

Client Update

Direct Lending by Funds: A Comparison of the Key EU Jurisdictions

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INTRODUCTION

The 2008–09 financial crisis and its impact on European banks ultimately resulted in a shortage of available finance for a wide range of borrowers. Many other factors also contributed to a funding squeeze, including prevailing low interest rates, higher capital and liquidity requirements from Basel III, and the general underperformance of the European economy relative to the U.S. economy and the resulting problems for banks as a result of non-performing loans. Post-financial crisis, the European financing markets were therefore in need of a new source of liquidity to fill the funding gap vacated by European banks.

European borrowers have historically been more dependent on the banking sector than European capital markets for financing (unlike in the United States, which has deep capital markets strength). The Capital Markets Union project has been developed by the European Commission with a view to improving the availability of European capital markets financing by removing legal and regulatory barriers. This plan, however, has not yet been implemented and, ultimately, the need for liquidity post-financial crisis was not fully satisfied by the European capital markets.

Instead, private funds emerged as a key source of direct finance to borrowers in Europe. Borrowers have welcomed the greater flexibility and more bespoke transaction structures made possible by private fund direct lending. As a result, European financing markets today have a wealth of liquidity.

As direct lending goes from strength to strength, this note discusses the pan-European regulation of loan originating by funds and the regulatory regime governing the provision of direct loans by private funds in the four largest economies of the European Union: the United Kingdom, Germany, France and Italy.

PAN-EUROPEAN REGULATION OF LOAN ORIGINATION BY FUNDS

Before we turn to the regulatory regimes of individual jurisdictions, it is helpful to understand recent pan-European efforts to regulate loan origination by funds.

The Current Position

Although private funds are regulated at a pan-European level under the Alternative Investment Fund Managers Directive (“AIFMD”),¹ there is currently no European directive or regulation governing loan origination by funds. Accordingly, in contrast to the EU-wide passport available for banks under the Capital Requirements Directive,² credit funds cannot obtain an EU-wide passport to lend.

Recent Cross-European Developments—ESMA

The European Securities and Markets Authority (“ESMA”) is taking steps to progress pan-European regulation of loan origination by funds. ESMA recently offered views on the steps necessary to create such a pan-European framework.³ This work forms part of the EU authorities’ Capital Markets Union project.

ESMA recommended that any such future EU legislation (which could be implemented either by new legislation or by supplementing AIFMD) should address the following:

- loan originating funds should be closed-ended;
- loan originating funds should not have liabilities with shorter maturity than the loans granted by them. Funds should hold sufficient liquid assets to meet redemption requests;
- there should be restrictions on short-selling and securities financing transactions, and derivatives may only be used for non-speculative hedging purposes (*e.g.*, to hedge interest rate risk); and
- a grandfathering regime and/or transitional provisions should be put in place for existing funds that no longer meet any new pan-European requirements.

¹ Directive 2011/61/EC.

² Directive 2013/36/EU.

³ ESMA’s views are in an opinion to the European Parliament, the Council and the Commission published by ESMA on 11 April 2016 (“ESMA Opinion - Key principles for a European framework on loan origination by funds”, ESMA/2016/596).

ESMA also raised a host of additional topics for further consideration, including (i) whether managers of loan originating funds should be authorised; (ii) whether the fund itself should be authorised; (iii) whether loan originating funds should be subject to leverage limits to avoid differences in treatment vis-à-vis bank lenders; and (iv) whether loan originating funds should be restricted from lending to certain categories of borrower, such as consumers.

Whilst it is clear that steps are being taken to develop the analysis on pan-European regulation for credit funds, it is just as clear that many steps remain to be taken. For example, ESMA only focused on the activity of loan origination. ESMA did not offer views on loan participation, loan restructuring or loan origination by alternative investment funds subject to the EuVECA Regulation,⁴ the EuSEF Regulation⁵ or the ELTIF Regulation.⁶

Recent Cross-European Developments—Insolvency Regimes

European regulators are also focused on the differences in the insolvency regimes of various EU member states. As part of the European Commission's Capital Markets Union project, in November 2016 the European Commission published a proposal for a directive covering measures to increase the efficiency of restructuring, insolvency and discharge procedures. The aims of this legislation include improving outcomes for creditors and making the insolvency procedures of member states more user-friendly. The proposal is currently going through the EU legislative process and is expected to be adopted by 2019. Once adopted, the proposal should enhance creditor confidence in making loans to European borrowers by improving recoveries in defaulted or distressed assets, although the real impact of this reform will only become apparent after the directive is implemented by the various member states.

In Summary

The current absence of a pan-European framework for loan origination by funds has not proved to be a serious obstacle to the activities of many established credit funds. Many funds are familiar with local regulatory regimes and have managed to structure their lending programmes to overcome any obstacles. The question for the moment, therefore, is what requirements in individual regimes do credit funds need to satisfy?

⁴ European Venture Capital Funds Regulation (Regulation 345/2013/EU).

⁵ European Social Entrepreneurship Funds Regulation (Regulation 346/2013/EU).

⁶ European Long-Term Investment Funds Regulation (Regulation 2015/760/EU).

United Kingdom

Unlike many other jurisdictions, in the United Kingdom the activity of lending or financing is not by itself a regulated activity requiring authorisation by the financial regulators.⁷ Accordingly, a person (including any fund vehicle) providing loans directly to a company would not require authorisation, even if it carries on the activity of providing such loans by way of business.

Consumer credit agreements and mortgage contracts are, however, subject to regulation and a person providing such loans or entering into such credit agreements is required to obtain authorisation from the financial regulators. The relevant legislation in the UK provides that entering into a “regulated credit agreement” or exercising the rights or duties of a lender under such an agreement, in either case by way of business, is a regulated activity requiring authorisation.⁸ “Regulated credit agreement” means any credit agreement which is not exempt.⁹ The legislation sets out a number of categories of agreements which are to be treated as exempt. One example is an agreement where the lender provides the borrower with credit exceeding £25,000 and the agreement is entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower.¹⁰ This category qualifying for exemption from consumer credit regulation should cover most types of loans extended by loan originating funds in the UK. However, care should be taken if a loan is extended to an individual, or could otherwise have a consumer element to it.

Although the United Kingdom’s mortgage regulation regime is beyond the scope of this note, activities in relation to mortgages (*i.e.*, loans secured by real estate) are also subject to authorisation or registration.¹¹ Any loans involving security over real estate assets need to be reviewed carefully to avoid triggering any authorisation or registration requirements.

⁷ The Financial Conduct Authority and the Prudential Regulation Authority.

⁸ Article 60B(1) and (2) of the Regulated Activities Order 2001.

⁹ Article 60B(3) of the Regulated Activities Order.

¹⁰ Article 60C(3) of the Regulated Activities Order 2001.

¹¹ Article 61 of the Regulated Activities Order 2001 and the Mortgage Credit Directive Order 2015.

Germany

In Germany, loan origination requires a banking licence under the German Banking Act¹² (irrespective of whether the lender also engages in deposit taking). Obtaining a banking licence is an onerous process and the licensee is subject to extensive regulation and supervision, including capital and liquidity requirements and other prudential and conduct of business rules. However, since March 18, 2016 new German legislation (the “New Legislation”) provides that loan origination by certain alternative investment funds (“AIFs”) is no longer deemed a banking activity requiring a banking licence but will constitute a “collective investment management activity”. As a consequence, the requirements under the German Banking Act will not apply to loan origination by such AIFs. The New Legislation also provides that restructurings (including maturity extensions) of existing loans are no longer considered as loan origination, and hence also permitted as a collective investment management activity if conducted by such AIFs.

Application of the New Legislation to German AIFs and Alternative Investment Fund Managers (“AIFMs”).

The New Legislation does, however, introduce into the German Investment Code¹³ certain restrictions and requirements to be met by German AIFs and their respective German AIFMs in order for them to fall outside the requirements of the German Banking Act.¹⁴ The most important requirements are:

- the AIF must be closed-ended and may only admit professional and semi-professional investors as investors. An investor is considered semi-professional if it is sophisticated and experienced and invests at least €200,000 in such AIFs;¹⁵
- the AIF may not grant loans to consumers;
- the AIF may not incur fund-level debt of more than 30% of its aggregate contributed and undrawn committed capital available for investments (after

¹² Kreditwesengesetz, “KWG”.

¹³ Kapitalanlagegesetzbuch, “KAGB”.

¹⁴ These requirements apply both to AIFs which originate loans and to AIFs which only acquire and/or restructure existing loans.

¹⁵ The AIFM must assess itself whether the investor is sufficiently sophisticated. Members of the management qualify as semi-professional irrespective of the amount of their commitment to the fund. The same applies to persons investing at least €10 million.

deduction of any costs and expenses borne by investors) (“Investment Capital”);

- AIFs may not grant loans to any one borrower in an aggregate principal amount in excess of 20% of the Investment Capital; and
- the AIFM managing such AIF must also satisfy the following requirements:
 - certain risk management requirements consistent with the risk management requirements applicable to the loan origination businesses of banks;
 - reporting obligations for loans in a principal amount of €1 million or more.¹⁶

Application of the New Legislation to EU and Non-EU AIFs and AIFMs

EU AIFs/AIFMs and third country AIFs/AIFMs lending into Germany can also benefit from the German Banking Act exemption if they meet the following conditions:

- EU AIFs and EU AIFMs may engage in loan origination in Germany without meeting any specific German requirements, including the requirements of the New Legislation that would apply if such EU AIFs/AIFMs were German (presumably because such AIFMs are authorised or registered in their home country). The loan origination business of such AIFs is subject only to home state regulations.
- AIFs from non-EU countries which are managed by an EU AIFM or a non-EU AIFM will benefit from the German Banking Act exemption, provided that the relevant AIF is registered for marketing to semi-professional or retail investors in Germany in accordance with the provisions of the KAGB. This requires the third country AIFMs to be fully compliant with the AIFMD.
- EU AIFs managed by non-EU AIFMs: It is not clear whether the German Banking Act exemption applies, as the German Banking Act does not expressly cover this scenario. It is possible to argue that the exemption for EU AIFs will apply. However, the German regulator is likely to take the view that such an AIF would only benefit from the exemption if it has been admitted for marketing to semi-professionals (and therefore the non-EU AIFM must be fully AIFMD compliant).

¹⁶ German registered sub-threshold AIFMs are subject to the above requirements only if they are engaged in loan origination for the account of an AIF (and not with respect to the acquisition and restructuring of loans).

Application of the New Legislation to Special Purpose Lending Vehicles

In practice, European AIFs often do not lend directly, but through wholly-owned SPVs. The New Legislation explicitly exempts only AIFs and AIFMs from the banking licence requirement but is silent as to whether such SPVs would benefit from the exemption. Until the German regulator gives specific guidance, it would be prudent to assume that the onerous German Banking Act licensing requirements will apply to loans originated by SPVs.¹⁷

France

Prior to January 1, 2016, French law prohibited persons other than credit institutions or investment firms from entering into credit transactions (such as granting loans) on a more than occasional basis (the so-called French banking monopoly rule).¹⁸ However, the French regulatory regime has now been liberalised to allow the following types of fund to grant loans to third parties:

- AIFs authorised as European long-term investment funds (“ELTIFs”) under the ELTIF Regulation;¹⁹ and
- certain French AIFs which are not authorised as ELTIFs.

Therefore, there are now two different regimes in France permitting loan origination by AIFs. For a fund to qualify under either regime, it must fall within any of the following categories:

- specialised professional funds (*fonds professionnels spécialisés*);²⁰
- professional private equity investment funds (*fonds professionnels de capital investissement*);²¹
- securitisation vehicles (*organismes de titrisation*).²²

Authorisation to Grant Loans in Accordance with the ELTIF Regulation

¹⁷ Note, however, that no licence requirements will apply if the SPV acquires the loan from the AIF following origination and draw-down.

¹⁸ Article L.511-5 of the French Monetary Code.

¹⁹ Implemented in France by French Law n°2015-1786 (Loi de finances rectificative pour 2015) dated December 29 2015.

²⁰ Article L.214-154 of the French Monetary Code.

²¹ Article L. L.214-160 of the French Monetary Code.

²² Article L. L.214-169 of the French Monetary Code.

Subject to the restrictions in the ELTIF Regulation, funds authorised as ELTIFs in France may grant loans to a “qualifying portfolio undertaking” with a maturity no longer than the life of the fund.²³ Broadly speaking, a “qualifying portfolio undertaking” is an undertaking (such as a company or partnership) which is neither a financial institution nor a listed company. It is currently unclear whether ELTIFs established in an EU member state other than France can benefit from this exemption from the French banking monopoly rule. The application of this exemption to non-French ELTIFs is expected to be clarified soon by legislation in France.

French AIFs That Are Not Authorised as ELTIFs

Specialised professional funds and professional private equity investment funds which are not authorised as ELTIFs may grant loans subject to compliance with the conditions below.

If the loans exceed 10% of the net assets of the fund, the fund may only grant loans if the following conditions are satisfied:

- such funds are closed-ended;²⁴
- the loans are granted only to entities that are not financial institutions or collective investment funds;
- the maturity of the loans must not exceed the maturity of the fund;
- such funds can only borrow money under certain specific conditions;
- such funds do not (i) short sell financial instruments or (ii) enter into financial agreements (such as derivatives) other than for the purpose of hedging interest rate or currency risk;
- such funds can only enter into temporary purchase transactions with respect to financial instruments under certain specific conditions; and
- such funds can only sell down existing loans if the AMF²⁵ expressly authorises such activity.

²³ Article 10(c) of the ELTIF Regulation.

²⁴ Although such funds may under certain conditions authorise redemptions as long as the redemptions do not create imbalances between the redemption requests and the assets of the fund that would preclude the fund from satisfying such redemption requests and preserving the interests of the other unit holders.

²⁵ Autorité des marchés financiers, the French financial regulator.

If the loans do not exceed 10% of the net assets of the fund, the fund need only comply with the following conditions:

- the maturity of the loan must not exceed the maturity of the fund; and
- such funds cannot enter into financial agreements (such as derivatives) other than for the purpose of hedging interest rate or currency risk.

Investment fund managers can manage such funds if they (i) have been authorised under the AIFMD, (ii) have a specific programme of operations that permits the grant of loans and (iii) satisfy certain additional requirements set out in AMF regulations (in particular with respect to their analysis and credit risk measurement system).

Italy²⁶

Italian law has recently been amended to allow certain funds to grant loans to third parties for business purposes.²⁷ Prior to this amendment, the activity of granting loans was reserved to banks and other financial institutions authorised to grant credit. Accordingly, Italian funds qualifying as AIFs under the AIFMD may grant loans to third parties (other than consumers), provided the funds are closed-ended.

AIFs established in other EU member states may grant loans to third parties (other than consumers) in Italy, provided the following conditions are met:

- the EU AIFs are authorised to invest in loans in their home state;
- the EU AIFs are closed-ended; and
- their home state requirements with respect to risk management, including limits on the use of leverage are similar (*i.e.*, equal or stricter) to those set out under Italian law for Italian AIFs investing in loans. Such equivalence may be established on the basis of the AIF's constitutional documents, provided that the AIF's home state competent authority ensures compliance with the risk-related restrictions in the AIF's constitutional documents.²⁸

²⁶ This section of the update, addressing the position in Italy, has been prepared by Chiomenti LLP.

²⁷ Italian Law Decree no. 91 of 24 June 2014.

²⁸ This can be demonstrated by submitting an opinion from counsel in the AIF's home state confirming that the AIF's home state competent authority ensures compliance with the risk-related restrictions in the AIF's constitutional documents.

Prior to commencing the activity of lending in Italy, the AIFM of an AIF established in another EU member state must give notice to the Bank of Italy of the AIF's intended commencement of lending activity in Italy. If the Bank of Italy does not expressly prohibit the AIF from commencing its lending activities in Italy within sixty days of the notification, the EU AIF will be entitled to commence its lending activities in Italy. When carrying out lending activities in Italy, EU AIFs are also subject to certain ongoing requirements.

A different procedure applies to Italian AIFs wishing to grant loans. Italian reserved AIFs (*i.e.*, those that may only be subscribed by professional investors or non-professional investors investing at least €500,000 in the AIF) do not require any approval from the Bank of Italy to undertake lending activities in Italy, if they are established in contractual form and provided the Bank of Italy has been sent a copy of the AIF's management regulations for information purposes. The AIF may be set up through a resolution of the Board of Directors of the AIFM. In the case of Italian reserved AIFs established in corporate form, although the Bank of Italy must first grant authorisation for the establishment of the AIF, any further amendments to the by-laws of an existing Italian AIF in corporate form (such as to enable it to make loans to persons), do not require the Bank of Italy's approval. Retail AIFs, whether set up in corporate or contractual form, require the authorisation of the Bank of Italy before they can be marketed or prior to any amendment of their constitutional documents. As part of this authorisation, the Bank of Italy will review the AIF's constitutional documents, including for the purpose of determining whether the AIF satisfies certain risk management requirements.

The Bank of Italy will assess notifications received from non-Italian EU AIFs to decide whether to exercise its power to disallow the AIF from carrying out lending activities in Italy. As part of this assessment, the Bank of Italy will verify whether such EU AIFs are subject to rules on risk management, including leverage limits, which are equivalent to those applicable to Italian AIFs investing in loans. The Italian rules on risk management depend on whether the AIF is a reserved AIF or a retail AIF.

The limits applicable to retail AIFs investing in loans are:

- the AIF may obtain financing for a maximum of 30% of its total net assets only from banks and other entities authorised to grant credit;
- the AIF may use derivatives only for non-speculative hedging purposes;
- the AIF's loans to a single counterparty must not exceed 10% of the total assets of the AIF; and

- the maturity of the loans must not exceed the maturity of the AIF.

The limits applicable to reserved AIFs are:

- the AIF may have a maximum leverage of 1.5 through financing provided by banks or other entities authorised to grant credit; and
- the AIF's loans to a single counterparty must not exceed 10% of the total capital of the AIF, including undrawn commitments.

CONCLUSION

The liberalisation of the national regimes for loan origination by funds in many European Union jurisdictions is a welcome development for both credit fund sponsors wishing to access investment opportunities in these jurisdictions and the borrowers unable to secure adequate financing from traditional sources such as banks. At the same time, the creation of a pan-European regulatory regime, with a passport for lending activities, would further facilitate market access by loan originating funds, as long as such regime does not impose onerous burdens or unnecessary restrictions on the funds and their managers. In particular, although the concerns expressed in the ESMA opinion about illiquidity are valid, there are important differences between loan originating funds and banks that justify exempting funds from the prudential regulations typically applied to banks, such as the fact that bank liabilities are usually repayable on demand and perform monetary functions, whereas most loan originating funds tend to be closed-ended with limited or no redemption rights and the fund interests are acquired usually for long-term investment purposes. In addition, banks take deposits from the general public, whereas loan originating funds typically only admit professional investors. Accordingly, the differential treatment of banks in matters such as prudential regulation is justified by the role they play in providing critical services to the general public.

We will continue to monitor developments in this area at the EU level and assist clients in putting forward their views on the appropriate pan-European regime for loan originating funds.

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Please do not hesitate to contact us with any questions.