

# AIFMD II and Loan Origination Funds

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## Background

On 6 November 2023, the Council of the European Union published its long anticipated final **compromise text** *‘as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds’* amending AIFMD and UCITS directives (**AIFMD II**). This note considers what are entirely novel requirements attaching to loan origination activities by alternative investment funds (**AIFs**) and their implications for credit funds once AIFMD II is fully in force, though it is worth pointing out at this stage that little has changed since the publication of the “final” compromised text on 1 June 2022 beyond some movement to increase flexibility, particularly in relation to the leverage limit for closed-ended funds.

## What is ‘Loan Origination’ and a ‘Loan-originating AIF’?

New draft Recital (3a) sets out the clarification that *‘the management of AIFs can also comprise the activities of originating loans on behalf of an AIF’*. In order to make it clear that loan origination can occur indirectly, Recital (9-a) sets out the anti-avoidance principle that where an AIF is involved in structuring the loan or defining or pre-agreeing characteristics, that should be considered as loan origination activities whether or not the loan is granted indirectly through a third party or special purpose vehicle. These facets are set out in the new definition of ‘loan origination’ or ‘originating a loan’ which means:

*‘...the granting of a loan directly by an AIF as the original lender or indirectly through a*

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*third party or special purpose vehicle, which originates a loan for or on behalf of the AIF, or for or on behalf of the AIFM in respect of the AIF, where the AIFM or AIF is involved in structuring the loan, or defining or pre-agreeing its characteristics, prior to gaining exposure to the loan’.*

A ‘loan originating AIF’ is further defined as an AIF: (i) whose investment strategy is mainly to originate loans; or (ii) with a notional value of originated loans representing at least 50% of its net asset value. This definition potentially encompasses secondary vehicles, subject to the transitional provisions set out below.

## Open-ended vs Closed-ended

Recital (14) sets out the starting point that, due to liquidity mismatches, loan-originating AIFs should be mandatorily closed-ended. However, and as with the risk retention requirement, there are significant derogations set out in Article 16 to allow open-ended AIFs provided they maintain appropriate liquidity managing systems using at least two of the liquidity management tools from the list set out in Annex V, points 2 to 7 (though money market funds may select a single tool).

The European Securities and Markets Authority (**ESMA**) has been directed to develop draft regulatory criteria setting out criteria for national regulators to determine whether a loan-originating AIF can operate as an open-ended fund, including on liquidity management and redemption policies as well as on the characteristics of the listed liquidity management tools. While much depends on these eventual technical standards, it is clear that AIFMD II is stopping well short of prohibiting the use of open-ended funds to originate loans.

## Risk Retention Requirement

**AIFMD II sets out an entirely new requirements for loan-originating AIFs:**

1. to retain a slice of risk when transferring loans to third parties;
2. that requirement involves a retention of 5% of the notional value of each loan originated and subsequently transferred to third parties;
3. it is up to the AIFM to ensure that the AIF maintains the retention according to the rules;
4. the retention period is until maturity for loans with a maturity of up to eight years, and for a period of at least eight years for other loans; and
5. loans originated with the sole purpose of selling them to third parties – ie, ‘originate-to-distribute’ strategies are not allowed, regardless of whether the AIF meets the definition of a loan-originating AIF. Loans can only be made for the purpose of investing the AIFs capital.

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Derogations to the risk retention requirement are permitted should it be necessary in order to implement the AIF's investment strategy in the best interests of investors or for regulatory purposes. Derogations contemplated include situations when maintaining the retention could cause the AIF to exceed investment or diversification limits or breach regulatory requirements, as well as on events such as redemptions, liquidation or the merger or default of the borrower. Also included are derogations available should the assets concerned become distressed or if the AIF's asset allocation policy has changed, rounding off what is a comprehensive set of allowances.

## **Leverage Limits**

New Recital (11a) sets out the need for leverage limits, and the requirement to allocate these on the basis of whether a fund is open or closed-ended. Being susceptible to higher redemptions, open-ended funds are subject to greater restrictions, which can be further enhanced by individual Member States within their discretion. AIFMD II sets leverage limits at: (i) 175% for open-ended AIFs; and (ii) 300% for closed-ended AIFs determined using the ratio between the AIF's exposures using the commitment method and its net asset value. Note also that borrowings fully covered by investors' contractual capital commitments will not be considered exposures for the purposes of this ratio.

## **Loans to Staff**

In order to avoid conflicts of interest, AIFMs and their staff are to be prohibited from receiving loans from any AIFs they manage, as are staff of delegates, depositories and entities in the same group as the AIFM. The group company prohibition does not apply to an entity that is a financial undertaking that exclusively finances borrowers who are not in any of these prohibited categories.

## **Policies and Procedures**

AIFMs managing loan originating AIFs, regardless of whether those AIFs meet the relevant definition, should have 'proportionate' policies, procedures and processes for granting loans, assessing credit risk, diversifying risk, managing exposures to specified limits and managing portfolios as well as around the activation and use of the liquidity management tools referred to above, including when the AIFs gain exposure to loans through third parties. Note that new Article 15 exempts 'shareholder loans' to undertakings in which the AIF holds (directly or indirectly) at least 5% of the capital or voting rights and which cannot be sold to a third party independently of the capital interest when the notional value does not exceed in aggregate 150% of the AIF's capital.

Note that AIFMD II looks to impose concentration limits on single borrowers that are financial institutions, other AIFs or UCITS to 20% of the AIFs capital.

## Loans to Consumers

Consumer credit is covered by other European legislation, and Recital (9a) allows that Member States should be able to prohibit loan origination by AIFs to consumers.

## Next Steps

**Timing:** Directives are required to be implemented into domestic legislation within Member States two years after publication in the European Commission's Official Journal and it is important to note that Member States may adopt stricter requirements than those set out in the Directive through 'gold-plating'. However, as we set out above, much of the important technical detail is yet to be seen. This will come in the form of ESMA technical standards, drafts of which will not be presented until after AIFMD II has come into force.

**Transitional rules:** Given the often illiquid and long-term nature of the assets of loan originating AIFs, AIFMD II contemplates transitional rules for requirements for AIFs constituted before the adoption of AIFMD II, with optional early opt-in. In addition, rules applying to loan-originating AIFs with the exception of rules on leverage and investment limits and the 'obligation' to form as closed-ended will only apply to loans originated after AIFMD enters into force.

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