



# Loan Funds Regulation

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Triggered by a number of enquiries relating to the regulation of loan funds in Malta, on 21 May 2015 the Malta Financial Services Authority ("MFSA") issued an updated set of Investment Services Rules (the "Rules") applicable to collective investment schemes authorized to invest through loans (also referred to as Loan Funds). Given that lending is a core banking function, the Rules draw on the MFSA Banking Rules in order to address the areas of risk in a manner that ensures consistency with the Banking Act.

The Rules essentially answer the question many have been asking themselves: Can a fund give loans? Maltese funds in possession of a collective investment scheme license structured in terms of these new rules may now give loans to other entities, subject to criteria listed therein. This is a marked improvement from the previous situation where funds were only permitted to invest in securities or other physical assets. The Rules permitting collective investment schemes to invest through loans are currently applicable to Alternative Investor Funds ("AIF") and Professional Investor Funds ("PIF").

The majority of a Loan Fund's assets (at least 70%) are to be invested 'through loans'. The remaining 30% may be invested in liquid securities. The Loan Fund Rules defines 'investing through loans' as covering both:

- direct origination of loans by the fund; and
- acquiring portfolios of loans or a direct interest in loans that result in a direct legal relationship between the fund as lender on the one hand and the borrower on the other.

## Investment and Lending Restrictions

The Rules prohibit a Loan Fund or its manager from using leverage, short selling techniques and the re-use of collateral. There are also certain diversification requirements and in fact a Loan Fund is not allowed to invest more than 10% of its capital in a single undertaking. A Loan Fund is also prohibited from investing more than 10% of its capital in units or shares of one or several other Loan Funds provided that these funds operate within the same investment restrictions applicable (subject to an aggregate limit of 20% in units of such funds), and may not own more than 25% of units or shares of any single Loan Fund. Cash borrowing for liquidity purposes is permitted, subject to certain restrictions, and may not exceed 30% of the fund's capital. Cross sub-fund investment is permitted subject to a 25% cap across all sub-funds of the same umbrella fund.

Loan Funds may lend solely and exclusively to unlisted companies and SMEs; financial undertakings are ineligible to receive financing from a Loan Fund. Entities which are eligible to receive loans in terms of the Rules are prohibited from transferring any loans so received to a third party.

# Requirements for Closed-ended Funds, and the Target Investors

The Rules provide that Loan Funds are to be constituted as closed-ended funds with a fixed duration. The Rules allow such funds to exceptionally permit redemptions on an annual basis provided that the auditors confirm that the fund has excess liquidity. Loan Funds may only attract investors that qualify as professional clients under MiFID II or who elect to be treated as professional clients and commit to invest at least €100,000, and thus meet the criteria of a Qualifying Investor.

## Service Providers

A Loan Fund is required to appoint a fund manager (unless self-managed), a custodian, an auditor, a compliance officer and a money laundering reporting officer. The fund manager may be a de minimis fund manager licensed in terms of the Investment Services Act (the "Act"), a fund manager authorised in terms of the AIFMD and licensed in terms of the Act, a de minimis fund manager authorised/registered in another member state or a fund manager authorised/ licensed in a recognised jurisdiction. Irrespective of whether the Loan Fund is licensed as a PIF or an AIF, the manager (or in the case of a self-managed Loan Fund, the Loan Fund itself) will be responsible for portfolio management and risk management of the Loan Fund as well as other permitted services. The MFSA requires the fund manager to be in possession of the necessary skills and expertise to ensure that lending decisions are effected properly. The fund manager is also required to establish a credit risk strategy in proportion to the scope and sophistication of the Loan Fund's activities. The fund manager needs to comply with the applicable sections of the Investment Services rules for Investment Services Providers together with other Rulebooks being the Standard Licence Conditions prescribed in the Investment Services Rules for Professional Investor Funds/ Investment Services Rules for Alternative Investment Funds as the case may be. Furthermore, the manager must ensure that the scheme maintains a minimum liquid- asset proportion.

## Credit Risk and Liquidity Management Policies

Loan Funds (or the Fund Manager) are expected to put in place policies on credit risk, credit provisioning and large exposures in proportion with the sophistication of the Loan Fund's activities. Such policies will include a risk appetite statement and address items such as structuring of credit limits and portfolio mix. A liquidity management system and procedures are required to be put in place to monitor liquidity risk of the fund.

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