CONSULTATION PAPER

NO. 142
CREDIT FUNDS

20 December 2021

PREFACE

Why are we issuing this Consultation Paper?

1. This Consultation Paper seeks public comment on the DFSA's proposals to introduce a regime for Credit Funds.

2. Under the existing DFSA Funds regime, Fund Managers are allowed to carry out a range of investment activities using investors' money (i.e., Fund property), but the direct origination of loans or the purchase of loan portfolios are not permitted activities. Loan-related activities bring a distinctly new element to Fund Management, requiring different conduct and prudential requirements, proposals for which are set out below.

Who should read this Consultation Paper?

3. The proposals in this Consultation Paper should be of interest to DFSA Regulated Fund Managers, to potential applicants, and to their advisers.

Terminology

4. In this CP, defined terms have the initial letter of a word, or of each word in a phrase, capitalised and are defined in the Glossary Module (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. Some of the commonly used terms are set out below:

What are the next steps?

5. Please send any comments online, by the deadline of **19 January 2022**, by clicking here. You will need to identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments, unless you expressly request otherwise at the time of making comments.

6. Following this public consultation, we expect to proceed to make the relevant changes – amended to reflect points raised in consultation - to the DFSA's Rulebook. You should not act on the proposals until the relevant changes to the DFSA's Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of this Consultation Paper

7. The remainder of this Consultation Paper contains:

   a) Background – Credit funds;

   b) Section 1 – the structure of Credit funds;

   c) Section 2 – regulatory requirements for Credit funds;

   d) Annex 1: Questions in this Consultation Paper;

   e) Appendix 1: Collective Investment Rules Module (CIR);

   f) Appendix 2: General Module (GEN);

   g) Appendix 3: Glossary Module (GLO);

   h) Appendix 4: Prudential – Banking , Investment, Insurance Intermediation and Banking Module (PIB); and

   i) Appendix 5: Fees Module (FER).

Background – Credit funds

What are credit funds?

8. Credit funds are collective investment funds that use fund property (i.e., investors' money) either to originate, or to purchase, loans, or both. Since the financial crisis of 2008/9, there has been substantial growth in the number and range of funds active in this market, with a wide range of different investment strategies adopted by fund managers. This has been, in part, a response to the withdrawal of traditional bank lending in certain markets.

9. Where banks have decreased lending in certain markets, for example, SME lending, fund managers have seen this as an opportunity to provide private credit. Credit funds have been seen by many as a potentially valuable asset class for investors, especially in the low interest rate environment that has persisted in many jurisdictions since the financial crisis.

10. Fund managers have been able to obtain access to reliable deal flow directly from targeted market segments, making use of underlying collateral (receivables, inventory). Fund managers have also gained access to lending transactions with banks (co-lending and syndication) as well as purchasing loan portfolios from banks and other loan originators. To deal properly with the risks arising from this business, fund managers have built up expertise in credit assessment and pricing of lending transactions.

11. This and other developments in credit provision has led to consideration by global regulatory organisations of the risks that are, or could be, posed by such 'shadow banking'. Both the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) have, from their different perspectives, looked at the potential impact of these activities.

12. In particular, the FSB has looked at the potential risks to financial stability that could arise from the introduction of new players, and new channels of contagion, to the credit markets. We recognise that such risks do exist, but can also see benefits in broadening the pool of potential credit providers, particularly in some areas of the market that are under-served. As we are starting from a zero base since credit funds are not currently permitted in the DIFC, it will be some time and require significant growth before systemic risks could be posed by this sector. We propose to put in place appropriate monitoring tools to enable the DFSA to understand the development of the sector.

How do other jurisdictions treat credit funds?

13. Funds regimes in other jurisdictions differ, and there is no consistent approach adopted by jurisdictions that allow fund managers to be loan originators, using fund property. One thing that is clear is that credit funds are not regulated in the same way as banks or other lending institutions. The prudential controls applied are not as onerous in the funds area, for a number of reasons, which we discuss below.

14. A number of the jurisdictions that we often look to do not allow the provision of credit by funds, although indirect credit provision is possible within hedge fund activities. Some jurisdictions allow Fund Managers to provide credit to generate income out of investors' contributions (i.e. fund money), but, there is little consistency in the way in which regimes permit this.

15. Overall, we have looked at the existing regulatory regimes in Australia, the EU, Germany, Ireland (where these differ from the EU regime), Hong Kong, Singapore, the

UK, the USA, and others. While we have found useful ideas in several other regimes, our proposals draw most on a comprehensive regulatory regime for funds and fund managers undertaking lending activities adopted by the Central Bank of Ireland (CBI),[1]

Section 1: the structure of Credit Funds

Foundational issues

16. We propose allowing Fund Managers to use Fund Property for the direct origination of loans or purchase of loan portfolios. As noted earlier, allowing the origination of loans or the purchase of loan portfolios using fund property would be a new departure for the DFSA and, as a result, some further questions arise. Lending is, clearly, not without risk. Although we do not propose to regulate this activity in the same way that the lending activities of banks are regulated, the proposals in this paper do adopt a generally conservative approach. This is a deliberate policy choice, reflecting the novelty of the proposed activity in the UAE and the broader region. As activity develops, we will review this initial approach when appropriate.

Should all funds be able to lend?

17. Our starting point is that this activity should not be available to a wide range of fund classes. Instead, we propose to create a specialist class of Funds who can originate loans and/or purchase loan portfolios, to be called Credit Funds. These Funds would be subject to the restrictions and controls discussed in the proposals set out in detail below.

18. Permitting only a specific type of fund to carry out lending activity is consistent with several the benchmarked jurisdictions.

Please see draft CIR Rule 3.1.14 in Appendix 1.

Question 1:

Do you agree with our proposal to introduce Credit Funds as a specialist class of Funds? If not, why not?

How do we define a Credit Fund?

19. In addition to the unique nature of the activities it can carry out, we have considered what other features should define a Credit Fund. As is suggested by the name of the specialist class of Funds, the primary business must be loan related.

20. We propose, therefore, that a Credit Fund must have, as its investment objective, using at least 90% of Fund Property for either loan origination (which constitutes Providing Credit under our Rules) or loan portfolio acquisition. As with other types of Fund that are subject to similar limits on the composition of Fund Property, the DFSA does not intend to impose any specific requirements as to the other types of investment, not exceeding 10% of the investment portfolio, which may be made.

Please see draft CIR Rule 3.1.14 in Appendix 1 and draft GLO definition in Appendix 3.

[1] The CBI regime is in line with the requirements of the European Union's Alternative Investment Fund Management Directive (AIFMD) and introduces Loan Originating Qualifying Investor Alternative Investment Funds, or QIAIFs.

Question 2:

Do you agree with our proposal that a Credit Fund should focus predominantly on lending activities? If not, why not?

Which types of funds and which types of investor should be allowed in this area?

21. We consider it appropriate to restrict lending activities to QIFs and Exempt Funds, where the unitholders would be professional investors, with adequate relevant expertise and the financial capacity to withstand loss. That is, Credit Funds will not be open to Retail Clients. This is necessary because Credit Funds will be extending credit to a potentially wide range of ventures, many of whom may struggle to obtain credit from the conventional banking system. The level of risk is likely to be such that it is only appropriate for professional investors to be involved.

    Please see draft CIR Rule 3.1.14 in Appendix 1.

Question 3:

Do you agree with our proposal that a Credit Fund should be either an Exempt Fund or a Qualified Investor Fund? If not, why not?

Fund vehicles, Fund legal structures and Fund management

22. The current DFSA regime permits Funds to be structured as Investment Companies, Limited Partnerships or Investment Trusts. Of these, only the first two are incorporated vehicles. We consider that it is appropriate to allow a Credit Fund to be structured only in one of these two incorporated forms, rather than allow the trust structure. This is because the trust structure is not generally amenable to the type of controls we intend to impose under the proposals.

23. Under the DFSA regime, a Fund can be either open-ended or closed-ended. If a fund is open-ended, the Fund Manager is required to have detailed additional systems and controls for liquidity risk management (see CIR section 8.6A). We do not think it is appropriate for a Credit Fund to be an open-ended Fund. Being an open-ended fund would introduce an additional layer of complexity.

24. We are, however, not averse to allowing finite redemption windows, which are pre-determined and on a no-commitment basis, provided the Fund Manager has adequate controls to ensure that there is no mismatch between a redemption window offered and the maturity of loans, with adequate buffers to absorb non-performing loans. We propose that a Credit Fund must be a closed-ended Fund, and address redemption windows later (see paragraphs 47 to 52).

25. The DFSA regime contains two models for the management of a Fund, namely externally managed and internally managed models. Under the latter, a Corporate Director of an Investment Company, with a licence to Manage Funds, can manage the Investment Company. However, such a licensed Corporate Director can only manage the Investment Company in which it is the Corporate Director, and no other Fund. We see no reason not to allow both models of Fund Management for Credit Funds, subject to the restriction noted above. No rule change is needed to permit this.

26. To summarise, we propose that a Credit Fund must be:

    a) either an Investment Company or an Investment Partnership;

b) a closed-ended legal structure with a specified end date (which we propose should not exceed 10 years); and

c) can be managed using the external or internal model, with the latter meaning that it must be an Investment Company.

Please see draft CIR Rules 13.11.1 and 13.11.9(a) in Appendix 1.

Question 4:

Do you agree with our proposals on permissible Fund vehicles, legal structures and management structures for Credit Funds? If not, why not?

Differentiating fund lending from bank lending

27. As we have already noted, the prudential requirements that we will apply to fund lending (see paragraphs 72 to 75) will not be the same as those applicable to bank lending. Nonetheless, we do consider it important that the activities of a Credit Fund are more limited, by design, than those of a bank.

28. There are a number of ways that such differentiation can be introduced, including limiting:

a) the riskiness of loans made by Credit Funds;

b) the complexity of lending products offered by Credit Funds, to reduce operational risk; or

c) permissible borrowers.

29. We see merit in using each of the above methods to differentiate Credit Fund loan activities from those of banks, while at the same time making sure that the overall regime applicable to such Funds is proportionate.

Types of lending products

30. We have considered whether we should introduce limitations on the types of lending a Credit Fund can undertake.[2] Having considered the position under other regimes, we are making the following proposals:

a) Credit Funds should not be able to issue letters of credit or to give financial guarantees;

b) Credit Funds should be able to undertake financial leasing,[3] along with discounting and factoring of invoices; and

c) we would welcome the views of stakeholders on whether Credit Funds should be able to undertake trade finance. While this activity shares some characteristics with the lending types discussed in sub-paragraph 30b, it is operationally much more complex, and so would be more challenging for a Credit Fund to manage. We would, therefore, welcome the views of stakeholders on whether it would be

[2] Investing in debt instruments, such as bonds or securitised debt, is already a permitted activity for DFSA-registered funds, and so a Credit Fund should continue to be able to make such investments.

[3] However, financial leasing of personal property would not be allowed.

both sensible and practical for Credit Funds to be able to carry out this type of business.

Please see draft CIR Rule 13.11.3 in Appendix 1.

Questions:

5. Do you agree with our proposal that Credit Funds not be permitted to issue letters of credit or give financial guarantees? If not, why not?

6. Do you think Credit Funds should be able to undertake trade finance activities? Please explain why you hold this view.

Types of permissible borrower

31. The DFSA regime already contains restrictions on the types of credit that can be provided by lenders (see COB 4.3). As part of our aim to differentiate fund lending from bank lending, and also to minimise future financial stability risks, we consider further restrictions are warranted.

32. We consider that Credit Funds should be prohibited from granting loans to:

a) natural persons;

b) the fund manager of the fund and related parties (including agents, intermediaries and introducers acting for the fund manager);

c) other funds;

d) financial institutions and their 'related parties' (except under additional conduct requirements or for purposes such as genuine treasury management);

e) persons intending to trade in equities and other tradable investments and commodities, including digital assets; and

f) persons whose business is the provision of credit.

33. Some of the above limitations would help to minimise interconnectivity within the financial system and so limit the potential growth of systemic risk.

Please see draft CIR Rule 13.11.4 in Appendix 1.

Question 7:

Do you agree with our proposals on who a Credit Fund should be able to lend to? If not, why not?

Section 2: regulatory requirements for Credit Funds

General requirements for licensing

34. Our normal approach is to apply the general requirements (in GEN) to an Authorised Firm which is a Fund Manager, regardless of whether the Fund Manager is managing a Public Fund, Exempt Fund or QIF. However, we differentiate our requirements,

regarding conduct and prudential requirements applicable to Fund Managers, based on the type of Fund and the specialist class of Fund.

35. These general licensing requirements include fitness and propriety of the Fund Manager, Authorised Individuals, and management systems and controls in GEN. We do not consider that any changes are needed to these requirements but, as part of our licensing process, we propose to assess whether a Fund Manager of a Credit Fund has adequate expertise and skills, as well as resources, to meet, on an ongoing basis, the additional requirements applicable to the Fund Manager, as discussed below. The only rule change required to GEN is to specify that a Fund Manager that manages a Credit Fund is taken to have the necessary authorisations relating to providing credit.

Please see draft GEN 2.12.1 in Appendix 2.

Question 8:

Do you agree with our proposal for the application of general licensing requirements to Fund Managers of Credit Funds? If not, why not?

Conduct requirements applicable to Fund Managers

36. Under our current Funds regime, there are two types of conduct requirements that are applied to Fund Managers with respect to their Funds. These are the general requirements applicable to all Fund Managers (with some differentiation based on whether the Fund is a Public Fund, Exempt Fund or QIF), and additional specialist fund related requirements.

37. The DFSA regime has two classes of professional investor Funds, i.e., Exempt Funds and QIFs. Although both Exempt Funds and QIFs are professional investor-only funds, QIF Fund Managers face less detailed regulation than the Fund Managers of Exempt Funds, based on the ticket size of the minimum subscription required to participate in these two types of funds.

38. We do not see any reason to deviate from the current approach, except with regard to the following areas:

    a) Custody (CIR section 8.2) – we propose to allow Fund Managers of both Exempt Funds and QIFs of Credit Funds to hold self-custody, where the loans are granted or acquired by the fund and hence the returns on the loans, and repayment obligations, represent Fund assets, segregated from the Fund Manager's balance sheet; and

    b) Conflict of Interests – we propose to require Fund Managers of both Exempt Funds and QIFs that are Credit Funds to be subject to the conflict of interests provisions in CIR section 8.3.

Please see draft CIR 8.1.1, 12A.3.1 and 13.11.2 in Appendix 1.

Question 9:

Do you agree with the proposals for application of conduct requirements to Fund Managers of Credit Funds? If not, why not?

Additional requirements for Credit Funds

Credit granting, monitoring and management

39. Under the DFSA regime, firms licensed to Provide Credit are subject to requirements under the PIB Module that cover credit and concentration risks. As Funds are not yet permitted to provide credit, no such requirements apply to a Fund Manager of a Credit Fund. We consider that it is necessary to address this gap, by imposing on Fund Managers of Credit Funds the type of requirements set out below.

40. We have considered the policies, procedures and other systems and controls that are necessary for a Credit Fund to operate in a sound and prudent manner. We propose that a Fund Manager of a Credit Fund must establish, in respect of the fund, and implement, appropriate, well documented, policies and procedures for each of the following:

    a) a risk appetite statement;

    b) the assessment, pricing and granting of credit (including criteria, governance, and decision making);

    c) credit monitoring, renewal and refinancing policy (including criteria, governance, and decision making);

    d) collateral management policy;

    e) concentration risk management policy;

    f) valuation, including collateral valuation and impairment;

    g) credit monitoring;

    h) identification of problem debt management;

    i) forbearance;

    j) delegation; and

    k) documentation and security.

41. In addition to the above:

    a) the credit granting must be based on sound and well-defined criteria, and for this purpose, the process for approving, amending, renewing and re-financing credit must be clearly established;

    b) there must be internal methodologies to assess the credit risk of exposures to individual obligors, securities or securitisation positions and credit risk at the portfolio level, which do not rely solely or mechanistically on external credit ratings;

    c) there must also be ongoing administration and monitoring of the various credit risk bearing portfolio positions and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions;

d) measures to ensure that the diversification of credit positions is adequate having regard to the target markets and overall credit strategy;

e) if the credit risk mitigation techniques adopted are to prove less effective than expected, measures to address and control credit risks; and

f) measures to address concentration risk, arising from exposure to counterparties, including indirect exposures.

Please see draft CIR Rules 13.11.5 and 13.11.6 in Appendix 1.

Question 10:

Do you agree with the proposal for credit-related requirements for Fund Managers of Credit Funds? If not, why not?

Stress testing

42. Under the DFSA Funds regime, there is an overarching requirement for a Fund Manager to have adequate systems and controls to manage risks to which the fund and its investments are exposed (including, if the fund is an open-ended fund, detailed liquidity risk management requirements that include stress testing). While firms providing credit are subject to prudential requirements that include stress testing, those do not apply to Fund Managers. We consider that it is necessary to address this gap, by imposing on Fund Managers of Credit Funds stress testing requirements as part of their systems and controls.

43. We have considered how this issue is treated under other regimes as part of our benchmarking. As an example, under the Irish regime, a fund manager of a loan originating QIAIF must have a comprehensive stress testing programme which:

a) identifies possible events or future changes in economic conditions that could adversely affect fund's credit exposures, and assess whether investors in the fund has the ability to withstand such effects;

b) takes into account internal risk limits;

c) comprehensively captures transactions and aggregate exposures across all forms of counterparty credit risk at the level of specific counterparties in a sufficient time frame to conduct regular stress testing;

d) provides for at least monthly exposure stress testing of principal market risk factors such as interest rates, FX and credit spreads for all counterparties of the fund to enable the fund manager to identify when it is necessary to reduce outsized concentrations in specific directional risks; and

e) applies at least quarterly multifactor stress testing scenarios that assesses material non-directional risks including yield curve exposure and basis risks. At a minimum, multiple-factor stress tests must address scenarios where severe economic or market events, market wide liquidity squeezes, or large financial intermediary liquidating positions, occur.

The results of stress testing must be reported to the board of the Fund Manager.

44. We propose to apply to Fund Managers of all Credit Funds systems and controls

requirements that include stress testing. However, we propose that the stress tests described above should be carried out at least annually, with the DFSA able to request more frequent testing, and the specific requirements set out in paragraph 43 should be included as guidance in the proposed regime, rather than as rules.

Please see draft CIR Rule 13.11.7 in Appendix 1.

Question 11:

Do you agree with the proposal for stress testing for Credit Funds? If not, why not?

Diversification and eligible investments

45. The DFSA regime requires Fund Managers of Public Funds to have a spread of risk that is consistent with the investment objectives of the Fund as stated in the prospectus, but, as Credit Funds are required under these proposals to be either Exempt Funds or QIFs, Fund Managers of Credit Funds will have no diversification requirements. We consider that it is necessary to address this gap, by imposing on Fund Managers of Credit Funds suitable diversification requirements.

46. We propose to introduce diversification requirements as follows:

    a) set out in its prospectus an explicit risk diversification strategy to achieve a diversified portfolio of loans that limits exposure to any one issuer or group to a maximum of 25% of net assets within a specified time-frame;

    b) not intentionally breach the specified risk diversification strategy;

    c) if, for reasons beyond its control, it is unable to achieve the risk diversification strategy within the time-frame specified in the prospectus, seek approval from the unitholders to continue to operate at the level of diversification that has been achieved, within 30 days of the end of the specified time for achieving the diversification strategy; and

    d) if the unitholders do not approve the proposal, terminate the fund.

Please see draft CIR Rule 13.11.8 in Appendix 1.

Question 12:

Do you agree with the proposal for diversification requirements for the loan portfolios of Credit Funds? If not, why not?

Liquidity and distributions

47. As noted earlier, we have considered whether it is appropriate to prohibit redemptions altogether but see no reason to do so.

48. Under the current DFSA regime, there are no similar requirements applicable to a closed-ended fund. A closed-ended fund that is an investment company may buy-back its own shares subject to controls under the DIFC Companies Law.

49. Given that both the investment partnership and investment company structure can be used for Credit Funds under these proposals, we consider it more appropriate to allow a Fund Manager of a Credit Fund to offer limited redemption subject to appropriate controls.

50. We also propose that the finite period of the Credit Fund should not exceed ten years, so that a Fund cannot be established for a finite period with an end date so far in the future that this requirement becomes meaningless.

51. Given the proposals in paragraphs 23 and 24, since a Credit Fund must be a closed ended fund, and must be established for a finite period, we think that it would be appropriate that such a Fund has the discretion to invite redemption requests of holdings from unitholders. This should be done at dates determined at the authorisation date, or such other dates as may be approved by the fund manager, without commitment and on a non-preferred basis.

52. Such distributions or redemptions should be permitted during the life of the fund, but only to the extent that there is unencumbered cash or liquid assets available for distribution or redemption purposes and such distributions or redemptions do not endanger the regulatory compliance or liquidity related obligations of the fund. Further, unless the assets of the fund are valued by reference to prevailing market prices, redemptions cannot be made without the approval of the unitholders, in accordance with the procedures set out in the constitution of the fund, on each occasion.

Please see draft CIR Rule 13.11.9 in Appendix 1.

Question 13:

Do you agree with the proposals for redemptions and lifespan for Credit Funds? If not, why not?

Leverage

53. Under the DFSA regime, we prohibit Public Funds, other than Property Funds, from borrowing more than 20% of the net asset value of the Fund. Public Property Funds can borrow up to 65% of GAV, and Money Market Funds can borrow only up to 10% of NAV.

54. As Credit Funds will be Exempt Funds or QIFs, they are not automatically subject to any restrictions relating to leverage. We have considered various options, recognising that not all leverage carries the same degree of risk, and that the risks posed by different structures can vary.

55. In line with the generally conservative approach discussed in paragraph 16, we propose that Credit Funds should be able to have leverage of no more than 10% of the Fund’s Net Asset Value.

56. In the event that the Credit Fund breaches this limit, within 30 days of the breach or such longer period as the DFSA may specify, it must secure the approval of the DFSA for a formal plan to achieve compliance with the leverage ratio.

Please see draft CIR Rule 13.11.10 in Appendix 1.

Question 14:

Do you agree with the proposals on leverage for Credit Funds? If not, why not?

Disclosure and marketing: warnings

57. The DFSA regime requires prominent risk warnings to be included in the prospectus to alert prospective investors to risks associated with particular types of Funds, such as

Hedge Funds, Money Market Funds, Feeder Funds, Property Funds and Venture Capital Funds. However, as we do not have Credit Funds yet, we have no such risk warnings relating to Credit Funds.

58. Again, having considered the position in other jurisdictions, we have concluded that, for the DIFC, the appropriate risk warnings should include drawing the attention of investors and prospective investors to:

    a) the particular risks that arise from loan origination;

    b) the possibility of investment losses and illiquidity in such funds; and

    c) the potential implications arising from the application of the regulator's standards of conduct for business lending to SMEs where loans are issued to them.

59. We consider that not only in the Prospectus, but also in all marketing material used in relation to Credit Funds, it is important to include such risk warnings, to alert potential investors to the risks associated with Credit Fund activities.

Please see draft CIR Rules 13.11.12 and 14.4.13 in Appendix 1.

Question 15:

Do you agree with the proposals on investor warnings? If not, why not?

Disclosure and marketing: Prospectus disclosure

60. As part of introducing Credit Funds, we consider it is important to include suitable prospectus disclosure, to help potential investors to make a well-informed investment decision relating to investing in Credit Funds. This is consistent with the approach we generally adopt in relation to specialist fund prospectus disclosure.

61. The prospectus of a Credit Fund must include:

    a) the risk warnings referred to in paragraph 58;

    b) information on the risk and reward profile to enable investors identify the specific risks linked to the fund's specific loan origination strategy;

    c) information on the extent to which the fund intends to be concentrated as regards individual entities, geographical locations and sectors and risk arising from the proposed concentrations; and

    d) details of the credit assessment and monitoring process (set out earlier).

Please see draft CIR Rule 14.4.13 in Appendix 1.

Question 16:

Do you agree with the proposals on Credit Fund prospectuses? If not, why not?

Disclosure and marketing: Periodic reports

62. While Fund Managers under the DFSA regime are subject to periodic reporting requirements, the periodic reports provided do not include the type of information needed under these proposals, as Funds are not allowed to provide credit currently.

63. We consider that the existing periodic reporting requirements need to be expanded to include:

    a) a breakdown of the originated loans, between senior secured debt, junior debt and mezzanine debt;

    b) a breakdown of the originated loans, between loans made with an amortising repayment schedule, and loans made with bullet repayments;

    c) a breakdown of the loan to value ratio for each originated loan;

    d) information in respect of:

        i. non-performing exposures, as defined in the applicable implementing technical standards; and

        ii. exposures subject to forbearance activities, as defined in the applicable implementing technical standards, which must be provided on an aggregated basis in respect of each exposure; and

    e) any material changes to the credit assessment and monitoring process.

64. The information above must also be provided to each unitholder at each NAV calculation point.

65. We believe that the above information, covering both originated and acquired loans, must be included in the periodic reports provided to the regulator annually (subject to exception reporting if there are material changes affecting the Fund), included in the annual and half-yearly financial reports provided to unitholders of a Credit Fund.

Please see draft CIR Rule 13.11.11 in Appendix 1.

Question 17:

Do you agree with the proposals on periodic reporting? If not, why not?

Disclosure and marketing: Offer and marketing of Foreign Credit Funds

66. The key underpinnings of the DFSA approach to allowing Foreign Funds to be offered and marketed in or from the DIFC are:

    a) not to allow Foreign Funds to be offered, promoted, or marketed, in or from the DIFC, unless the relevant fund and its fund manager is subject to adequate comparable regulation in a jurisdiction acceptable to the DFSA; and

    b) to require the person undertaking the offer, marketing or promotional activities to comply with the DFSA requirements relating to foreign funds, including prospectus disclosure, foreign fund marketing rules, and the financial promotions regime.

67. We consider that similar requirements should apply to the offer and marketing of Foreign Funds that are Credit Funds. It would be the obligation of the person wishing to market the Foreign Fund in or from the DIFC to take reasonable steps to satisfy themselves that the regulation of the fund in its jurisdiction is actually adequate comparable regulation.

Please see draft CIR Rules 15.1.5 and 15.1.6 in Appendix 1.

Question 18: **Do you agree with the proposals on offer and marketing of Foreign Credit Funds? If not, why not?**

<u>External Fund Managers and External Funds</u>

68. Under the Collective Investment Law, a DIFC Fund can be operated by an External Fund Manager and a DFSA-licensed Fund Manager can operate a Fund established outside the DIFC, provided the requirements in CIR Chapter 6 are met. Given the relative novelty of Credit Funds, and the generally conservative approach discussed in paragraph 16, we do not consider that it is appropriate that External Fund Managers be allowed to operate DIFC Credit Funds, or DFSA-licensed Fund Managers be allowed to establish and operate External Funds that are Credit Funds.

Please see draft CIR Rules 6.1.5 and 6.2.3 in Appendix 1.

Question 19: **Do you agree with the proposals on External Fund Managers and External Funds? If not, why not?**

Islamic funds

69. We permit Islamic Funds to establish in the DIFC, subject to requirements intended to ensure that the Fund's investments and operations are Shari'a compliant (see IFR Chapter 6). Islamic finance does not permit loans at interest and the Islamic equivalent of a Credit Fund (which would probably need some different name) would, therefore, need to advance funds through other contractual structures. These would need to be subject to controls with similar substantive effect to those proposed for direct lending activities.

70. In addition, some contractual structures create a debt relationship in the legal sense, while some do not. Since most Shari'a scholars believe that debt instruments can be traded only at the face value of the outstanding debt, there would be difficulties in buying portfolios of certain types, and indeed difficulties in selling a portfolio if the Fund for any reason needed to realise cash.

71. We would welcome views from stakeholders as to whether it would be viable to establish an Islamic equivalent of a Credit Fund as currently proposed, what the practicalities would be, and what parameters a DFSA regime should put in place around such funds, in addition to those currently in IFR Chapter 6, to reflect the nature of their operations and the assets in which they might invest. We should also welcome views on what such a fund might be called.

Question 20:

Is it viable to establish Islamic funds in this area? What practical issues would arise? What should the DFSA put in place, in addition to its existing rules, to reflect the nature of the operations of such funds?

Other requirements applicable to Fund Managers

Prudential requirements

72. Under the current DFSA regime, Fund Managers of Exempt Funds and QIF are subject to a capital requirement which is the higher of a base capital of USD 70,000 or an expenditure based capital minimum (EBCM) of 13/52.

73. We consider that a Fund Manager of a Credit Fund is undertaking a more complex type of business than a Fund Manager operating many other types of Exempt Fund or QIF (although Hedge Funds and ETFs can be as risky and complex). As a result, unwinding of the business of a Credit Fund, like that of a firm providing credit, is likely to be more complex and time consuming. Therefore, we consider it appropriate to impose on a Fund Manager of an Exempt Fund or QIF which is a Credit Fund a base capital requirement of USD 100,000.

74. We have considered introducing a volume-based capital requirement related to the size of Assets under Management by the Fund Manager of the Credit Fund. However, further work would be needed to calibrate such a capital requirement, so we do not intend to propose this at the current time.

75. We propose to require Fund Managers of Credit Funds to meet a base capital requirement of USD 100,000 and to face an EBCM requirement, as for most other Fund Managers.

Please see draft PIB Rule 3.6.2 in Appendix 4.

Question 21:

Do you agree with our proposals for prudential requirements for Fund Managers of Credit Funds? If not, why not?

Reporting

76. In terms of regular reporting to the DFSA, the Fund Managers of Credit Funds will need to submit annually the Fund Management Return, in line with other Fund Managers.

77. Additionally, as Credit Funds will – by definition – be involved in lending, we will need to capture periodic information on the credit portfolio of such funds, as we do for banks. This will inform us about the growth of ‘shadow banking" activities in the DIFC and help us to understand macro-prudential and systemic risks.

Please see PIB A2.4 for the list of forms that Firms can be required to submit.

Question 22:

Do you agree with our reporting proposals for Fund Managers of Credit Funds? If not, why not?

Fees

78. Under the current regime, the application fees and annual fees for Managing a Collective Investment Fund that is a Public Fund or an Exempt Fund is USD 10,000; for a QIF it is USD 5,000, and if it is a Venture Capital Fund, USD 2,000. We do not think that these lower fees are commensurate with the administrative task of authorising and supervising a Fund Manager managing a Credit Fund, as direct lending activities are more complex than conventional investment activities. Therefore, we consider a higher application and authorisation fee of USD 10,000 appropriate for a Fund Manager who proposes to manage a Credit Fund.

79. It follows from the above proposal that licensing Credit Fund Managers is expected to be a lengthier and more detailed process than for some other categories of Fund Manager. The DFSA has previously committed publicly to service standards of licensing an Exempt Fund/QIF Fund Manager within four to six weeks of accepting an application and of licensing a Venture Capital Fund Manager within one week of accepting an application. However, in dealing with applications for Credit Fund Managers we will not use these standards. Instead, we will set a more appropriate service standard once we have sufficient experience.

Please see draft FER Rules 2.1.1 and 3.2.1 in Appendix 5.

Question 23:

Do you agree with our fee proposals regarding Credit Fund Managers? If not, why not?

Transitional arrangements

80. As we have noted in this paper, Credit Funds are not currently permitted in the DIFC. There should, therefore, be no transitional issues to address arising from these proposals.

Question 24:

Do you have any other comments on our proposals? If so, please set out your comment and explain what you think the DFSA should do to address your point.

Annex 1: Questions in this Consultation Paper

Q1: Do you agree with our proposal to introduce Credit Funds as a specialist class of Funds? If not, why not?

Q2: Do you agree with our proposal that a Credit Fund should focus predominantly on lending activities? If not, why not?

Q3: Do you agree with our proposal that a Credit Fund should be either an Exempt Fund or a Qualified Investor Fund? If not, why not?

Q4: Do you agree with our proposals on permissible Fund vehicles, legal structures and management structures for Credit Funds? If not, why not?

Q5: Do you agree with our proposal that Credit Funds not be permitted to issue letters of credit or give financial guarantees? If not, why not?

Q6: Do you think Credit Funds should be able to undertake trade finance activities? Please explain why you hold this view.

Q7: Do you agree with our proposals on who a Credit Fund should be able to lend to? If not, why not?

Q8: Do you agree with our proposal for the application of general licensing requirements to Fund Managers of Credit Funds? If not, why not?

Q9: Do you agree with the proposals for application of conduct requirements to Fund Managers of Credit Funds? If not, why not?

Q10: Do you agree with the proposal for credit-related requirements for Fund Managers of Credit Funds? If not, why not?

Q11: Do you agree with the proposal for stress testing for Credit Funds? If not, why not?

Q12: Do you agree with the proposal for diversification requirements for the loan portfolios of Credit Funds? If not, why not?

Q13: Do you agree with the proposals for redemptions and lifespan for Credit Funds? If not, why not?

Q14: Do you agree with the proposals on leverage for Credit Funds? If not, why not?

Q15: Do you agree with the proposals on investor warnings? If not, why not?

Q16: Do you agree with the proposals on Credit Fund prospectuses? If not, why not?

Q17: Do you agree with the proposals on periodic reporting? If not, why not?

Q18: Do you agree with the proposals on offer and marketing of Foreign Credit Funds? If not, why not?

Q19: Do you agree with the proposals on External Fund Managers and External Funds? If not, why not?

Q20: Is it viable to establish Islamic funds in this area? What practical issues would arise? What should the DFSA put in place, in addition to its existing rules, to reflect the nature of the operations of such funds?

Q21: Do you agree with our proposals for prudential requirements for Fund Managers of Credit Funds? If not, why not?

Q22: Do you agree with our reporting proposals for Fund Managers of Credit Funds? If not, why not?

Q23: Do you agree with our fee proposals regarding Credit Fund Managers? If not, why not?

Q24: Do you have any other comments on our proposals? If so, please set out your comment and explain what you think the DFSA should do to address your point.