to a minimum of 70 % of their assets. According to this legislation the use of derivatives is limited to the acquisition of loans or for hedging

12 "Qualified" investors are mostly referred to as sophisticated investors with a special expertise.

13 Australia, Belgium, Italy, Switzerland and US.

14 Belgium, France, Germany, Ireland, Italy and Spain.

purposes and borrowings are limited to 10 % of the NAV. Further to this, loans can only be granted to growth or non-listed companies, and the maximum initial exposure is 20 % per company. There are also special disclosure requirements to retail investors.

- In Italy, borrowing by Loan Originating Funds is limited to 30 % of the NAV, whereas the exposure to any issuer is limited to 10 % of the NAV. Additionally, financial derivatives must be used for hedging purposes only. Furthermore, Loan Originating Funds are subject to reporting requirements on a half-yearly basis, allowing the competent authority to conduct off-site monitoring. Finally, loans shall not be originated to consumers; nor shall they be originated to persons who perform administrative, management or control functions at the asset manager.

- Under German law, asset managers managing Loan Funds have to comply with specific risk management rules which are based on risk management guidelines for the banking sector. Borrowing by Loan Originating Funds is limited to 30% of the Fund's capital. Furthermore, the loans must not be originated to consumers and there has to be a diversification of credit positions. However, there are some exceptions for Loan Originating Funds granting loans to companies in which they hold shares.

- When designing the Irish legal framework for Loan Originating Funds, the Irish authorities took into consideration features of banking regulation, Capital Requirement Directive No. 2013/36/EU, the Basel Framework and the credit assessment and monitoring policies. In particular, there are special requirements for Loan Originating Funds as regards risk management, diversification of credit positions or disclosure. In addition, Loan Originating Funds must not have gross assets of more than 200% of the NAV and the loans must not be originated to, among others, natural persons, the asset manager, other Funds or financial institutions.

- In Spain, only hedge funds can be Loan Originating Funds. They may set up lock-up periods that may be extended to match the maturity of the loans. In addition to the general requirements for hedge funds, there are special provisions regarding, among others, risk management or diversification in terms of borrowers. Borrowing by Loan Originating Funds is not allowed. However, Loan Originating Funds can use leverage through derivatives, which has no limit. Finally, borrowers are required to be legal persons, not natural persons.

- Under French rules, asset managers of Loan Originating Funds have to be specifically authorised to originate loans and demonstrate their competence and adequate means. Borrowing is only allowed to finance assets other than loan origination and only up to 30% of the NAV. Derivatives are limited to interest rate and currency hedging. Loans must have maturities shorter than the life of the Fund to prevent any maturity transformation.

Regarding Loan Participating Funds, only Belgium and Spain apply the same special provisions for Loan Originating Funds also to Loan Participating Funds. [15] Germany applies those special provisions for Loan Originating Funds only in respect of risk management for Loan Participating Funds, too. France and Ireland have no special provisions for Loan Participating Funds, in contrast to Loan Originating Funds. [16] All other jurisdictions that allow Loan Participating Funds have no special provisions, but apply the general rules.

4. Risks

The following types of risks were identified for Loan Originating Funds:

- Liquidity risk: loans are hard to value and since they are also hard to trade, they are very illiquid assets;
- Credit risks: the risk of a default of the borrower;
- Systemic risks from excessive credit growth; and
- Regulatory arbitrage.

To address the above mentioned risks, different jurisdictions have taken various approaches, which are presented below.

Liquidity:

In several jurisdictions, Loan Originating Funds are required to be structured as closed-ended Funds to address liquidity risks. [17] However, in Hong Kong and the US, regulators try to mitigate this risk for open-ended structures by limiting the investment in illiquid assets.[18] Some jurisdictions, in turn, trust in a robust and appropriate liquidity risk management.[19] Finally, to avoid liquidity risks, Spain allows the use of lock-up periods which may be extended to match maturity of the loans.

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15 According to Spanish legislation, the only difference is that borrowing is not allowed for Loan Originating Funds, but it is possible for Loan Participating Funds.

16 However, as already stated above, Ireland has a special type of Fund (Loan Origination Qualifying Investor Alternative Investment Fund) which operations are limited to the business of issuing loans, participating in loans, participations in lending and to operations arising directly therefrom. This is the only type of Irish Fund that is allowed to invest in loan origination. Apart from that, Irish Funds in general are not prohibited from investing in loan participation, if they meet eligible asset rules.

17 Belgium (when available for the public), France, Germany, Ireland, Italy, Jersey and UK (in Jersey and UK not mandatory by law, but in practice most Loan Originating Funds are structured closed-ended).

18 In Hong Kong, publicly offered open-ended Funds are not expected to engage materially in loan origination or to have any substantial investments in loans. In the US, asset coverage requirements applicable to open-ended Funds would place significant limitations on an open-ended Fund’s ability to originate loans.

19 Belgium (and when available for the public as additional means to the closed-ended structure), France, Germany (as additional means to the closed-ended structure), Hong Kong (regarding publicly offered open-ended Funds) Ireland (also as additional means to the closed-ended structure), Italy, Luxembourg, Spain and UK.

Credit default:

The risk of a default of the Loan Fund's borrowers is addressed in some jurisdictions by diversification requirements regarding those borrowers. Whereas Spain requires a *sufficiently* diversified credit portfolio, other jurisdictions have assigned a fixed proportion of credit exposure to each borrower. [20]

Limitation of leverage:

Italy requires more stringent diversification and leverage constraints when marketing Loan Funds to retail investors. Like in Italy, the US has a limitation on the use of leverage in order to protect investors against potentially adverse effects of its use. Open-ended Funds are only allowed to borrow from a bank and are required to maintain 300% asset coverage. Furthermore, borrowing is limited in Belgium (10% of the NAV), France (30% of the NAV) and Germany (30 % of the Fund's capital) to mitigate systemic risks due to cyclical vulnerabilities. Belgium, France and Italy additionally limit the use of derivatives for hedging purposes. Ireland has limited leverage to 100% of the NAV. Spain prohibits borrowings for Loan Originating Funds, but allows the use of derivatives.

Regulatory arbitrage:

Loan origination by Funds may lead to regulatory arbitrage between banking and non-banking lenders. To address this potential risk, German, Irish and Italian regulators have put in place detailed regulation, similar to the respective provisions for lending activities in the banking sector. By contrast, in a few jurisdictions, loan origination is not considered a trigger for arbitrage between securities and banking laws, but is subsumed under what is often referred to as "shadow banking activity".[21]

Investor protection:

In addition to the already mentioned risks and, as indicated above, there are also concerns regarding investor protection. Beyond the restrictions introduced for the sake of investor protection (e.g., the limitation of leverage in Italy and the US), some jurisdictions have detailed disclosure requirements for Loan Originating Funds in place. [22] For Australia, Belgium and the US, these requirements only apply if Funds are accessible to retail investors. Finally, Loan Originating Funds are in many jurisdictions available only for professional or "qualified" investors. [23] [24]

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[20] E.g., Belgium, Germany or Ireland.

[21] Please refer to footnote 1 above.

[22] Australia, Belgium, Ireland, Spain and US.

[23] France, Germany, Hong Kong, Ireland, Jersey, Luxembourg, Singapore, Spain and UK. In Hong Kong, publicly offered open-ended Funds are subject to explicit limitations on making loans, and loan origination and loan participation is not considered a compatible investment strategy with the nature of publicly offered open-ended Funds (please see also footnote 18 above).

Other risks:
A further issue that was identified in the course of the analysis is the challenge around the valuation of loans. Loans are illiquid assets. There is very often no readily available market quote for loans, which makes them hard to value. The valuation of loans could be inconsistent and its fairness could depend strongly on the quality of the Fund's valuation procedures as well as on the expertise of its valuer. As a result, valuation might be inadequate and unfair.

Besides, there may also be problems with the evidence of ownership of the loan, since the custody of loans as privately-issued uncertified instruments are less standardised than other types of securities.

Finally, Australia also identified a potential conflict of interest, where the Loan Fund's asset manager intermediates between the borrowers and the investors that provide the Funds to lend. This intermediary position gives rise to potential conflicts between the investors' interests and the intermediary's desire to generate revenue by continuing to grant loans, particularly where most of its revenue is generated from granting the loans, for example, as through set-up fees, rather than from the borrower repaying the loans back to the investors. This risk is partially managed by the asset manager's duties to act in the best interest of investors and to lend only to borrowers that are able to make repayments.

The risks indicated above illustrate why Loan Funds are an area that may warrant further analysis in the future.

CONCLUSION:

Current data on the level of investment in loan origination and participation, indicates that the market is predominantly located in the US.

However, in terms of recent market and regulatory developments, interest in this asset class has increased in Europe.

A global view of the Loan Funds market shows that Loan Funds are a relatively new product/asset class in an early stage of development and with a limited market so far. As already indicated above, Loan Fund assets represent a very small fraction of total assets invested in Funds, even in a jurisdiction such as the US, where Loan Funds have long been permitted. In Europe, where interest in this asset class has increased in recent years, Luxembourg and the UK are the main players. Net AuM of Loans Funds in Luxembourg

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[24] Please refer to footnote 12 above.

amount to EUR 37.3 bn (or 1% of all domestic funds) whereas in the UK the gross AuM of Loan Funds is GBP 20.7 bn (representing 0.4% of the gross AuM of all UK Funds).

Although the Loan Fund market is at present a small niche-market, it is generally perceived as an alternative to traditional financing-channels. Due to stricter capital requirements, banks have recently retreated from certain segments of the markets and thereby created a gap on the financing side that might be filled by Loan Funds.

In respect of potential risks that may derive from Loan Funds, a large number of jurisdictions have identified liquidity risks, credit risks and systemic risks as key areas to focus on. In this context, there is general consensus that risk management, particularly for liquidity risks, as well as leverage and investor protection, are important areas that require particular attention.

Further to this, all jurisdictions consider loan origination by Funds to be a so called "shadow banking activity", highlighting the merit of monitoring its developments. [25] Further analysis and work in this particular asset class, especially regarding regulatory arbitrage, may be warranted should Loan Funds become more significant. Notwithstanding this possible development, many jurisdictions consider their general rules for Funds to be sufficient to address the specificities of Loan Funds. Risk management provisions, especially, are considered sufficient as the asset manager is required to take into account the Fund's investment strategy and its specifics when conducting its risk management process. In contrast, a few jurisdictions have special provisions in place.

Therefore, further work on Loan Funds is not warranted at this stage. Given the specific risks identified by this survey, IOSCO will continue to monitor the issue with a view to possibly revisiting it for further work, should it be called for by market developments.

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[25] Please refer to footnote 1 above.