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New Regime for Loan Origination Funds in the Revised Alternative Investment Fund Managers Directive (AIFMD 2)

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Executive Summary

The European Leveraged Finance Association's (ELFA) Engagement Committee recently held a Member Workshop with our Expert Panel partner, Akin, to help ELFA members understand the new rules applicable to loan origination funds under the revised Alternative Investment Fund Managers Directive (AIFMD 2).

AIFMD 2 establishes a new regime for loan originating alternative investment funds (AIFs). Alternative Investment Fund Managers (AIFMs) that engage in loan origination activities on behalf of AIFs are brought under a new regulatory framework which includes the following:

- 20% concentration limits on certain borrowers
- Risk retention requirements for loans (5% of the notional value of loans originated for 8 years or until maturity (if shorter))
- Restrictions on types of borrowers
- Requirements for effective policies, procedures, and processes
- Prohibition on "originate to distribute" strategies
- Additional investor disclosure requirements

AIFMs that manage "loan originating AIFs" are subject to additional requirements under the new framework as follows:

- Leverage limits (175% of net asset value (NAV) and 300% of NAV for open-ended and closed-ended AIFs respectively)
- Mandatory closed-ended structure

Key takeaways from the workshop are summarised in this report.

Introduction

ELFA's Engagement Committee recently held a Member Workshop with our Expert Panel partner, Akin, to help ELFA members understand the new rules applicable to loan origination funds under the Alternative Investment Fund Managers Directive (AIFMD 2).

Scope of AIFMD 2

AIFMD is a regulatory framework that was implemented to better regulate alternative investment funds. AIFMD 2 is a revision of the original AIFMD and was adopted in February 2024 and came into force on 15 April 2024.

The UK is no longer an EU member. However, AIFMD 2 remains relevant for non-EU AIFMs as the rules apply to EU AIFs managed by non-EU AIFMs and non-EU AIFs managed by EU AIFMs. There is currently no indication that the rules will be extended to apply to non-EU AIFs registered under national private placement regimes (NPPR), but this may be clarified in the future and extraterritorial application is not precluded.

Further, AIFMD 2 does not restrict the ability of specific Member States to introduce specific restrictions for consumer protection purposes.

Timing and transitional provisions for AIFMD 2

AIFMD 2 came into force on 15 April 2024 and must be transposed into national law in April 2026. Further clarification of specific items in the form of secondary legislation and guidance by the European Securities and Markets Authority (ESMA) will be issued in the lead-up to the implementation of AIFMD 2.

Grandfathering
During the two-year implementation period, there will be grandfathering provisions that will be applied to existing loan portfolios with respect to the policies and procedures required, loan proceeds and related investor disclosures, prohibited loans, originate to distribute strategies and risk retention.

Existing portfolios of AIFs that closed fundraising and were formed before AIFMD 2 came into force are not required to comply with the requirements relating to concentration limits, the leverage cap and the additional liquidity management rules for open-ended loan originating funds. Existing portfolios of AIFs that were formed but were still fundraising on the date AIFMD 2 came into force are grandfathered with respect to the concentration limit, the leverage cap and the requirement for the AIF to be closed-ended for five years from 2024. The grandfathering provisions specify that if the AIF is in breach of the concentration or the leverage limits at the beginning of the transitional period (April 2024), the AIFM may maintain, but not increase, the fund's exposure exceeding the relevant limits. However, AIFMs will generally need to comply with the AIFMD 2 rules with respect to loans originated on or after AIFMD 2 came into force.

AIFs that were formed when or after AIFMD 2 came into force must comply with the provisions under AIFMD 2 from 16 April 2026.

Loan origination funds under AIFMD 2

AIFMD 2 acknowledges the importance of private debt AIFMD 2 acknowledges the importance of private debt fund managers and regulates the ability of AIFMs to carry on the loan origination activities across the EU.

AIFMD 2 aims to enhance investor protection, risk management, and transparency within the alternative investment fund industry. It completes the AIFMD framework by introducing a new regime for "loan originating AIFs" and, more generally, for loan origination activities by or on behalf of AIFs. The new regime aims to facilitate EU cross-border activities of loan originating AIFs by creating a harmonised framework. Some AIFMD 2 requirements apply to any AIF engaged in originating loans and others apply only to AIFs that conduct significant loan origination activity (loan originating AIFs) (see below).

A loan-originating AIF is defined as 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.

Loan origination is defined as the granting of a loan directly by an AIF as the original lender or indirectly through a third party or special purpose vehicle, which originates a loan for or on behalf of the AIF or AIFM in respect of the AIF, where the AIF or AIFM is involved in structuring the loan, defining or pre-agreeing its characteristics prior to gaining exposure to the loan.

Requirements applicable to all loan origination activity

Concentration limits on certain borrowers: All AIFs that originate loans will need to employ a concentration limit. This means that they cannot make loans to other AIFs or any other "financial undertakings" (e.g. undertakings for collective investments in transferable securities (UCITS) and other financial entities) that are more than 20% of the loan originating AIF's capital (including those made through a special purpose vehicle. The 20% limit does not apply where the AIF is selling assets to meet redemptions or as part of the liquidation of the AIF and may also be suspended for up to 12 months where the capital of the AIF is increased or reduced.

1. **Risk retention requirements for loans:** Risk retention provisions apply to reduce incentives for AIFMs to originate poor quality loans without retaining long-term exposure. AIFs that originate loans must retain 5% of each loan they originate and subsequently transfer to third parties as follows:
   - loans with a maturity of less than eight years: 5% of the notional value until maturity
   - loans to consumers: 5% of the notional value until maturity
   - loans with a maturity of more than eight years: 5% of the notional value for at least eight years

There are exemptions from this requirement, including where:

- the AIFM sells assets of the AIF in order to redeem units or shares as part of the liquidation of the AIF
- the disposal is necessary to comply with EU sanctions or product requirements
- the sale of the loan is necessary to enable the AIFM implement the investment strategy of the AIF in the best interests of the AIF's investors
- the sale of the loan is due to a deterioration in the risk associated with the loan and the purchaser is informed of such deterioration when buying the loan

Further clarification may be provided by ESMA.

2. **Restrictions on lending:** AIFs that originate loans must not make loans to the AIFM (or its staff), the AIFM's delegate (or its staff); or the AIF's depositary or its delegate. Lending to entities in the same group as the AIFM is only permitted if the entity is a financial undertaking which exclusively finances borrowers that are not any of the entities previously mentioned. Member States will have the option to prohibit loan origination to consumers (i.e., natural persons acting outside their trade, business or profession).

3. **Requirements for effective policies, procedures, and processes:** There are specific requirements around governance and risk management for AIFMs for the granting of loans. These include where the AIF gains exposure to loans through third parties. Shareholder loans (loans made to the investee companies in which the AIF holds at least 5% of capital or voting rights, either directly or indirectly, and cannot be transferred independently of the AIF's holding in the undertaking) are excluded from the governance requirement and the leverage limit provided that the loans do not exceed 150% of the AIFs capital.

4. **Prohibition on "originate to distribute":** AIFMs are prohibited from managing any AIFs the investment strategy of which consists of originating loans with the purpose of transferring those loans or exposures to third parties.

5. **Additional disclosure requirements:** There are additional disclosure requirements requiring all costs and expenses that are linked to the administration of the loans to be specifically disclosed to investors. The proceeds of loans originated must be attributed to the AIF in full. Less any allowable fees for loan administration. This is intended to allow greater transparency on the disclosure of the fees at the fund level.

Requirements applicable to Loan Originating AIFs

1. **Leverage limits: The leverage limits set under AIFMD 2 are 175% of net asset values (NAV) for open ended AIFs and 300% of NAV for close ended funds. Leverage should be calculated based on the commitment method but excluding borrowing covered by investor commitments.**

   The leverage limits do not apply to shareholder loans, provided that these loans do not exceed 150% of the AIF's capital.

2. **Requirement to be closed-ended: Loan originating AIFs are required to be closed-ended unless the AIFM can demonstrate that its liquidity risk management system is compatible with its investment strategy and redemption policy. ESMA will develop the criteria for an AIF to establish the same.**

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

About Akin:
Akin is a leading global law firm providing innovative legal services and business solutions to individuals and institutions. Founded in 1945 by Richard Gump and Robert Strauss with the guiding vision that commitment, excellence and integrity would drive its success, the firm focuses on building lasting and mutually beneficial relationships with its clients. Our firm's clients range from individuals to corporations and nations. We offer clients a broad-spectrum approach, with over 85 practices that range from traditional strengths such as appellate, corporate and public policy to 21st century concentrations such as climate change, intellectual property litigation and national security.

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