

# AIFMD II — Loan Origination and Liquidity Management

6 August 2024

The updated Alternative Investment Fund Managers Directive (“AIFMD II”) was [published](#) in the Official Journal of the European Union on 26 March 2024 and entered into force on 15 April 2024. In this Debevoise In Depth we summarise the provisions in AIFMD II which cover loan-origination activities by alternative investment fund managers (“AIFMs”) of alternative investment funds (“AIFs”).

Member states must transpose AIFMD II into national law and regulation within 24 months from the date of its entry into force. There is transitional relief for some of the provisions relating to loan origination, which we discuss further below.

The provisions for loan-origination activities by AIFs create common rules as the basis for an efficient internal market for loan-originating AIFs to allow AIFs to originate loans in all member states and facilitate access to finance by EU companies. The provisions are also designed to provide appropriate investor protection.

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## National Implementation

AIFMD II recognises the right of an AIFM to originate loans as part of its fund management origination activity and introduces consistent requirements for AIFMs to conduct this activity. This is generally helpful in addressing existing concerns under which some Member States did not recognise loan origination as a type of investment activity and prohibited loan origination under the national laws governing AIFs and AIFMs. However, the Directive does not go so far as addressing existing “banking monopoly” concerns which exist in countries such as Germany, Italy, France and Austria, where, if the borrower is based in the jurisdiction, lending requires a licence under applicable banking laws. AIFMD II did not grant a “passport” for loan origination activities by requiring Member States to ensure that an AIFM can engage in loan origination on a cross-border basis in another Member State without breaching banking license requirements, possibly because this would have required a new exemption from banking-licence requirements for AIFMs. However, it is expected that the Member States mentioned above, when implementing AIFMD II, will introduce an exemption in their banking laws (to the extent not already the case, as for example in Germany) now that

loan-originating AIFs are subject to harmonised requirements, addressing investor and borrower protection concerns.

The application of the regime to non-EU managers is more complex. Whilst the regime is not directed at non-EU managers of AIFs that originate loans in the European Union, it is possible that Member States may implement AIFMD II in a way that leads to a less favourable regulatory position for non-EU managers that originate loans in the state and apply all or some of the conditions on loan origination to non-EU managers that market funds in the European Union under national private placement regimes. In our view, the new rules should not prevent the establishment of parallel structures in which an EU AIF originates a loan under the new framework and then transfers the loan in part to one or more non-EU AIF parallel funds. We discuss this further below.

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## New Terms Introduced by the New Regime

The new conditions for loan origination activities apply depending on whether the AIF is (a) a “loan-originating AIF” or (b) an AIF “engaging in loan origination”. The key concept of “loan origination” or “originating a loan” means 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 for or on behalf of an 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. “Loan-originating AIF” means an AIF (i) whose investment strategy is mainly to originate loans or (ii) where the notional value of the AIF’s originated loans represents at least 50% of its net asset value.

The term “loan” is not defined in AIFMD II. In the absence of further guidance, we take the view that it covers loans in the ordinary meaning of the term, which are lending arrangements negotiated and entered into by a borrower and one or more lenders. It should not be taken to include loans in the form of transferable debt securities, such as bonds, notes or preferred equity.

“Originating loans on behalf of an AIF” has been added to the list of additional functions that an AIFM may perform in the course of managing an AIF in Annex I of AIFMD II.

We set out below the provisions that apply to all AIFs that engage in loan origination, which may include, for instance, private equity or real estate funds which originate loans as part of their investment policy, and those that only apply to “loan-originating AIFs”.

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## Requirements Applying to all AIFMs and AIFs Engaging in Loan Origination

### AIFM Policies, Procedures and Processes

An AIFM is required to implement effective policies, procedures and processes for assessing credit risk and administering and monitoring the credit portfolio where an AIF that it manages engages in loan origination, including when the AIF gains exposure to loans through third parties. An AIFM is required to put in place policies, procedures and processes that are proportionate to the extent of the loan origination and review them regularly and at least once a year.

In practice, most AIFMs that have engaged in loan origination to any scale are likely to have these policies in place to some degree, and this rule reflects the current position in some Member States, such as Luxembourg, where the CSSF introduced similar requirements for AIFMs that engage in debt activities in 2016.

The requirement does not apply to the origination of shareholder loans, where the notional value of such loans does not exceed in aggregate 150% of the AIF's capital. "Shareholder loan" means a loan which is 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 the same undertaking. This is designed to exclude shareholder loans in private equity and real estate holding structures.

### Risk Diversification Rule

An AIFM must ensure that when an AIF originates loans, the notional value of the loan originated to any single borrower that is a "financial undertaking" (such as a credit institution, an insurance undertaking or an investment firm), an AIF or a UCITS is limited to 20% of the AIF's capital. According to a recital, this is to reduce the risk of interconnectedness between loan-originating AIFs and other financial market participants.

This restriction applies from the date specified in the fund's constitutional document, so long as this date is no later than two years from the date of the first closing, and ceases to apply once the AIFM starts to sell the fund's assets in order to redeem units or shares as part of the fund's liquidation. The limit may be temporarily suspended when the fund's capital is increased or decreased. Any such suspension must be limited in time to the period that is strictly necessary, taking due account of the interests of the investors in the AIF, and in any case may last no longer than 12 months.

In setting the date on which the restriction applies, the AIFM must take into account the particular features and characteristics of the AIF's assets. Competent authorities may in exceptional circumstances approve an extension of this time limit by one additional year.

## Restrictions on Types of Borrowers

AIFMs must ensure that AIFs do not grant loans to the AIFM or the staff of the AIFM, its depositary and its delegates, any entity to which the AIFM has delegated functions and staff of that entity, or a group entity of the AIFM, except where that entity is a financial undertaking that exclusively finances borrowers. A recital to the Directive states that this provision addresses conflicts of interest.

## Proceeds of Loans

Where an AIF originates loans, the proceeds of the loans, less administration fees, must be attributed to the AIF in full. All costs and expenses linked to the administration of the loans must be disclosed in full to investors.

## Loans to Consumers

A member state may prohibit AIFs that originate loans from granting loans to “consumers” (individuals acting outside their business or trade) in its territory and may prohibit AIFs from servicing credits granted to such consumers in its territory. This prohibition will not affect the marketing of AIFs in the European Union that grant loans to consumers or service credits granted to consumers. A recital to the Directive notes that EU law already specifies requirements on consumer lending and credit servicing, and for overriding reasons of public interest, Member States should be able to prohibit loan origination by AIFs to consumers in their territory.

## Prohibition of “Originate-to-Distribute” Strategies

An AIFM that manages an AIF that engages in loan origination, and whose investment strategy in full or in part is to originate loans, may not originate loans with the sole purpose of transferring those loans or exposures to third parties. In this regard, a recital states that “Loans should be granted for the sole purpose of investing the capital raised by the AIF in accordance with its investment strategy and regulatory constraints.” The prohibition should not apply to parallel fund structures or to the transfer of participations in a loan from an AIF to co-investment vehicles.

## Risk Retention Rule

An AIFM must ensure that the AIF it manages retains at least 5% of the notional value of each loan it originates and is subsequently transferred to third parties. A recital explains that this is to “avert moral hazard and maintain the general credit quality of loans originated by AIFs”.

The applicable retention period is determined in two ways: (i) for loans with a maturity of up to eight years or for loans granted to consumers, 5% of the notional value must be retained until maturity; and (ii) for loans with a maturity longer than eight years, 5% of the notional value must be retained for a period of at least eight years.

There are also some potentially helpful exemptions from this requirement:

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

An AIFM should, at the request of the competent authorities of its home Member State, demonstrate that it meets the conditions to use one of the above exemptions.

As above, the retention requirement is triggered by a transfer to a "third party". Where funds originate loans and transfer them in part to a related entity, such as a parallel fund or co-investment vehicle under the same manager's control, it is arguable whether such a related entity is a third party. However, on the basis that "third party" refers to any transferee other than the AIF, a prudent approach is to apply the risk-retention requirement to the AIF originating the loan.

## Reporting

An AIFM will need to report periodically on the composition of the "originated loan portfolio" to the investors in the fund as part of its regular reporting.

## Liquidity Management

AIFMD II extends the existing liquidity-management provisions in the AIFMD. AIFMs managing open-ended AIFs must choose at least two appropriate liquidity-management tools from a specified list included in a new Annex to the Directive. These tools should align with the AIF's strategy, liquidity profile and redemption policy. Funds classified as money market funds can select only one tool from the list.

AIFMs may temporarily suspend subscriptions and redemptions or activate other liquidity tools in exceptional situations to protect investors. Side pockets, which segregate illiquid assets, can be used in exceptional cases when justified. Using redemptions in kind as a liquidity-management tool is limited to professional investors and must typically reflect a proportional share of the AIF's assets, with exceptions for certain types of funds.

AIFMs must develop detailed procedures for using these tools and communicate those to the national authorities. They must also notify their home country's regulator when they activate or deactivate liquidity-management tools. Regulators will inform other relevant bodies, including ESMA and the European Systemic Risk Board, if necessary.

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## Requirements Applying to Loan-Originating AIFs Only

### Leverage Limits

AIFMD II introduces new leverage limits for loan-originating AIFs. Any loan-originating AIF that applies any form of leverage should carefully review its existing basis for assessing and calculating leverage in light of the new limits.

An AIFM that manages a loan-originating AIF will be subject to the following limitations on the use of leverage:

- 175% for open-ended loan-originating AIFs; and
- 300% for closed-ended loan-originating AIFs.

The definition of leverage remains unchanged as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means”. Leverage is expressed as the ratio between the AIF's exposure (broadly, the gross value of its assets, using the commitment methodology in the AIFMD) and its net asset value.

For the purpose of the leverage limits, borrowings that are fully covered by commitments from investors in the loan-originating AIF are not considered exposure for the purpose of the limitations above. This helpful exemption is directed at subscription line facilities. Fund managers will be aware of the existing treatment of subscription line facilities in the Level 2 Regulation, which refers to temporary borrowing arrangements which are fully covered by commitments from investors as excluded from the scope of an AIF's leverage. The exemption under the new rules is helpful in that it no longer requires the facility to be temporary. The European Union may amend the corresponding provision in the Level 2 Regulation so that the same conditions for the subscription line exemption applies to all AIFs and not only loan-originating AIFs.

The leverage limitations do not apply to a fund whose lending activities consist solely of originating shareholder loans, provided that the notional value of those loans does not exceed in aggregate 150% of the fund's capital.

Where a loan-originating AIF infringes this requirement and the breach is beyond the control of the AIFM that manages it, the AIFM shall, within an appropriate period, take such measures as are necessary to rectify the position, taking due account of the interests of the investors in the loan-originating AIF. This reflects existing manager's practice to address "passive" breaches.

### **Conditions for Open-Ended Loan-Originating AIFs**

An AIFM must generally ensure that each loan-originating AIF it manages is closed ended. By way of derogation, a loan-originating AIF may be open ended, provided that the AIFM is able to demonstrate to the relevant national competent authority that its liquidity risk management system is compatible with its investment strategy and redemption policy.

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## **Transitional Provisions**

### **Limited Transitional Relief for Risk Diversification, Leverage Limit and Open-Ended Loan-Origination AIF**

AIFMD II includes transitional (or "grandfathering") provisions in relation to the leverage limits, risk diversification limits and the requirement for loan-originating AIFs to be closed ended. AIFs that have been constituted before the date of entry into force of AIFMD (i.e., 15 April 2024) ("Existing AIFs") and that were no longer fundraising at that point in time will be deemed to comply with the new rules without any applicable time limit. Existing AIFs that were still fundraising at that point will have until 16 April 2029 to comply. During the grandfathering period, where the rules on single-borrower exposure or the leverage limit are breached, the AIFM may not increase that exposure or leverage. Where the limits are not exceeded, the AIFM may not increase that value or leverage above those limits. In our view, the requirements that exist during the grandfathering period will only apply once AIFMD II has been implemented into the national law of the AIFM.

### **Open-Ended Transitional Relief for AIFMs That Originate Loans before the Date of Entry into Force of AIFMD**

Where an AIF originated loans before 15 April 2024, the AIFM may continue to manage such AIFs without complying with the following provisions but only with respect to those already-originated loans:

- the requirement to implement effective policies, procedures and processes for granting of loans;

- the prohibition on granting loans to certain types of borrowers;
- the requirement to attribute the proceeds of loans to the AIF in full;
- the right for Member States to prohibit loans to consumers;
- the prohibition on AIFMs managing AIFs with an “originate to distribute” strategy;  
and
- the requirement to retain 5% of the notional value of each loan originated and subsequently transferred to third parties.

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## Conclusion

AIFs and AIFMs that engage in loan-originating activities throughout the European Union now have much greater legal certainty as to their activities. However, Member States will need to take further action to address existing barriers in banking regulation. Once this has occurred, the regime should bring helpful harmonisation to cross-border lending by investment funds. However, any such harmonisation comes at a price. Debt fund sponsors will need to apply the new requirements with careful planning. The borrowing limitations and the retention rules in case of secondary transfers will be a source of concern, particularly for existing funds that benefit from transitional relief but do not benefit from full grandfathering relief.

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Please do not hesitate to contact us with any questions.





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