

Understanding AIFMD II: loan origination

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In a new series of briefings from our Investment Funds team in Luxembourg, we'll be summarising the upcoming changes to the Alternative Investment Fund Managers Directive (AIFMD). [1]

The long-awaited amendments to directive, (the AIFMD II [2]) were adopted by the European Council on 26 February 2024 and will enter into force 20 days after its publication in the EU Official Journal. Member States will have 24 months to transpose it into their national laws.

In this first article, we'll be focusing on loan origination, its definition under AIFMD II, and what to expect when the changes come into force.

AIFMD II and loan origination

Recognising the market reality and the importance of deploying private capital to the economy as a part of the EU's plan to further strengthen the Capital Markets Union, a focus of the EU Commission is the granting of loans by alternative investment funds (AIFs).

Until now, there was no uniform regulatory framework in EU for such activity by market players other than credit institutions.

Going forward, the AIFMD II will provide for the following key elements in this area:

Definition of loan origination

Loan origination under the AIFMD II means the granting of a loan directly by an AIF as the original lender. Where the loan is granted by a third-party or a special purpose vehicle (SPV) which acts on behalf of the AIF or its alternative investment funds manager (AIFM), the AIF will still be considered as originating the loan if the AIF or its AIFM was involved in structuring the loan, pre-agreeing or defining its characteristics, prior to gaining exposure. This definition is in line with current Luxembourg regulatory guidance and market practice, in which a clear distinction has been made between loan acquisition and origination.

A loan-originating AIF means an AIF whose investment strategy is mainly to originate loans or where the notional value of the AIF's originated loans represents at least 50% of its net asset value.

The AIFMD II does not specifically cover umbrella structures although we understand that this definition applies on the AIF level, and therefore across compartments on a cumulative basis - this will need to be confirmed.

Concentration limits

The AIFMD II imposes concentration limits depending on the type of borrower: notional value of the loans originated to any single borrower will be limited to an aggregate of 20 % of the capital^[3] of the AIF where the borrower is a financial undertaking^[4], a UCITS or an AIF.

This limit will apply as of the date specified in the legal documents of the AIF, and shall be no later than 24 months as from the first subscription for interests or shares in the AIF. The period may exceptionally be extended by one additional year, subject to approval of the regulator^[5]. The limit will cease to apply once the divestment phase of the AIF's starts at the end of its life cycle. A temporary suspension of the concentration limit is foreseen for situations where the capital of the AIF is increased or reduced, for no longer than 12 months.

These rules on single borrower exposure and the related application limits will apply as of five years from the entry into force of the AIFMD II (the **Transitional Period**). AIFs established before this date, which do not raise additional capital after the date of entry into force of the AIFMD II, will be deemed compliant in this regard.

The AIFMD II also foresees a two-level ban on exposure increase during the Transitional Period. Where the exposure to a single borrower is above the permitted thresholds, the AIFM will not be permitted to increase it; increasing that value above the 20% will not be permitted for those funds whose exposure is lower than the limit.

Finally, an opt-in possibility regarding the above limitations will be in place for legacy loan originating AIFs.

Leverage thresholds

Leverage thresholds for loan-originating funds will be 175% for open-ended AIFs and 300% for closed-ended AIFs. The threshold expresses the ratio between the exposure of that AIF and its net asset value, and will be calculated according to the commitment method, in line with the Commission Delegated Regulation 231/2013, and the following specific rules:

- borrowing arrangements fully covered by capital commitments from investors in the loan-originating AIF shall not be taken into consideration

- thresholds shall not apply to a loan-originating AIF whose lending activities consist solely of originating shareholder loans, provided that the notional value of those loans does not exceed in aggregate 150 % of that AIF's capital

Shareholder loan will be a loan granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in that same undertaking.

During the Transitional Period, the same rules as those for the concentration limits above shall apply in relation to leverage thresholds (ie five-year grace period, closed legacy funds, thresholds and ban on increasing exposure, opt-in).

Asset retention on resale

The AIFM will need to ensure that an AIF retains, for each loan it originated and transferred to third parties; 5% of the notional value of each loan, either:

- until maturity for those loans whose maturity is up to eight years
- until at least eight years for other loans
- until maturity for consumer loans

Derogations will be possible upon the approval of the competent authority, where (i) the AIFM starts to sell assets of the AIF in order to redeem units as part of the liquidation, (ii) the disposal is necessary for the purposes of compliance with restrictive measures, (iii) the sale of the loan is necessary to enable the AIFM to implement the investment strategy in the best interests of the AIF's investors, or (iv) the sale of the loan is due to a deterioration in the risk associated with the loan.

Loan prohibition to certain linked entities

An AIF will not be able to grant loans to certain linked entities: to the AIFM or its staff, to the depositary or sub-depositary, or to an entity being part of the same group as the AIFM.

Originate-to-distribute prohibition

Investment strategy (or a part of it) of originating loans with the sole purpose of transferring those loans or exposures to third parties will not be permitted.

Opt-in prohibition for consumer loans

Member States will be able to prohibit AIFs to originate loans to consumers or service such credits. This shall not affect marketing in the EU of AIFs which carry out loan originating activity in the Member States where this is permitted.

Risk management policy

AIFMs will have to implement and maintain effective policies, procedures and processes for the granting of credit, as well as for assessing the credit risk and monitoring their credit portfolio where they manage AIFs that engage in loan origination.

This requirement shall not apply to origination of shareholder loans, where their notional value does not exceed in aggregate 150% of the capital of the AIF.

It is worth noting that these requirements are in line with supervisory expectations of the Luxembourg Financial Sector Supervisory Authority (the **CSSF**) already in place, ie a necessity for AIFMs and AIFs engaging in loan origination and acquisition to have a robust and appropriate approach for this activity, as well as to address all related aspects and risks. Aspects to be considered, in particular are organisational and governance structures, necessary expertise, credit and liquidity risk management, concentration and risk limitation and adequate disclosures.

Liquidity management for open-ended AIFs

Loan origination is a strategy which is a good fit for closed-ended funds. This being said, the AIFMD II clarifies conditions for open-ended AIFs having loan origination as part of their strategy.

Loan originating AIFs will be able to be open-ended solely if its AIFM demonstrates to the competent authority that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy (as per the regulatory technical standards to be published by ESMA).

These liquidity management requirements shall also apply as from the end of the Transitional Period.

Pre-existing funds not raising additional capital after the date of entry into force of the AIFMD II will also be considered compliant in this regard but can nevertheless choose to opt-in.

Precontractual and periodic disclosures

In their offering document and annual reports, the loan originating AIFs will have to disclose all costs and expenses linked to the administration of loans, in accordance with existing article 23 AIFMD disclosures.

Transitional period for "existing" loans

Besides the already mentioned deferred application periods for concentration limits, leverage threshold and liquidity management tools, the AIFMD II introduces a general rule for existing

AIFMs managing loan originating AIFs – they will be able to continue to do so, with respect to individual loans, without having to comply with the requirements on (i) asset retention on resale, (ii) loan prohibitions to linked entities, (iii) originate-to-distribute prohibition, (iv) risk management policy and (v) cost attribution and disclosures.

What to expect

Loan origination by AIFs was already a permitted activity in Luxembourg under specific conditions provided for by the CSSF. The AIFMD II aims to introduce loan-originating AIFs at the EU level and overall will provide greater flexibility to finance the EU real economy. The rules that will have a major impact on sponsors doing loan origination are the concentration limits, leverage limits and asset retention requirements.

Further, clients who have open-ended loan-originating AIFs should already start looking at their risk management process and the liquidity management tools in place.

All loan-originating AIFs should also adopt internal credit procedures which will be subject to annual review. The costs of lending should be disclosed in a transparent way in the fund documentation.

At the first stage, AIFMs will need to comply with these new rules. However, some of these rules will also be important to delegated portfolio managers and other delegates who are not subject to AIFMD directly, but will be required to indirectly comply with some of these rules that are imposed by the AIFM on them.

Finally, the AIFMD II will have a 24-month transposition deadline and a five-year Transitional Period for certain AIFMD II requirements. In addition, particular attention should be brought to compliance deadlines for specific AIFMD II requirements, as mentioned above.

How can Ogier help?

Our dedicated Investment Funds team in Luxembourg can advise funds and their managers on compliance with the new rules and their implementation. For more information, please reach out to the team listed below.

[1] The legislative proposal intends to amend the UCITS directive as well, however in this series, we will be covering only the proposed amendments to the AIFMD.

[2] Proposal for a Directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds [procedure 2021/0376(COD)].

[3] To be noted that capital means aggregate capital contributions and uncalled capital committed to the AIF, calculated on the basis of amounts investible after deduction of all fees borne by investors.

[4] Any of the following entities: (a) a credit institution, a financial institution or an ancillary banking services undertaking within the meaning of Article 4(1), (5) and (21) of Directive 2006/48/EC respectively; (b) an insurance undertaking, or a reinsurance undertaking or an insurance holding company within the meaning of Article 212(1) (f); (c) an investment firm or a financial institution within the meaning of Article 4(1) (1) of Directive 2004/39/EC; or (d) a mixed financial holding company within the meaning of Article 2(15) of Directive 2002/87/EC.

[5] The details of this approval procedure will be further specified at EU and/or on a national level.

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