



ADVISORY | INDUSTRY INFORMATION

# **AIFMD II 101: Part 1 – Loan-Originiation**



On 15 April 2024, Directive [2024/927/EU](#) ("AIFMD II") entered into force, which marked a significant milestone for the European asset management industry. AIFMD II will introduce a harmonised framework for loan-origination activities across the European Union ("EU"), which seeks to improve risk management across the financial market and increase transparency for investors.

Our advisory series considers a number of key changes for the asset management industry introduced by AIFMD II. This first part of our advisory series focuses on the key changes for asset managers and funds pursuing loan origination strategies, in light of AIFMD II. With the entry into force of AIFMD II, this now provides an opportunity for Ireland to align its existing domestic loan origination rules applicable to funds and to further grow its reputation as a leading domicile for loan origination funds.

Please also refer to our recent AIFMD II publications '[AIFMD II – timeline to implementation](#)' and '[AIFMD II – a closer look](#)'.

## A new European loan origination framework

### "Loan-Originating AIFs" versus "AIFs which originate a loan"

A significant change under AIFMD II is the introduction of a new regime applicable to alternative investment funds ("AIFs") which engage in loan origination activities. The new loan origination framework applies where an EU authorised alternative investment fund manager ("AIFM") manages an AIF, which is engaged in loan origination activities.

The loan origination provisions included in AIFMD II apply in respect of all AIFs which engage in "loan origination" or "originating a loan". A new definition of "loan origination" or "originating a loan" is being introduced as part of AIFMD II and means the granting of a loan:

- i. **directly** by an AIF (as the original lender); or
- ii. **indirectly** through a third party or special purpose vehicle ("SPV"), 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.

AIFMD II provides that certain of the loan origination provisions shall only apply in respect of AIFs, which engage significantly in loan origination.

Known as a "loan-originating AIF", such funds are classified 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 ("NAV").

AIFMD II recognises that loan origination is not always conducted directly by the AIF itself, and therefore, indirect loan origination activities, for example, via a third party or by an SPV may fall within the scope of the new loan origination framework. The acquisition of loans on the secondary market, where the AIFM or AIF was not involved in structuring the loan, or defining or pre-agreeing its characteristics should fall outside of scope.

AIFMD II acknowledges that EU member states are not prevented from laying down national product frameworks that define certain categories of AIFs with more restrictive rules.



**Loan-originating AIFs" versus "AIFs which originate a loan."**

## New obligations applicable to loan originating activities

The new loan origination framework introduces a range of new requirements applicable to both Loan Originating AIFs and AIFs which originate a loan. However, certain provisions in relation to liquidity requirements and leverage limits, as detailed below are specific to Loan-Originating AIFs only.

### Diversification (concentration)

An AIFM must ensure that, where an AIF it manages originates loans, the notional value of the loans originated to any single borrower by that AIF does not exceed in aggregate 20% of the capital of the AIF where the borrower is an AIF, a UCITS or a financial undertaking (as defined in Article 13(25) of Solvency II (Directive 2009/138/EC)).

This 20% limit shall (a) apply by the date specified in the AIF rules, instruments of incorporation or prospectus, which shall be no later than 24 months from the date of the first subscription for units or shares of the AIF (unless an extension in limited circumstances is granted by the AIFM's home state competent authority); (b) cease to apply once the AIFM starts to sell assets of the AIF in order to redeem units or shares as part of the liquidation of the AIF; and (c) be temporarily suspended (limited in duration to the period that is strictly necessary and no greater than 12 months in any event) where the capital of the AIF is increased or reduced.

This new requirement shall be subject to applicable transitional provisions, as detailed further below.

### Risk retention

AIFMD II introduces a risk retention requirement, with the intention of reducing moral hazard and seeking to maintain the general credit quality of loans originated by AIFs. An AIFM shall be required to ensure that each AIF it manages which originates loans must retain an interest of 5% of the notional value of any loan the AIF originates and subsequently transferred to third parties (i.e. subsequently sold on the secondary market). This amount must be retained for the following period:

- i. until maturity for those loans whose maturity is up to eight years, or for loans granted to consumers regardless of their maturity; and
- ii. for a period of at least eight years for other loans.

The above risk retention requirement is subject to certain limited but helpful exceptions, namely:

- i. where the AIFM starts to sell assets of the AIF in order to redeem units or shares as part of the liquidation of the AIF;
- ii. the disposal is necessary for the purposes of compliance with EU sanctions rules (as per Article 215 of The Treaty on the Functioning of the EU), or with product requirements;
- iii. the sale of the loan is necessary to enable the AIFM to implement the investment strategy of the AIF it manages 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, detected by the AIFM as part of its due diligence and risk management process under AIFMD II, and the purchaser is informed of that deterioration when buying the loan.

The AIFMD II recitals make clear that the derogations may include:

- i. situations where retaining part of the loan would result in the AIF exceeding its investment or diversification limits or breaching regulatory requirements;
- ii. where the borrower's situation has changed (for example, in the event of a merger or of default of the borrower);
- iii. if the AIF's investment strategy is not to manage distressed assets; or
- iv. where the AIF's asset allocation is changed, resulting in the AIF no longer pursuing exposure to a specific sector or to a specific asset class.

Upon the request by its competent authority, the AIFM shall be required to demonstrate that it meets the conditions for the application of the relevant derogation from the above risk retention requirements. This new risk retention requirement shall be subject to applicable transitional provisions, as detailed further below.

### Prohibition of "originate-to-distribute"

AIFMD II requires that each EU member state must prohibit AIFMs from managing AIFs that engage in loan origination where the whole or part of the investment strategy of those AIFs is to originate loans with the sole purpose of transferring those loans or exposures to third parties.

This new requirement shall be subject to applicable transitional provisions, as detailed further below.

## Allocation of proceeds and investor disclosures

AIFMD II requires that the proceeds of originated loans, minus any allowable fees for their administration, shall be attributed to that AIF in full. All costs and expenses linked to the administration of the loans must be disclosed to investors (in accordance with Article 23 of AIFMD).

Furthermore, AIFMs shall be required to ensure that the composition of the originated loan portfolio in respect of each EU AIF that it manages and each EU or non-EU AIF that it markets in the EU is also disclosed to investors as part of Article 23 periodic disclosures. This new requirement shall be subject to applicable transitional provisions, as detailed further below.

## Connected party restrictions

The AIFM must ensure that an AIF it manages does not grant loans to the following entities: (a) the AIFM and its delegates (or the staff of the AIFM or its delegates); (b) the AIF's depository (or its delegates); and (c) members of the AIFM's group (save for certain exceptions).

## Consumer lending

EU member states may prohibit AIFs that originate loans from granting loans to consumers or from servicing credits granted to such consumers in the relevant EU member state.

This new requirement shall be subject to applicable transitional provisions, as detailed further below.

## Policies and procedures

AIFMD II establishes rules in relation to the maintenance of specific policies and procedures in relation to loan origination activities. AIFs that engage in loan origination are required to have effective policies, procedures and processes for the granting of loans, assessing credit risk and administering and monitoring the credit portfolio, including where those AIFs gain exposure to loans through third parties.

The AIFM must keep those policies, procedures and processes up to date and effective, and review them regularly and at least once a year. Such policies, procedures and processes should be proportionate to the extent of the loan origination.

The above rules do not apply to an 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 the capital of the AIF. A "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".

## Requirement to be closed-ended (*Loan-Originating AIFs only*)

AIFMD II places a regulatory onus on AIFMs to ensure that Loan-Originating AIFs are established as closed-ended funds, unless, the AIFM is able to demonstrate to the competent authorities of its home EU member state that the Loan-Originating AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. Where this is demonstrated, the Loan-Originating AIF may be established as an open-ended fund and provided certain requirements are fulfilled. These requirements include the establishment of a liquidity management system that minimises liquidity mismatches, ensures the fair treatment of investors and is under the supervision of the competent authorities of the home member state of the AIFM. In this regard, ESMA is mandated to develop draft regulatory technical standards, no later than the 16 April 2025, to establish those criteria, taking due account of the nature, liquidity profile and exposures of Loan-Originating AIFs.

## New leverage limits (*Loan-Originating AIFs only*)

Following extensive discussion as part of the negotiation of AIFMD II and with a view to ensuring the stability and integrity of the financial system and to introduce proportionate safeguards, AIFMD II introduces new leverage requirements which differ depending on whether the AIF is of an open-ended or closed-ended type and apply regardless of whether the AIF is marketed to professional and/or retail investors.

An AIFM must ensure that the leverage of a Loan-Originating AIF it manages represents no more than:

- i. 175%, where that AIF is open-ended; and
- ii. 300%, where that Loan-Originating AIF is closed-ended, (in each case expressed as the ratio between the exposure of that Loan-Originating AIF, calculated according to the commitment method and its NAV).

The above leverage limits do not apply to a Loan-Originating AIF whose lending activities consist solely of originating shareholder loans (as defined above), provided that the notional value of those loans does not exceed in aggregate 150% of the capital of the AIF. National home state regulators in each EU member state may impose stricter leverage limits where it is deemed necessary to ensure the stability and integrity of the financial system.



The definition of 'Leverage' for the purposes of AIFMD<sup>1</sup> remains unaltered and continues to mean "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". Borrowing arrangements which are temporary in nature and fully covered by contractual capital commitments from investors in the Loan-Originating AIF shall not be considered to constitute exposure for the purpose of leverage calculations.

In the event of a breach of leverage limits beyond the control of the AIFM, the AIFM must, 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 new leverage requirement shall be subject to applicable transitional provisions, as detailed further below.

### Transitional (grandfathering) provisions

AIFMD II contains certain grandfathering provisions in respect of the AIFs which engage in loan origination that have been constituted before the date of entry into force of AIFMD II, namely, 15 April 2024 (the "Effective Date") giving them up to five years to comply with certain aspects of AIFMD II. It is expected that AIFMD II will be transposed into Irish law by 16 April 2026, at the latest.

AIFs which engage in loan origination that have been constituted after the Effective Date will be required to comply with the requirements of AIFMD II, upon transposition of the directive into local law in the home EU member state of the AIF. This is subject to adherence with any additional domestic framework for AIFs which engage in loan origination in the home EU member state of the AIF.

Details of the relevant transitional periods, are set out in the table on the following page. An AIFM managing AIFs that originate loans and that were constituted before 15 April 2024 may choose not to avail of the transitional periods (until 16 April 2029) and may choose to be subject immediately to the above-mentioned AIFMD II provisions prior to 16 April 2029. In such a case, the AIFM is required to notify its home member state regulator.

1. See Article 4 (1) (v) of Directive 2011/61/EU.



New obligations	Loan-Originating AIFs	AIFs which originate a loan	Transitional arrangements	
Diversification (concentration)	✓	✓	AIFMs managing AIFs constituted before 15 April 2024 and which do not raise further capital after 15 April 2024	Such AIFMs shall be deemed to comply with the new requirement in respect of those AIFs.
			AIFMs managing AIFs constituted before 15 April 2024 and which raise further capital after 15 April 2024	<p>Such AIFMs shall be deemed to comply with this new requirement until 16 April 2029.</p> <p>During the applicable transitional period, where the notional value of the loans originated by an AIF to any single borrower of the AIF:</p> <ol style="list-style-type: none"> <li>exceeds the 20% diversification limit applicable, the AIFM managing that AIF shall not permit the exposure level to that single borrower to be increased; or</li> <li>does not exceed the 20% diversification limit, the AIFM managing that AIF shall not permit the notional value of the loans originated by an AIF to that single borrower to be increased above the 20% diversification limit.</li> </ol>
Requirement to be Closed-Ended versus Open-Ended	✓	✗	AIFMs managing AIFs constituted before 15 April 2024 and which do not raise further capital after 15 April 2024	Existing AIFs constituted before 15 April 2024 and which raise further capital after 15 April 2024 shall be deemed to comply with this new requirement until 16 April 2029.
			AIFMs managing AIFs constituted before 15 April 2024 and which raise further capital after 15 April 2024	Existing AIFs constituted before 15 April 2024 and which do not raise further capital after 15 April 2024 are deemed compliant with the new requirement.

New obligations	Loan- Originating AIFs	AIFs which originate a loan	Transitional arrangements	
New Leverage Limits)	✓	✗	AIFMs managing AIFs constituted before 15 April 2024 and which do not raise further capital after 15 April 2024	Such AIFMs shall be deemed to comply with the new requirement in respect of those AIFs.
			AIFMs managing AIFs constituted before 15 April 2024 and which raise further capital after 15 April 2024	<p>Such AIFMs shall be deemed to comply with the new requirement in respect of those AIFs until 16 April 2029.</p> <p>During the applicable transitional period, where the leverage of the AIF:</p> <ul style="list-style-type: none"> <li>a) exceeds the limit applicable to open-ended AIFs (i.e. 175% of NAV) or closed ended AIFs (i.e. 300% of NAV), as applicable to the AIF, the AIFM managing that AIF shall not permit the leverage level to be increased; or</li> <li>a) does not exceed the limit applicable to open-ended AIFs (i.e. 175% of NAV) or closed ended AIFs (i.e. 300% of NAV), as applicable to the AIF, the AIFM managing that AIF shall not permit the leverage level to be increased above those limits.</li> </ul>
Risk Retention	✓	✓	<p>These requirements shall apply with respect to all loans originated after 15 April 2024, as and from the application date set down in the transposing legislation of the home member state of the AIFM (expected to be 16 April 2026).</p> <p>Where AIFs originate loans before 15 April 2024, AIFMs may continue to manage such AIFs without complying with the new requirements in respect of these loans.</p>	
Prohibition of "originate to distribute"	✓	✓		
Allocation of Proceeds and Investor Disclosures	✓	✓		
Connected Party Restrictions	✓	✓		
Consumer Lending (if applied by local EU member state)	✓	✓		
Policies and Procedures	✓	✓		

## The opportunity for Ireland

From an Irish perspective, the Central Bank of Ireland ("Central Bank") established the domestic loan-originating qualifying investor AIF ("L-QIAIF") regime in Ireland in 2014, which introduced limits on the scope of activities, leverage and diversification requirements, borrower eligibility rules, as well as requirements to implement and maintain appropriate policies and procedures in relation to the assessment, pricing and granting of credit, the management of concentration risk and credit risk and the diversification of credit positions.

It is noted that the loan origination related amendments introduced under the AIFMD II framework borrow heavily from the existing L-QIAIF regime and, in this regard, should not present any material surprises for existing managers of such Irish funds.

It is noted that in a [speech](#) to industry at the Irish Funds Annual UK Symposium Derville Rowland, Deputy Governor of the Central Bank confirmed that the changes agreed as part of AIFMD II are appropriately targeted and the harmonisation of the rules for funds which undertake lending activity is seen as a positive development.

In light of the existing framework and service provider experience in Ireland with loan origination products and the fact that an L-QIAIF can avail of a 24-hour authorisation process with the AIFM and legal advisers to the L-QIAIF confirming compliance with the relevant rules, it is expected that Ireland's reputation as a domicile for loan origination funds will continue to go from strength to strength.



## Further information

We practice Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Irish and Jersey law from an international network of ten offices across Europe, the Americas, Asia and the Middle East. For more information, please get in touch with your usual contact at Walkers or any of the contacts in your region listed below.



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