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ASSET MANAGEMENT AND INVESTMENT FUNDS

Central Bank – Investment Funds Authorisation Seminar – QIAIF Applications

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The Central Bank recently convened the second of its fund industry seminars with Irish fund industry representatives to discuss its authorisation and supervision framework for Irish Qualifying Investor Alternative Investment Funds (QIAIFs) and to explain some recent changes in its authorisation process.

This seminar followed the recent Central Bank seminar in relation to UCITS funds and our briefing on that seminar can be found here.

Several senior representatives of the Central Bank's funds authorisation and supervision teams spoke at the seminar and covered the following topics;

- QIAIF applications generally;
- the need for a pre-discussion with, or a submission to, the Central Bank on infrequent or uncommon asset types or funds with unusual features;
- directors' time commitments; and
- the quality and clarity of investment policy disclosure.

QIAIF applications

The Central Bank explained that since 2007 QIAIFs had availed of the Central Bank's 24-hour approval process and since that date the Central Bank has authorised over 2600 QIAIFs. It was also noted that QIAIFs have grown to represent approximately 50% of all funds authorised in Ireland. The Central Bank noted that the need to ensure the integrity of the QIAIF authorisation regime is crucial to its continued operation. The Central Bank noted that the regime was intended for institutional and professional investors where there may be less of a need for the Central Bank to overlay the review process with investor protection requirements and considerations.

However, the Central Bank reiterated the need to ensure that, as QIAIFs are funds authorised by the Central Bank (with all that that authorisation implies), QIAIF applications are completed with due care and are given no less consideration by the relevant boards and AIFMs than a UCITS application would be.

The Central Bank highlighted that where an applicant is in any doubt as to whether to disclose any matter in the application it should seek prior guidance from the Central Bank. In particular, the Central Bank noted that for QIAIFs that include unusual features, it would encourage the applicant to make contact with the Central Bank in advance of any submission of such an application.

Where a pre-submission is required, the Central Bank is likely to require additional information including:

i. a model portfolio
ii. a rationale for the asset type or structure
iii. details of the due diligence conducted on the assets, service providers etc
iv. information on the liquidity characteristics of the fund to ensure the liquidity profile is aligned with the asset type.

Pre-discussion/submission

The Central Bank gave some insight on why certain categories of QIAIF would be considered suitable for pre-submission.

The first consideration was the ability for funds to cause unanticipated investor detriment. The Central Bank accepted that for institutional and sophisticated investor products such as QIAIFs, where the investor base more commonly understood the risks involved, this was less of a concern.

The second risk noted however was the ability for funds, *in extremis*, to amplify systemic risk. In this regard the Central Bank referred to the example of significant property funds suspending during a time of crisis or extreme market uncertainty.

The Central Bank set out the features and categories of funds that it considered necessitated additional consideration including as follows:

Funds with high levels of leverage

The Central Bank noted that while it has not set any limits or other restrictions on the degree of leverage which may be employed by a QIAIF, the leverage figure disclosed should still be clearly relatable to the strategy of the fund and be disclosed in such a manner as to provide a good understanding of the actual expected levels of leverage to be employed and as such should be a realistic limit.

The Central Bank spoke about numerous examples where it appeared from the Central Bank's perspective that the limits were simply being inserted to ensure that there was no reasonable prospect of them ever being broken and the limits in fact bore no relation to the expected leverage that was to be employed by the portfolio.

The Central Bank stated that while it was still not the intention to introduce any leverage limit within the AIF Rulebook, it was expected that applicants should be able to provide information on the necessity for substantial leverage without delay when requested to do so by the Central Bank. Again, the Central Bank referred to examples where, when the question was raised on the disclosed leverage level, it took some time for the justification to follow, which indicated to the Central Bank that the levels in the documentation were not set with due care or consideration of the strategy but rather in an effort to ensure maximum flexibility.

The Central Bank noted that it would expect evidence of a board's consideration of leverage limits to be available for the Central Bank to review upon request.

Property funds

In relation to property funds, the Central Bank noted that since late 2019 it had raised a number of questions in relation to how property funds were established and operated and now had a number of expectations in terms of filings for authorisation of these types of funds. In particular it was confirmed that all property funds seeking authorisation should now include a pre-submission prior to the intended authorisation date.

It was the Central Bank's expectation that property funds should be either closed-ended or open-ended with limited liquidity. The Central Bank expressed the view that an open-ended property fund represented a misalignment between the liquidity profile of the fund and its redemption facilities and was therefore not appropriate. As a general principle, the Central Bank stated that it could not envisage any circumstances where an application to authorise an open-ended property fund would be considered.

All property funds are required to provide the following in a pre-submission:

- a rationale for any proposed leverage limits;
- information on any proposed shareholder loans (which the Central Bank noted were generally not permissible in its view);
- information on the type and number of investors expected in the fund;
- a board explanation of the timing of launch if authorisation is being sought during the Covid crisis given, in particular, possible difficulties in valuing assets at this time;
- a completed model portfolio; and
- information on bank loans and covenants (including loan to value covenants).

Loan Originating QIAIFs

The Central Bank confirmed that any funds seeking authorisation as Loan Originating QIAIFs (LO-QIAIFs) would also need to make a pre-submission to the Central Bank and would confirm, *inter alia*, the following:

- rationale
- number of investors
- profile of borrowers
- details concerning the valuation of loans

The Central Bank did confirm that, to date, there was nothing of concern in this category of funds, but given the critical mass of such funds now authorised (with over 50 LO-QIAIFs were now authorised by the Central Bank), it was seeking to better understand this constituency of funds.

Life Settlement Funds

The final category called out by the Central Bank for pre-submission was life settlement funds.

The Central Bank confirmed that in future it will specifically require detailed information in advance in relation to any proposal to invest in life settlements. In particular, the Central Bank noted that it would require information such as:

- the nature of the life settlements (for example, whether they are life contingent settlements or guaranteed structure settlements);
- the experience of the various service providers including, in particular, the investment manager or advisor, in this asset class; and
- the acquisition process in relation to life settlements to include information on the due diligence process undertaken on the policies, how they were originated, whether purchased on the secondary or tertiary market, tracking originators, beneficiaries etc.

Directors' time commitments

The Central Bank confirmed that director time commitments were a renewed area of focus, and that recently it has seen an increasing number of director submissions with high numbers of directorships.

The Central Bank reconfirmed the guidance as set out in part III of the Fund Management Companies Guidance in 2016 which sets out a risk indicator for funds that have appointed directors with significant time commitments which is a joint test of (a) having more than 20 fund/fund management company directorships and (b) having an aggregate professional time commitment in excess of 2000 hours.

Where any risk indicator is triggered additional supervisory attention is appropriate under the Central Bank's risk based approach to supervision.

The Central Bank stated that time commitments would continue to be assessed on a case by case basis and that where they are found to be below the appropriate level it would raise questions with the relevant applicant firm and the director.

The Central Bank further noted that where these concerns around significant time commitments arise the Central Bank would engage with the applicant to request additional information to address the areas of specific concern and that the Central Bank would expect significant supporting information to be provided.

In principle, there did not seem to be anything new in the Central Bank's discussion on this topic, rather a reiteration of existing principles and a confirmation that the Central Bank will continue to be focused on this area.

Quality and clarity of investment policy disclosure

The Central Bank highlighted that it had, on ad hoc basis, reviewed certain investment policy submissions over the preceding few months which had raised some concerns with regard to the quality and clarity of that investment policy disclosure. The Central Bank highlighted a number of examples including:

- disclosure in a QIAIF that was not a property fund that it could invest up to 75% in a single real estate asset;
- disclosure in a leveraged property fund or a leverage limit of up to 1,000,000%; and
- disclosure in a QIAIF that was not a LO-QIAIF that stated that the fund might make a certain loan or other investments.

The Central Bank highlighted the need for the investment policy disclosure to be clear, precise and accurate disclosure. Investment policy disclosure which did not clearly and accurately describe what the QIAIF would invest in but rather attempted to provide the broadest range of possible investment strategies to avoid "being caught up in possible breaches" was not in keeping with the Central Bank's expectations.

Central Bank Guidance

The Central Bank noted that it is increasingly focused on QIAIFs given some of the risks that may be embedded in these structures. The Central Bank reiterated concerns about broad "catch-all" disclosures and it was noted that those funds with unusual features must be brought to the attention of the Central Bank at the time of application.

The Central Bank confirmed that it will issue QIAIF application guidance in due course. In this regard, while it did not propose to engage in a formal consultation process, the Central Bank did ask Irish Funds to co-ordinate any relevant comments from industry on the QIAIF application process.

Conclusion

The Central Bank used the seminar to continue to emphasise its role in the authorisation and supervision of QIAIFs. The Central Bank emphasised once again the need for Irish fund management company boards to exercise and be able to demonstrate their effective decision-making in relation to the establishment and ongoing operation of funds and in particular noted the requirement to ensure that the QIAIF authorisation process, while not as involved as the UCITS authorisation process, required appropriate due diligence or review prior to a submission being made to the Central Bank.

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