

Non-bank lending in the European Union

ALTERNATIVE
CREDIT COUNCIL

LENDING
FOR GROWTH

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Foreword

Four years ago, the EU Commission published a green paper¹ that formed the basis of what would become the Capital Markets Union (CMU) project. Policymakers have spent the intervening years addressing the challenges that were identified in this paper through a series of interlinked measures - each designed to channel investment from the capital markets to the real economy. Great strides have been made and we applaud the determination shown by policymakers in pursuing this agenda.

During the same period, we have seen a rapid growth in the finance provided by non-bank lenders across the EU. What was once seen as a relatively niche offering is now a recognised source of finance for EU businesses. The main beneficiaries of this growth have been SMEs and mid-market companies who have traditionally relied on bank financing. As well as being a source of new investment capital, non-bank lenders are also providing borrowers with a more tailored offering. This allows EU businesses to compete in a global marketplace, invest in their future and support job creation.

The successful growth of non-bank lending in the EU is a significant achievement. A natural corollary of this growth is that policymakers are now re-evaluating their approach to this market and considering whether the current regulatory framework remains appropriate. The Alternative Credit Council has published this paper in partnership with Allen & Overy to provide insights from industry and an overview of the European regulatory landscape to support them in this exercise.

We recognise that there are legitimate questions about the impact of non-bank lending on the financial system - whether it exacerbates pro-cyclicality or acts as a useful buffer, the extent to which responsible lending practices are being adhered to, and if investors' interests are sufficiently protected. This white paper provides an overview of how the existing regulatory framework addresses each of these questions and identifies several areas where policymakers can make changes to support the sustainable growth of this market, while maintaining their oversight of this activity.

This white paper seeks to be an honest and transparent engagement on behalf of non-bank lenders about the future of our industry in Europe, which builds on the successful dialogue between our industry and policymakers. We believe that the focus of this dialogue should now be on the following key themes ; (i) removing barriers to finance flowing from the capital markets to European businesses; (ii) facilitating knowledge sharing between stakeholders on non-bank lending activities in Europe; and (iii) ensuring that non-bank lending benefits borrowers and enhances the financing of innovation throughout Europe.

Policymakers, supervisors and industry acting together will be the most effective way of catalysing the growth of non-bank lending and improving access to finance across the continent. It is our intention that this paper will mark the first stage of greater collaboration.



Jiří Król
Deputy CEO,
Alternative Credit Council



Nick Williams
Partner, London,
Asset Management,
Allen & Overy

¹ EU Commission Green Paper – *Building a Capital Markets Union* - http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

Executive Summary

Alternative Credit Council² (ACC) members are an important source of funding for the European economy. They provide a wide range of finance to SMEs, mid-market businesses, large corporates, commercial and residential real estate developments, infrastructure developments, as well the trade and receivables business. Our members are asset managers and therefore this type of finance is typically referred to as non-bank lending.

The development of alternative sources of finance within the European Union (EU) is an important component of the European Commission's Capital Markets Union (CMU) initiative. The ACC supports policymakers' efforts to encourage non-bank lenders as a means of diversifying the finance available to European borrowers. While we are pleased with the recognition that the alternative credit sector is now receiving, we are keen to ensure that any new regulatory initiatives continue to support the sustainable development of the sector.

We believe that policymakers' approach towards the non-bank lending sector should be based on the following premises:

1. Lending from the capital markets supports financial stability

Alternative sources of finance promote financial stability by increasing market liquidity and improving the allocation of risk among investors. The development of non-bank lending also diversifies the sources of finance available to businesses, providing healthy competition to the banking sector and reducing the impact of economic shocks during times when banks are unable or unwilling to lend. This supports a resilient economy and better outcomes for customers and borrowers. Any consideration of regulatory measures should recognise the role non-bank lenders can, and do, play in supporting financial stability and financing the real economy.

2. Lending is not banking

The provision of credit by non-bank lenders to borrowers relies on capital from investors which is at risk rather than customer deposits. This creates a tight alignment of interests as investors in non-bank lenders ultimately bear the risk of their decisions. Asset managers undertaking lending activity also have a fiduciary duty to act in the best interests of their investors. Any attempt to superimpose bank-like regulatory approaches on non-bank lenders will erode the uniqueness of the sector and limit the benefits that accrue from a diverse financial system.

3. The role played by existing regulation should be recognised

Non-bank lenders in Europe are already subject to regulatory oversight – including, authorisation and ongoing supervision – under the existing regulatory framework (for example, the Alternative Investment Fund Managers Directive ('AIFMD')). This ensures that non-bank lenders:

- are authorised and supervised by national competent authorities ('NCAs');
- match the liquidity arrangements of their funds with the liquidity profile of their lending activity;
- undertake rigorous borrower due diligence and credit underwriting procedures on any loans they originate;
- implement risk management systems, including stress testing, to identify, monitor and manage risk arising from their lending activity;
- are transparent in their use of leverage to their investors and NCAs; and
- provide detailed reporting to investors and NCAs.

² The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

The existing regulatory framework therefore provides NCAs with the necessary tools to supervise the non-bank lending sector. Further regulatory measures for non-bank lenders should only be introduced in instances where it has been demonstrated that the risk management processes and regulatory oversight tools established under the AIFMD and other existing regulations are demonstrably insufficient to manage any risks potentially arising from non-bank lender's activity.

4. Existing barriers to non-bank lending in individual EU Member States should be addressed

Although we recognise the efforts of the European Commission (Commission) and Member States to encourage alternative sources of finance, there are still several areas where policy changes are required to support further development of the non-bank lending market in Europe. This should be primarily tackled by addressing the different barriers in each Member State rather than through harmonising legislative measures at EU level. This would be both practical, as different issues arise in different Member States, and consistent with the principle of subsidiarity.

Such diverse national rules introduced by Member States (e.g., requirements for local fund presence, prescribed exposure limits, maturity periods) unnecessarily limit the ability of non-bank lenders to scale their business. Additionally, they prevent the cross-border flow of capital within the EU, limit the ability of non-bank lenders to diversify their investment risks, and reduce the potential investor base for non-bank lenders. Removing these barriers would support the development of the market and increase the flow of credit to businesses in Europe. Further detail on these barriers is provided in chapter three of this paper.

Non-bank lending in the European Union

In April 2016, the European Securities and Markets Authority (ESMA) published an opinion³ to the European Parliament, the European Council and the Commission setting out its views on what could constitute the necessary elements for a common European framework for loan origination by investment funds. While this opinion focussed on loan origination funds, the key considerations it identified are also relevant for non-bank lenders more generally.

This paper provides an overview of how non-bank lenders currently take these considerations into account as part of their investment activity, and the role of existing regulatory requirements in addressing some of these concerns.



³ ESMA opinion – Key principles for a European framework on loan origination by funds (11 April 2016) (the "ESMA Opinion").

Chapter 1

Regulation of non-bank lenders in Europe



i. Authorisation

Most non-bank lenders and the funds they manage are subject to the requirements of the AIFMD. This means that they are treated as EU Alternative Investment Fund Managers (AIFMs) and Alternative Investment Funds (AIFs) respectively under existing regulation. It is unclear what would be gained by requiring these non-bank lenders to follow discrete authorisation requirements (*in lieu of* or in addition to those already found in the AIFMD) in relation to any AIFs they are managing which originate loans.

Article 7(3)(a) of the AIFMD requires EU AIFMs to provide competent authorities with "information about the investment strategies...it manages or intends to manage."⁴ This requirement means EU AIFMs who are pursuing a non-bank lending strategy are already subject to an authorisation process that enables NCAs to assess the considerations highlighted by ESMA in relation to any lending activity carried out by an EU AIFM and the funds they manage.

The AIFMD currently provides an exemption for AIFMs that fall below thresholds specified in Article 3(2) of the AIFMD. This means that they are subject to registration rather than authorisation requirements with their respective NCAs. We believe that this approach is also proportionate for non-bank lenders who fall below the same thresholds given the significantly diminished regulatory risks they present. This would also ensure a consistent regulatory approach across these types of firms' investment activities and support greater diversity in the non-bank lending sector.

ii. Credit origination

One of the conditions for granting authorisation under the AIFMD is that "the persons who effectively conduct the business of the AIFM are of sufficiently good repute and are sufficiently experienced also in relation to the investment strategies being pursued by the AIFs managed by the AIFM".⁵ In addition, Article 12(1)(c) requires that AIFMs "have and employ effectively the resources and procedures that are necessary for the proper performance of their business activities" (emphasis added).⁶ When applied to AIFMs acting as non-bank lenders, these requirements provide NCAs with sufficient powers to assess credit origination capacity without the need for a further regulation.

The ability of non-bank lenders to deliver a return to their investors rests on their ability to make good lending decisions. It is ultimately in the interests of non-bank lenders to lend responsibly and to be diligent when assessing a borrower's creditworthiness. As shown in Figure 1, ACC research⁷ indicates that 85% of fund managers surveyed view credit analysis or sourcing viable credit opportunities as their most resource intensive activity. This demonstrates the importance placed by non-bank lenders on this aspect of their investment activity.

When considering a lending opportunity, non-bank lenders will typically assess a borrower's credit worthiness and its ability to repay the loan using credit scoring techniques, analyse key financial information about the borrower, undertake market research and undertake a detailed assessment of the borrower's management team (further detail about the policies and processes employed by asset managers is provided in Chapter 2 of this paper).

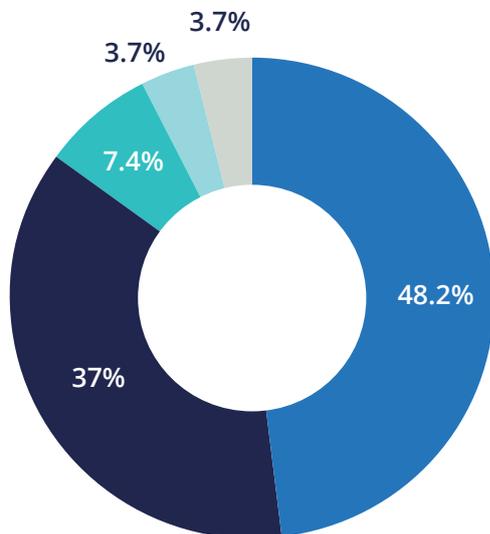
⁴ Article 7(3)(a) of the AIFMD.

⁵ Article 8(1)(c) of the AIFMD.

⁶ Article 12(1)(c) of the AIFMD.

⁷ ACC Research Paper, *Financing the Economy 2017* (*Financing the Economy 2017*). This research is based on a global survey of private credit managers who collectively represent approximately \$500 billion in assets under management ('AUM'). Almost half of the respondents to this survey were EU based private credit managers.

Figure 1: What is the most resource intensive activity in carrying out private credit strategies?⁸



iii. Borrowers

Borrowers obtaining finance from non-bank lenders are not subject to any potential risks that are not already addressed through existing safeguards and borrower protection rules. The primary legal and regulatory safeguards for business borrowers are generally found within the legal systems of EU Member States. European borrowers obtaining finance currently benefit from various legal protections that help safeguard their interests. Laws relating to property rights, insolvency, restructuring, contracts, fraud and misrepresentation provide EU Member States with a range of tools to ensure there is an appropriate balance between the legitimate interests of borrowers and lenders. This framework supports the effective functioning of the business finance markets and applies to lending by both non-bank lenders, credit institutions and other sources of business finance.

It should also be noted that the existing regulation of non-bank lenders provides borrowers with assurances that they are dealing with a lender who is subject to regulatory oversight.

There is also regulation to govern the provision of credit to certain types of borrowers such as individuals, financial institutions, collective investment schemes and related parties (e.g., the Consumer Credit Directive or prudential regulation of loans between financial institutions). Non-bank lenders providing credit to these borrowers would be subject to the same rules and, where necessary, the same authorisation requirements. Borrowers' interests are therefore already protected through a range of means within the legal systems of EU Member States.

iv. Investors

The interests of investors in non-bank lenders already benefit from protections within the AIFMD. Article 12 of the AIFMD requires AIFMs to, among other things: (i) act honestly, with due skill, care and diligence; (ii) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market; (iii) avoid conflicts of interest that will adversely affect the interests of their AIFs or investors in their AIFs (and where these cannot be avoided identify, manage, monitor and disclose these); and (iv) treat all investors fairly.

In addition to these general principles, investors benefit from specific provisions under the AIFMD relating to conflicts of interest (see Article 14) and valuation (see Article 19). Article 23 of the AIFMD also requires AIFMs to make specific disclosures to investors including, among other things, the AIF's investment strategy and objectives, a description of fees and charges, the AIF's liquidity risk management and use of leverage. The AIFMD also includes several provisions governing how AIFMs market their AIFs to investors including specific provisions restricting and controlling the marketing of AIFs by AIFMs to retail investors.

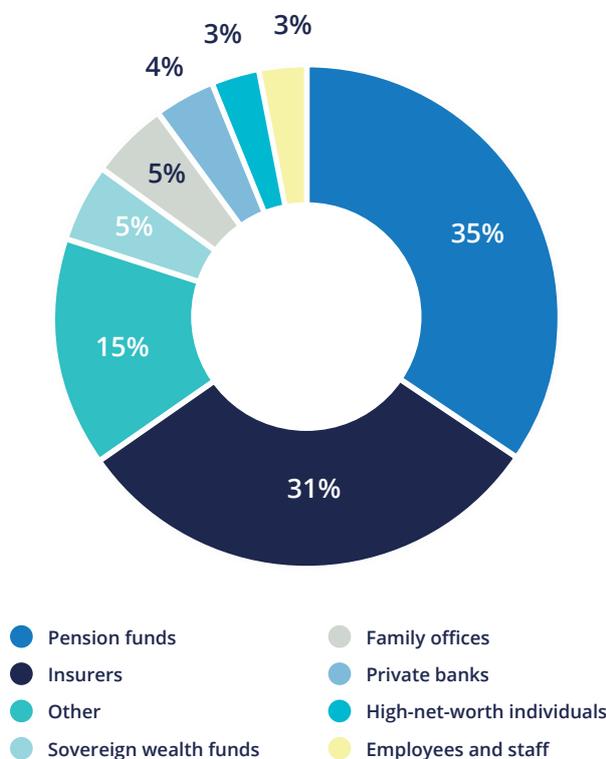
⁸ *Financing the Economy 2017*, Figure 12, page 15, supra note 6.

Taken in aggregate, we believe that the interests of investors in AIFMs undertaking lending activity already benefit from robust protections. We are not aware of any potential risks to investors in non-bank lending strategies that could not be addressed through these existing mechanisms.

ACC research (see Figure 2⁹) indicates that investors in non-bank lenders are typically institutional in nature, with over 70% of all committed capital to this market coming from pension funds, insurers and sovereign wealth funds. Investors are attracted by the investment yields made by non-bank lenders and their ability to offer a range of risk-return profiles that match the investors' requirements. An increasing number of institutional investors now have specific alternative credit allocation categories in their portfolios and this trend is expected to continue.

There may be some types of investors for which funds involved in non-bank lending activity are unsuitable. For example, the openness of these funds to retail investors should be carefully considered. In line with general regulatory principles on investor protection, the AIFMD already provides NCAs with the discretion to implement greater safeguards and protections in instances where AIFs can be marketed to retail investors. The ACC supports applying the same principle for funds undertaking lending activity. This approach would allow NCAs to pursue a consistent approach to retail investors within their jurisdiction and could be achieved without introducing any new or specific requirements for investors in funds undertaking lending activity.

Figure 2. Investor type breakdown as percentage of total private credit AUM

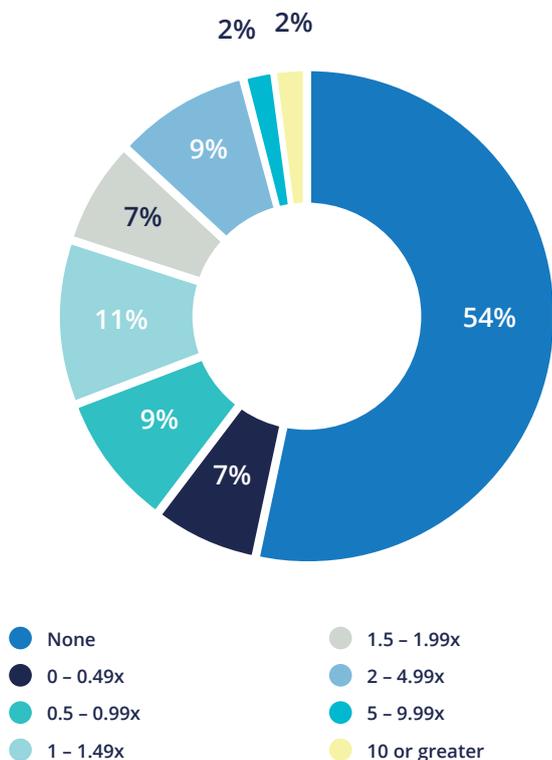


⁹ ACC research paper - *Financing the Economy 2018* (*Financing the Economy 2018*), Figure 25, page 23. This research is based on a global survey of private credit managers who collectively represent approximately \$470 billion in AUM. Almost half of the respondents to this survey were EU based private credit managers.

v. Leverage

ACC research (see Figure 3¹⁰) indicates that leverage levels employed by non-bank lenders remains low overall with nearly 90% of respondents to our survey indicating that they employ less than 2x leverage and 54% stating that they employ no leverage at all. This reflects the general preference of investors in non-bank lenders for either unlevered investment strategies or modestly levered strategies.

Figure 3. How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)?



Where non-bank lenders do use leverage as part of their investment strategy, they manage its use through a range of means that will typically involve consideration of:

- the source of leverage;
- any interlinkage/relevant relationships with other financial institutions;
- the need to limit exposure to any one counterparty;
- the extent to which the leverage is collateralised;
- the asset-liability ratio; and
- the scale, nature and extent of the AIFM's activity on the market concerned.

The use of leverage by non-bank lenders is also assessed by NCAs as part of their supervisory responsibilities. For example, AIFMs employing leverage are required to: (i) set a maximum level of leverage for each AIF (including funds originating loans); (ii) manage and monitor leverage levels to ensure they do not exceed this maximum; and (iii) provide extensive disclosures to both investors and regulators on how they are using leverage as well as levels of leverage. There are also enhanced reporting requirements for AIFMs where leverage exceeds three times the net asset value ('NAV') of the fund.

The information provided to NCAs on leverage by AIFMs is also shared with other NCAs, ESMA and the European Systemic Risk Board (ESRB). This enables these bodies to understand overall levels of leverage in the non-bank lending sector. While the non-bank lender already bears the burden to demonstrate that each leverage limit it sets is reasonable in relation to its investment strategy, NCAs can impose overriding leverage limits where this is deemed necessary. ESMA and the ESRB are also empowered to advise NCAs on appropriate remedial measures for firms or groups of firms where they deem necessary.

While we understand that leverage will remain an area of ongoing interest, we do not believe that current levels, and use of, leverage by non-bank lenders warrants additional regulatory intervention at this stage.

¹⁰ *Financing the Economy 2018*, Figure 43, page 35, supra note 8.

vi. Non-bank lending and other investment activity

Some non-bank lenders will carry out lending activity alongside other investment activity. The ACC is of the strong view that distinguishing between non-bank lenders who originate loans and those that originate loans alongside other investment activity is unnecessary. Regulatory oversight of non-bank lenders already includes an assessment of whether they have the operational capacity to effectively manage their investment activity, regardless of whether their funds are exclusively focused on lending activity or part of a mixed investment strategy.

While we acknowledge that the operational capabilities to manage their investment activity will differ, depending on whether the non-bank lender is solely undertaking lending activity or not, there is no reason why this could not be assessed effectively by NCAs under the existing authorisation regime. Indeed, the relaxations of the prohibitions against asset mixing introduced by the Central Bank of Ireland with effect from 7 March 2018¹¹ are a welcome acknowledgement of this.

vii. Supervisory reporting and monitoring

Article 24 of the AIFMD places robust and comprehensive reporting requirements on AIFMs in relation to the principal exposures and most important concentrations of each of the AIFs they manage. This includes, among other things:

- arrangements for managing liquidity;
- the risk profile and risk management systems employed by the AIFM;
- information on the main assets invested in;
- stress testing results; and
- use of leverage.

These reporting requirements provide NCAs with the necessary information to monitor and assess how AIFMs acting as non-bank lenders are managing their business, and monitor any risks potentially arising from this activity.

viii. Additional regulatory requirements

Although some EU Member States have introduced additional authorisation requirements for non-bank lenders and loan origination funds in their jurisdiction, we would caution against the introduction of additional pan-EU authorisation requirements.

A specific EU authorisation regime for non-bank lending activity would be a departure from the approach established by the AIFMD that focussing on the AIFM is the most effective way to supervise the alternative investment management sector.

Any move towards product level regulation, in addition to the regulation of fund managers through the AIFMD, would lead to a fragmentation of the regulatory framework for AIFMs across different alternative investment products. This would create overlapping and potentially conflicting requirements for these AIFMs, introduce unnecessary regulatory barriers and limit the growth of the market.

Where EU Member States have introduced additional requirements for non-bank lenders operating in their jurisdiction, these have typically been seen by managers as unduly restrictive (for example, by prescribing exposure limits, maturity and lock-up periods or unnecessarily limiting the ability of funds to fully participate in the capital structure of a borrower). These requirements have also acted as a barrier to the cross-border flow of capital within the EU, preventing the fund's portfolio investments from obtaining geographical diversification and making it harder for non-bank lenders to achieve scale. In some instances, these requirements are also unappealing to investors who may be unfamiliar with the fund structures required to meet national requirements, the local laws governing the fund or the potential tax implications when investing through these structures.

We support the intention of EU Member States to support non-bank lenders in their markets. It is our view that this can be best achieved by first addressing the barriers that exist for non-bank lenders in each EU Member State before seeking to introduce any new requirements. Chapter 3 of this paper outlines some of the key issues identified by our members.

¹¹ Central Bank of Ireland, *Notice of intention for a rule change to the AIF Rulebook* (7 Feb. 2018).

Chapter 2

How do
non-bank
lenders
manage their
business?

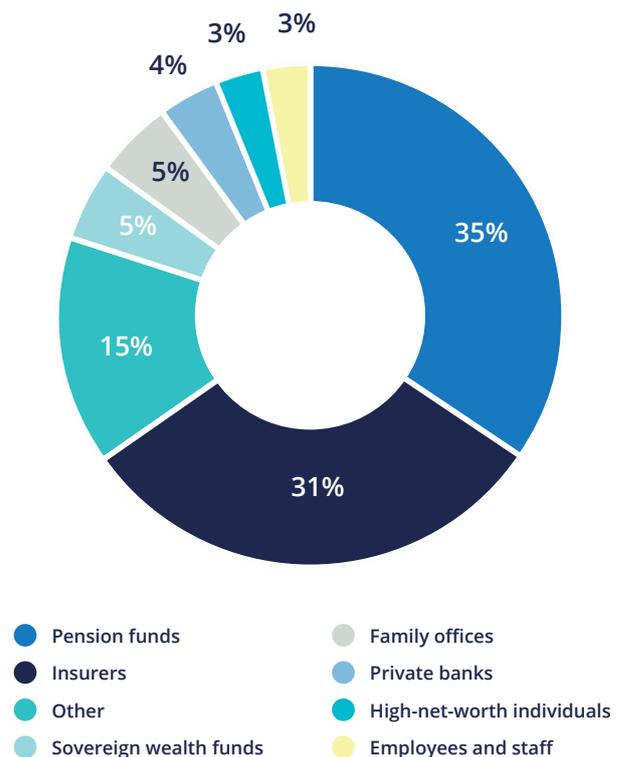


i. Structures and maturity transformation

The ACC recognises the concerns expressed by policymakers in relation to non-bank lenders, maturity transformation and the risks this may present to financial stability. While maturity transformation is an important issue in the financial sector, we believe it is less salient for non-bank lenders where the maturity of the loans made by the fund are generally aligned to the maturity of the capital provided by investors. Capital allocated to non-bank lenders is typically invested via closed-ended fund structures that have a fixed life cycle. This means that investors are not able to recall this capital and that borrowers benefit from a stable and patient source of finance.

The illiquid nature of these fund structures and the underlying loans made by non-bank lenders is well understood by investors. These investors (see Figure 4¹²), predominantly pension funds and insurance companies and endowments, are typically attracted to these investments by factors such as the yield that can be achieved with this type of investment (sometimes described as an illiquidity premium) or the alignment of the loan repayment schedule with their income requirements. These institutional investors also have long-term investment horizons that more closely fit the nature of private credit.

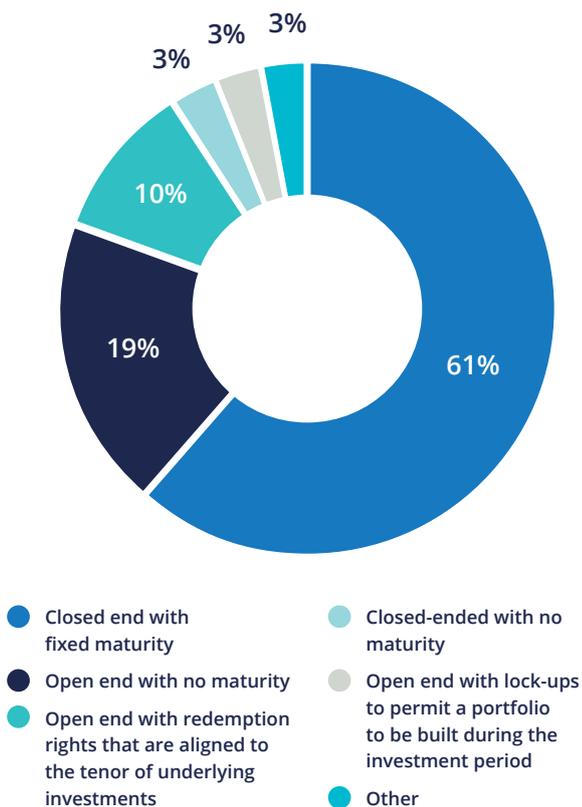
Figure 4. Investor type breakdown as percentage of total private credit AUM



¹² *Financing the Economy 2018*, Figure 25, page 23, supra note 8.

Ensuring that the liquidity profile of the fund matches that of the illiquid nature of the loans being originated is a key driver of non-bank lending fund structures. ACC research (see Figure 5¹³) demonstrates that nearly two thirds of non-bank lenders' funds are closed-ended and that non-bank lenders with open-ended fund structures typically use tools to limit redemptions. These tools would typically include lock-up periods, redemption gates, side pockets, suspension of redemptions. As a result, investors are fully aware at the outset of (i) their committed investment period and, more importantly, (ii) the time it will take to unwind positions with the borrowers. This means that both closed-ended and open-ended fund structures can deliver matched liquidity models.

Figure 5. Is your flagship or main fund...



These features provide substantial structural safeguards against policymakers' concerns in relation to maturity transformation. While we recognise that maturity transformation will remain an important consideration as the non-bank lending market develops, we do not believe any specific regulatory measures are required at this stage.

ii. Responsible lending

Non-bank lenders undertake detailed borrower due diligence, credit underwriting and risk analysis on any lending opportunity before deciding whether to provide credit. Robust lending standards are business critical functions for non-bank lenders and form an essential part of their broader risk management framework. These functions have a direct impact on the commercial success and reputation of the non-bank lender and are, in all instances, designed to enable them to understand, monitor and manage any risks arising from their lending activity.¹⁴ Non-bank lenders are also subject to risk management requirements prescribed within the AIFMD, and to consider the impact of any lending activity at the portfolio level as well as on a case-by-case basis.

We have provided more detail below on how this influences the conduct and practices of non-bank lenders in specific areas of their business.

a) Due diligence

The due diligence undertaken by a non-bank lender on any lending opportunity is substantially similar to that which would be undertaken by traditional lenders. This will involve an assessment of the borrower's creditworthiness and its ability to repay the loan. In addition to using data to understand these risks (e.g., credit scoring, analysis of key financial information), non-bank lenders will also typically assess the borrower's management team as a means of determining the management team's capability to manage the borrower's business effectively during the period of the loan.

Non-bank lenders will also undertake research into the borrower's business/industry sector, often using expert networks and third-party advisors. This will involve both an assessment of the risks facing the borrower, the sector in which it operates in and how the borrower's business may be affected by broader macro-economic conditions.

¹³ *Financing the Economy 2018*, Figure 58, page 44, supra note 8.

¹⁴ See Article 15 of the AIFMD.

As well as assessing each individual loan on its own merits, non-bank lenders will also assess how the loan will affect the diversification of their investment portfolio overall. This ensures that potential concentration risks (e.g., within a particular geography or industrial sector) are identified and mitigated within the context of the non-bank lender's investment mandate.

Commission Delegated Regulation (EU 231/2013) under the AIFMD (the 'AIFMD Level 2 Regulation') already requires non-bank lenders to apply a high standard of diligence in the selection and ongoing monitoring of investments, including loans, which must be reflected in written policies and procedures.¹⁵ Specifically, when investing in assets of limited liquidity such as loans and some bonds, a non-bank lender must also: (i) set out and regularly update a business plan consistent with the duration of the AIF undertaking lending activity and market conditions (in the context of lending, this often takes the form of stress testing that includes a borrower base case, upside case and downside case); (ii) conduct due diligence and invest in accordance with that plan; and (iii) monitor the performance of the assets against the plan.¹⁶

While no form of due diligence can mitigate against every eventuality, we believe that the approach taken by non-bank lenders towards borrower due diligence and identifying credit risk is as, if not more, robust than that taken by traditional lenders.

b) Risk management

Non-bank lenders typically implement risk management systems to identify, monitor and manage the risks that are relevant to their lending activity or investment strategy, and to each of the funds that they manage. As well as being critical to the success of the non-bank lender, there are also regulatory and investor expectations that non-bank lenders will have effective systems in place. At a minimum, this means that, in accordance with Article 15(3) of the AIFMD, non-bank lenders will:

- implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;

- ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures; and
- ensure that the risk profile of the AIF corresponds to the size, portfolio structure and the investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

Any lending activity is also subject to the same level of scrutiny. In practice this means that non-bank lenders will ensure they have adequate resources (including staff with the right blend of skills and experience) to support an effective risk management function which, in this context, primarily means being able to effectively identify, manage and monitor credit risk.

The performance of the risk management function is also subject to investor and regulatory oversight through the provision of information to these stakeholders via regular disclosure. Should a non-bank lender fail to meet their disclosure obligations to NCAs, it will be subject to regulatory sanctions up to and including withdrawal of their authorisation. If a non-bank lender does not meet its disclosure obligations to investors, it will also face commercial consequences and potentially legal action following its failure to meet the terms of the investment mandate.

Diversification is also a fundamental risk management tool. Non-bank lenders already manage their exposure to sectors, geographies or other concentration risk in line with their defined investment strategy of the fund. As noted above, where EU Member States have introduced mandatory diversification requirements, these have acted as a barrier to entry for non-bank lenders by constraining the type and volume of lending that managers are able to undertake and made it uneconomical for some managers to operate in those jurisdictions.

¹⁵ See Article 18 of the *AIFMD Level 2 Regulation*.

¹⁶ See Article 19 of the *AIFMD Level 2 Regulation*.

c) Governance

The due diligence and risk management requirements outlined above are also subject to oversight from internal governance arrangements such as risk and investment committees, third-party advice/reviews and other recognised corporate governance measures. Article 15(1) of the AIFMD requires that non-bank lenders establish the functional and hierarchical separation of their risk management activities from portfolio management. This separation helps manage potential conflicts of interest by establishing the independence of the risk management function. This separation is also subject to oversight and sanction from NCAs.

Chapter 3

Barriers faced by non-bank lenders within Europe



France

i. Typical structures used by non-bank lenders in this jurisdiction

Some French AIFs, including private equity funds (fonds professionnels spécialisés (FPS), fonds professionnels de capital investissement ('FPCI'), organismes de titrisation ('OT') and the organismes de financement spécialisés ('OFS')) are authorised to originate loans, whether they are managed by a French or a non-French EU AIFM. Implementing regulations for the OT and OFS were published (Decree no. 2018-1004¹⁷ and Decree no. 2018-1008¹⁸) in November 2018. This confirmed that the assets of the French debt funds shall be composed of:

for OT

- a) loans, whether governed by French law or foreign law, and cash assets;
- b) equity securities received in particular by conversion, exchange or redemption of debt securities or securities giving access to the capital, or by the exercise of the rights attached to these securities;
- c) rights derived from loans;
- d) forward financial instruments or transferring insurance risks;
- e) guarantees;
- f) security interests; or
- g) funded or unfunded sub-participations.

for OFS

- a) financial instruments;
- b) loans, whether governed by French law or foreign law;
- c) any other asset;
- d) cash deposits, equity securities and securities giving access to the capital;
- e) rights from loans;
- f) forward financial instruments;
- g) guarantees;
- h) security interests; or
- i) funded and unfunded sub-participations.

The decree also provides that the maximum leverage of the OFS (expressed as a ratio between the fund's exposure and its NAV), shall be set in the statutes or the fund's by-law, within the limits defined by a decree of the Minister of Finance. The calculation of this leverage excludes equity bridge financings that are fully secured by pledges of equity commitments from investors in the fund. The exposure is calculated according to the commitment calculation method as indicated in Article 8 of the AIFMD Level 2 Regulation.

Direct lending by certain types of French AIFs to borrowers based in France may be allowed subject to certain requirements (related to the duration of the loans, the entities that can receive such a loan) but is not applicable to all other French AIFs or non-EU AIFs.

In order to manage such funds, the French AIFM will be required to ask for an extension of its license with the French regulator to include loan origination. Similarly, a non-French EU AIFM will need to be licensed for loan origination by its home authority and subject to equivalent conditions as those applicable to the French AIFM.

A non-French EU AIFM managing the French AIFs referenced above should be able to originate loans in France, so long as that AIFM has a passport to provide AIFM services in France and there is nothing preventing it originating loans under its AIFM licensing arrangements in its home Member State. There is, however, little precedent in this area.

EU ELTIF funds, managed by an authorised EU AIFM with a management passport, can also originate loans in France. Non-French investment funds may originate loans through a French fronting bank or by providing bonds. Both are well-established routes for non-French alternative lenders to originate loans in France.

¹⁷ www.legifrance.gouv.fr/affichTexte.do;jsessionid=DD9A6D49F9982B62A8C0C2757F836E08.tplgfr42s_1?cidTexte=JORFTEXT000037627204&dateTexte=&oldAction=rechJO&categorieLien=id&idJO=JORFCONT000037627150

¹⁸ https://www.legifrance.gouv.fr/affichTexte.do;jsessionid=4EEB9D80F668B680F632533A7AC7F387.tplgfr29s_1?cidTexte=JORFTEXT000037629968&dateTexte=&oldAction=rechJO&categorieLien=id&idJO=JORFCONT000037629709



ii. Barriers for non-bank lenders in this jurisdiction

The requirement to originate loans from a French-domiciled AIF is a significant barrier for non-bank lenders looking to lend in France. Establishing a fund solely for the purposes of originating loans in France under the conditions required by the French loan fund regime is often not economical for non-bank lenders. Costs are incurred in the creation of the vehicle itself and adherence to the conditions required limits the ability of the fund to deliver an adequate return on investment. This both undermines the commercial case for investing in France and ultimately increases the cost of finance for French businesses seeking finance.

The ACC believes that the requirement under the French loan fund regime for the fund to be domiciled in France is inconsistent with the free movement of capital within the EU and the AIFMD. Removal of this requirement would enable EU AIFs to also originate loans in France and significantly improve the availability of finance to French businesses.

Existing banking secrecy laws can impede the sharing of information between non-bank lenders and their investors about the performance of their loan portfolios. Investors often require certain amounts of information on underlying loans but banking secrecy laws and the imposition of local regulatory requirements in relation to privacy make obtaining the consent of each borrower very difficult. This places the French market at a disadvantage compared to other jurisdictions where it is easier to provide information relating to the underlying loans and performance of the investment.

The insolvency and credit protection regime in France can place non-bank lenders at the risk of excessive defaults and bankruptcies of borrowers. Creating a secure framework which protects the fund as lender from this eventuality would support the growth of non-bank lending activity in France and foster alignment with the regime for banks as derived from the EU Financial Collateral Directive.

Private credit managers are only able to access a limited number of double tax treaties when investing in France whether via a French loan originating AIF or other vehicles.

ACC recommendation:

- enabling non-French EU AIFs with EU or French AIFMs to lend directly to borrowers in France without the need for a French fronting bank;
- enabling funds that originate loans to enforce a security interest given to secure the borrower's repayment obligations in case of bankruptcy of the borrower;
- provide greater certainty for non-bank lenders regarding the sharing of loan portfolio data with their investors without being in breach of banking/professional secrecy rules;
- enable non-bank lenders to service the loans they make without being subject to specific local servicing rules; and
- making funds originating loans eligible to claim withholding exemptions or reductions under applicable double tax treaties by extending them a similar regime to that which applies to private equity funds (Régime Arthuis).

iii. Summary of requirements for loan funds in this jurisdiction

	France 
Fund structure	Closed-ended. Loan originating AIFs also have to be domiciled in France or otherwise rely on the ELTIF regime.
Leverage limits	30% of NAV. This is only permitted for cash borrowings and expressly cannot be used to finance a loan.
Exposure limits	Not applicable.
Maturity and lock-ups	Loans can only be resold during the life of the fund if the AIFM has a specific operational program approved by the AMF or in specific circumstances.
Risk management	Specific credit files containing information on the borrowers must be established, and a specific loan decision procedure must be formalised.
Credit restriction	Lending to financial institutions and collective investment schemes is prevented.
Other features	Derivative contracts permitted solely for hedging.

Germany



i. Typical structures used by non-bank lenders in this jurisdiction

The use of German loan originating funds by private credit managers providing finance in Germany is rare, as certain investment, leverage and risk management conditions apply to German AIFs and AIFMs under the rules of the German Investment Code. These rules were introduced relatively recently and, therefore, there is some uncertainty among private credit managers about how this regime for loan funds will operate in practice. In addition, some features of the German regime for loan funds are not necessarily a good fit with the typical market practices of private credit managers, as such features typically mimic the banking model (e.g., the structural distinction between loan approval from a risk perspective and loan origination. The German regime requires German loan funds to establish detailed procedures for loan origination, processing, workout, restructuring and processing control).

Under the German regime, open-ended Spezial-AIFs and closed-ended retail AIFs are unable to grant external loans (but can grant shareholder loans). Funds are open-ended where the fund documents provide for a redemption mechanism. Closed-ended Spezial-AIFs are therefore what would be used under the German regime.

An exemption in the German Banking Act means that no additional authorisation is required if the loan is granted by:

- a German AIF/AIFM;
- a non-German EU AIF/EU AIFM; or
- non-EU AIFs/non-EU AIFMs admitted for marketing to professional and semi-professional investors in Germany, i.e., if fully AIFMD compliant.

As a result, EU AIFs/EU AIFMs have become common lenders, typically through special purpose vehicles ('SPVs') owned by the AIFs. SPVs are, however, not expressly mentioned under the exemption.

ii. Barriers to non-bank lenders in this jurisdiction

As noted above, the use of SPVs as originator of loans is not expressly covered under the exemption under the German Banking Act. However, the German regulator (BaFin) takes the view that SPVs held by an AIF are merely extensions of such AIF, as they do not pursue their own strategy but are used to implement the AIF's strategy. One could argue that, in light of the SPV being merely an implementation tool, it benefits from the same exemption that applies to the AIF. Amending the exemption to clarify that this also expressly covers origination from SPVs that are wholly owned subsidiaries of the entities that are exempt from the requirements of the German Banking Act would improve the certainty for private credit managers and promote greater access to alternative sources of finance for German businesses.

Non-EU AIFMs/AIFs may only grant loans if they are admitted for marketing to semi-professional investors, i.e., only if fully AIFMD compliant.

ACC recommendation:

- Amending the exemption under the German Banking Act to clarify that this also covers origination from SPVs that are wholly owned subsidiaries of the entities that are exempt from the requirements of the German Banking Act would improve the certainty for private credit managers to finance German businesses.

iii. Summary of requirements for loan funds in this jurisdiction

	Germany 
Fund structure	Closed-ended Spezial-AIF (i.e., AIFs with only professional and semi-professional investors), whether EU AIF/EU AIFM or German AIF/German AIFM or, where admitted for marketing to professional and semi-professional investors in Germany, Non-EU AIFs/non-EU AIFMs.
Leverage limits	For German AIFs, borrowing limited to 30% of the net capital of the AIF that is available for investment. For other AIFs, subject to the usual AIFMD tests.
Exposure limits	For German AIFs, loans granted to a single borrower cannot exceed 20% of the net capital of the AIF that is available for investment.
Maturity and lock-ups	None.
Risk management	For German AIFs/AIFMs, the Minimum Requirements on Risk Management for Investment Companies (KAMaRisk) stipulate that loan origination funds in Germany should have adequate structures and procedures in place for (i) credit processing, (ii) the management of non-performing loans and (iii) the early detection of risks. These requirements are based on risk management guidelines for the banking sector.
Credit restriction	The AIF cannot grant loans to consumers and there has to be a diversification of credit positions.
Other features	There are some exceptions for loan originating funds granting loans to companies in which they hold shares.

Proposals to reform the regulation of credit servicing firms by extending the existing regime to the owners of Irish loans are currently being considered in Ireland.²⁰ These proposals risk reducing the appetite of private credit managers to invest in Irish loans and the securitisation of Irish loan portfolios. Asset managers who purchase Irish NPLs are already subject to regulatory authorisation requirements such as the AIFMD or the ELTIF Regulation. Imposing additional Member State-specific licencing requirements on these firms in relation to their business as a credit owner, may be incompatible with their existing authorisation under this legislation and passporting rights. It is also unclear whether regulating loan owners based outside Ireland would be consistent with legislation governing the free movement of capital within the EU and EU competition law. Furthermore, in March 2019 the Commission proposed a Directive on credit servicers, credit purchasers and recovery of collateral that would prevent EU Member States from introducing any additional requirements on credit agreement owners.²¹

ACC recommendation:

- The policy objectives behind the proposals to extend the regulation of credit servicing firms to credit agreement owners should be addressed through other means, such as introducing requirements focussed on their activities rather than through a licencing regime.

²⁰ Consumer Protection (Regulation of Credit Servicing Firms) Bill 2018. [NOTE TO WORKING GROUP: This section will need to be reviewed proximate to the publication date to assure that it remains accurate based on the then-current status of the legislation.]

²¹ Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral (2018/0063 (COD)) dated 14 March 2018.

iii. Summary of requirements for loan funds in this jurisdiction

	Ireland
Fund structure	QIAIFs required to be closed-ended with finite life and although no investor redemption rights permitted, distributions and redemptions (subject to limitations) may be made out of unencumbered cash and available liquid assets.
Leverage limits	Gross assets of a QAIF must not exceed 200% of NAV.
Exposure limits	A QAIF's exposure to a single borrower/issuer or group cannot exceed 25% of net assets after specified period.
Maturity and lock-ups	Not applicable.
Risk management	Special risk management, assessment, credit granting, monitoring, valuation procedures to be complied with.
Credit restriction	<p>QIAIFs engaged in loan origination must limit operations to issuing loans, participating in loans, participation in lending; may only invest in debt and equity securities of entities or group to which the QAIF lends and as part of a related activity; and may not originate loans to natural persons, AIFM, depositary or related parties, other collective investment schemes, financial institutions or related companies (other than treasury management), investors in equities or traded investments or commodities.</p> <p>There are no specific requirements for unregulated structures but they may be subject to other legislation such as the Irish SME Code (when lending to Irish persons/entities) or similar local laws.</p>
Other features	QIAIFs face restrictions on acquiring loan from credit institutions (i) retaining exposures correlated to performance of loan or (ii) providing administration, credit assessment or credit monitoring services in relation to loan unless certain conditions are met (e.g., independent monitoring valuation and stress testing and retention by vendor of net economic interest of at least 5%).

Italy

i. Typical structures used by non-bank lenders in this jurisdiction

Within the Italian debt market, the most common loan originators are banks and financial intermediaries enrolled in the register (i.e., authorised) set in Article 106 of Legislative Decree No. 385/1993 (the 'Consolidated Banking Act').

Under Italian law the activity of loan origination is a reserved activity and authorisation from the Bank of Italy is required. Private credit managers authorised under the AIFMD are also permitted to carry on loan origination in Italy, albeit on a restricted basis.

Private credit managers have only been permitted to carry on loan origination activity since 2016 and currently form a very small part of the Italian loan origination market. Italian credit funds are permitted to do direct lending within a specific regulatory framework.

The performance of pre-lending activities (e.g., soliciting, advertising, inducing, arranging/origination activities to find borrowers), promotion and marketing activities which are carried out in Italy for the purpose of granting loans by funds to borrowers are restricted by Italian laws and regulations and subject to strict licensing requirements.

EU AIFs may perform direct lending activities in Italy subject to certain conditions, including in particular that (i) the fund is duly authorised to perform lending in its home state, (ii) the fund be structured as a closed-ended fund and subject to diversification and leverage limits equivalent to those envisaged for Italian credit funds and (iii) a prior notification be filed with the Bank of Italy.

The requirement is for funds to be closed-ended. Open-ended fund structures (even where effectively closed-ended due to the rigid and strict redemption mechanics that they employ) may not originate loans in Italy.

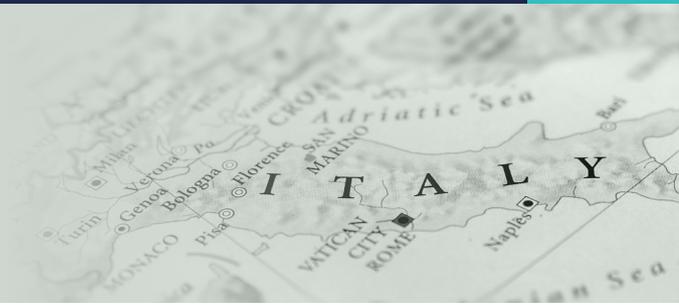
Lending by non-EU AIFs into Italy is restricted under Italian laws and regulations.

ii. Barriers to non-bank lenders in this jurisdiction

There are a number of areas where the Italian regime for loan funds hinders the provision of credit for Italian businesses. For example:

- The 10% exposure limit is too low and not in line with the thresholds used by other European jurisdictions or market practice;
- It is unclear whether fully compliant EU AIFMs originating loans via wholly owned SPVs would meet the requirements of the loan origination fund regulations. In the absence of a specific rule allowing wholly owned SPVs to do lending the answer is that this will be restricted (unless it is an Italian securitisation SPV, which can carry out lending activities subject to certain conditions); and
- The requirement for EU AIFs seeking to originate loans in Italy to demonstrate that they meet 'equivalent' requirements to the Italian regime for credit funds in their home jurisdiction is not always easy to verify in terms of compliance. This prevents EU AIFs from originating loans in Italy as the AIF (through its AIFM) has to file an application with the Bank of Italy which should include a declaration by the legal representative of the EU AIF that the relevant home-state rules are deemed equivalent to the Italian rules as well as a legal memorandum concerning such equivalence.

Generally, there are no barriers from a purely Italian tax perspective in relation to payments made in favour of Italian investment funds, i.e., interest paid by Italian borrowers should generally not be subject to any Italian withholding tax. Additionally, interest should not be taxable in Italy at the level of the Italian fund. On the contrary, a 26% withholding tax may apply on interest paid in favour of non-Italian funds, which may be reduced in accordance with double tax treaty provisions, if applicable. A domestic exemption from such withholding tax may apply on interest paid under medium/long-term loans extended in favour of Italian enterprises, if the lending investment fund is, *inter alia*, established in a Member State allowing for an exchange of information with Italy (which includes EU Member States), is subject to regulatory supervision in its State of establishment and is lending into Italy in compliance with the Italian regulatory provisions.



ACC recommendation:

- The 10% exposure limit is too low and should be brought into line with the thresholds used by other European jurisdictions;
- It should be clarified how EU AIFMs originating loans via wholly owned SPVs can be eligible to meet the requirements of the loan origination fund regulations; and
- The requirements for EU AIFs seeking to originate loans in Italy to demonstrate that they meet 'equivalent' requirements to the Italian regime for credit funds in their home jurisdiction should be amended to state that EU AIFs originating loans in Italy only have to be compliant with the requirements under the AIFMD.

iii. Summary of requirements for loan funds in this jurisdiction

	Italy 
Fund structure	Closed-ended.
Leverage limits	130% for retail investor funds and 150% for professional investor funds.
Exposure limits	Exposure to a single client up to a limit of 10% of the total assets of the fund.
Maturity and lock-ups	Credit maturity cannot exceed the fund's maturity.
Risk management	Required to define a specific process of managing credit risk.
Credit restriction	The fund may only take loans from banks, Article 106 financial intermediaries and other entities duly authorised to grant loans.
Other features	<ul style="list-style-type: none"> • derivative contracts permitted only for hedging (retail funds); • restrictions on transactions with related parties (including granting of loans); and • limits on the issue of guarantees by the fund.

Luxembourg

i. Typical structures used by non-bank lenders in this jurisdiction

According to the updated AIFM Law FAQ (the 'FAQ') published by the Commission de Surveillance du Secteur Financier (CSSF), which is Luxembourg's financial sector regulator, all Luxembourg based AIFs may carry on lending activities (loan origination, loan acquisition or loan participation), subject to compliance with the requirements of the AIFMD and the act of 12 July 2013 on alternative investment fund managers, as amended (the '2013 Act'). Although the FAQ remains silent on this point, it is prudent to consider that this confirmation only relates to Luxembourg AIFs which fall under one of the following categories:

- they are managed by a duly authorised AIFM established in Luxembourg or any other EU member State or are authorised by the CSSF as internally-managed AIFs; or
- they are authorised by the CSSF either as specialised investment funds ('SIFs') or as undertakings for collective investment ('UCIs') under part II of the act of 17 December 2010 relating to UCIs ('Part II UCIs').

Luxembourg AIFs which are established as reserved alternative investment funds ('RAIFs'), as ELTIFs or as unregulated limited partnerships (SCSs or SCSps) may rely on the confirmation under the FAQ to carry on lending activities to the extent they are managed by a duly authorised external EU AIFM (or are authorised as internally-managed AIFs).

By contrast, Luxembourg funds which do not fall under one of the above categories (e.g., unregulated limited partnerships which are managed by a non-EU AIFM or by a registered AIFM) cannot rely on said confirmation to carry on lending activities. The same applies to non-Luxembourg AIFs, which are not covered by the FAQ.

The CSSF has confirmed that the following activities can be performed without requiring a professional lender's licence ('PSF Licence'):

- one-off transactions (where the lender or a SPV grants one or more (drawn or undrawn) loans under a single transaction and does not repeat this type of transaction);
- intra-group loans (where the lender or a SPV grants a loan to a legal person belonging to the same group); and
- loans granted to a "restricted circle of persons previously known (to the lender)" (i.e., not "to the public"). In addition, loans may not be granted to consumers.

Non-Luxembourg AIFs may originate loans to Luxembourg-based borrowers to the extent they fall under one of the above exemptions. Non-Luxembourg AIFs which are managed by a duly authorised AIFM (or are authorised as internally-managed AIFs) should be permitted to originate loans to Luxembourg borrowers even if they do not fall within one of the above exemptions. However, for the avoidance of doubt, it would be recommended to obtain prior clearance from the CSSF before starting the loan origination activities.

The CSSF remains vigilant concerning shadow banking issues. Therefore, it is recommended that promoters and fund managers who do not clearly fall within one of the above categories should seek prior clearance from the CSSF.

i. Barriers to non-bank lenders in this jurisdiction

Not applicable.



iii. Summary of requirements for loan funds in this jurisdiction

	Luxembourg 
Fund structure	Closed-ended or open-ended Luxembourg AIF.
Leverage limits	None.
Exposure limits	Specific to investment fund regime (e.g., cannot exceed 30% of gross or net assets for SIFs and RAIFs).
Maturity and lock-ups	None.
Risk management	<p>In addition to (i) the general requirements applicable to AIFMs in regard to their managed AIFs according to the 2013 Act as well as (ii) the particular requirements of the applicable Luxembourg investment fund laws, the AIFM (if based in Luxembourg) or, where applicable, the AIF should:</p> <ul style="list-style-type: none"> • ensure to address all aspects and risks of the origination activity; • avail of (amongst other) proper organisational and governance-structures (processes and procedures), necessary expertise/experience in origination activity combined with appropriate technical and human resources, with a focus on credit and liquidity risk management (within an overall adequate risk management process), concentration and risk limitation, clear policies regarding assets and investors (e.g., loan and investor categories, avoidance of conflicts of interest) and proper disclosure and transparency.
Credit restriction	None.
Other features	None.

The Netherlands

i. Typical structures used by non-bank lenders in this jurisdiction:

Within the Dutch loan origination market, the typical structures used by credit institutions and investment firms are EU/non-EU AIFs. Depending on the most tax efficient structure available, direct and indirect lending takes place in the Netherlands via SPVs.

There are no banking licence or regulatory requirements for conducting pre-lending activities (e.g., soliciting, advertising, inducing, arranging/origination activities to find borrowers) in the Netherlands so long as the targeted entities are not consumers and the fund does not hold any deposits from the public.

A licence is required for granting a loan if the loan is granted to consumers (natural persons not acting in the pursuit of a business or profession to whom a financial enterprise provides a financial service) or if such activity is combined with attracting deposits and other repayable funds from the public. Public means (i) beyond a restricted circle and (ii) from parties other than professional market parties, e.g., regulated financial undertakings, government bodies and large corporates.

Therefore, primary direct lending transactions are permitted provided (i) the fund does not receive, attract or hold repayable funds (deposits) from the public in the Netherlands and (ii) assuming the targeted borrowers/professional investors are not consumers within the meaning of applicable Dutch laws.

ii. Barriers to non-bank lenders in this jurisdiction

An interest withholding tax may be introduced in the Netherlands, which is expected to target interest payments directly or indirectly made to beneficiaries in low-tax jurisdictions or countries in the EU list of non-cooperative jurisdictions. If introduced as of 1 January 2021, the conditional withholding tax would apply to certain payments made by a Dutch entity directly or indirectly to group companies in a low-tax jurisdiction. A low-tax jurisdiction is a jurisdiction that does not levy a tax on profits or applies a tax rate of less than 7% on profits (this can be a federal, state or municipal tax) calculated according to Dutch standards or that is included in the EU list of non-cooperative jurisdictions. Every year a list will be published of countries that are deemed to be low-taxed. The interest withholding tax could be relevant if the borrower is a Dutch entity and the interest is (deemed to be) paid to an investor in such a jurisdiction (in case the fund is tax transparent) or if the fund itself enters into a back-to-back financing arrangement. In these situations, the withholding tax is expected to result in the non-Dutch investor suffering an additional tax cost which reduces its after-tax return on the investment. Furthermore, it may trigger gross up obligations under the relevant finance documentation.

To expand on the above tax impact for the Dutch scenario, the conditional taxes will be levied on a yearly basis. The tax rate is likely to be set at 20.5% which is higher than the current dividend withholding tax rate of 15% but the same as the proposed corporate income tax rate for 2021. As of 2021, the rate will be reduced to 22.25%, which will then also be the corporate income tax rate. If the tax was not paid, the tax administration has the option to either levy the tax from the tax payer that received the payment or from the Dutch entity that should have withheld the tax when distributing the payment.

iii. Summary of requirements for loan funds in this jurisdiction

	Netherlands 
Fund structure	Closed-ended or, in limited circumstances, open-ended (with redemption arrangements carefully matching the liquidity of the underlying loans).
Leverage limits	N/A
Exposure limits	N/A
Maturity and lock-ups	N/A
Risk management	The credit manager should take general regulatory requirements into account, such as those dictated by the AIFMD.
Credit restriction	N/A
Other features	N/A

Spain

i. Typical structures used non-bank lenders in this jurisdiction

Spain is a comparatively straightforward jurisdiction from a regulatory perspective for private credit managers seeking to originate and make loans to commercial businesses.

In Spain, neither loan origination (nor any pre-lending activity such as soliciting, advertising, inducing, arranging/origination activities to find borrowers) is a reserved activity or an activity subject to credit institution or financial institution license. As a result, loan origination through domestic and foreign vehicles is possible according to Spanish regulation and no credit institution license is required in order to carry out this activity (although some consumer body registration requirements must be complied with in respect of origination of consumer mortgage loans).

The typical structures used by private credit managers in Spain are Luxembourg or Irish AIFs and their SPV vehicles. The use of Spanish vehicles is in practice extremely unusual, as a result of the barriers to the use of Spanish vehicles mentioned below. EU fund vehicles are more efficient and, in practice, are the way in which loan origination funds usually operate in Spain.

The Spanish fund vehicles which feature the typical tax regime in Spain of a fund which is legally permitted to carry out loan origination are open-ended hedge funds ('IIC de IL'). For these purposes, they can set up lock-up periods which can be extended depending on the maturity date of the loans and, apart from meeting the general requirements for hedge funds, they must comply with some special provisions including in relation to risk management or diversification in terms of borrowers. Finally, borrowers must be legal entities, not natural persons.

Note that there also exists a closed-ended AIF which can be used for loan origination, but such a closed-ended AIF does not have the typical fund tax regime mentioned above. It is subject to tax as any other corporate and subject to withholding tax so is an even less viable alternative for loan origination activities.

ii. Barriers to non-bank lenders in this jurisdiction

As mentioned above, the creation of Spanish loan origination funds is not efficient from a financial and tax standpoint. Closed-ended AIFs are subject to ordinary corporate tax and withholding tax. Open-ended hedge funds enjoy a more favourable tax regime, but the payment of loan interest to a non-credit institutional Spanish lender is subject to withholding tax and the creation of a domestic vehicle in the form of a Spanish hedge fund requires the appointment or the establishment of an AIFM. Given that Spain is otherwise a straight forward jurisdiction for private credit managers, the usual outcome is the use of foreign vehicles as explained above.

iii. Summary of requirements for loan funds in this jurisdiction

	Spain	
Fund structure	Open-ended ('IIC de IL').	
Leverage limits	Borrowing is not allowed for loan originating funds, but the use leverage through of derivatives is permitted without limitation.	
Exposure limits	Requires a "sufficiently" diversified credit portfolio, with no fixed proportion of credit exposure to each borrower.	
Maturity and lock-ups	The use of lock-up periods is allowed which may be extended to match maturity of the loans.	
Risk management	The risk management system shall monitor the non-fulfillment of the commitments to repay cash or deliver securities and shall include the realisation of periodic simulation exercises to assess the effect on the entity's capacity to comply with its obligations in the event of adverse market conditions.	
Credit restriction	None.	
Other features	Loan originating funds in Spain are available only for professional or "qualified" investors.	

Belgium

i. Typical structures used by non-bank lenders in this jurisdiction

Loan origination funds are not prevalent in Belgium. The National Bank of Belgium in a 2017 study on shadow banking stated that Belgian AIFs with a leverage that exceeds 300% or that grant/purchase loans only accounted for EUR 2.4 billion in assets at the end of 2016 (which is dwarfed by the Belgian regular banking sector). There is also no legal framework that applies to loan origination funds specifically.

From a regulatory perspective, loan origination (including pre-lending activities such as soliciting, advertising, inducing, arranging/origination activities to find borrowers) is not subject to any licensing requirements in Belgium.

However, this assumes that the credit manager does not engage in a public solicitation of funds. The concept of repayable funds is broad and refers to all type of instruments whereby the repayment of principal is contractually agreed upon. Repayable funds can thus also refer to bonds and other types of debt instruments. The form or legal qualification of debt instruments is not relevant. What matters is that funds are made available to an institution and that the institution is free to use these funds as part of its operations. If the institution receiving the funds is contractually not free to use these funds, the regulations regarding deposit taking will not be applicable, but other regulations could be applicable (e.g., rules regarding custody or asset management). A solicitation will be public if: (i) advertisements are made in Belgium and are addressed to 50 or more persons, (ii) intermediaries are involved in Belgium or (iii) more than 50 persons are solicited. The issue of debt instruments is considered as the public solicitation of funds, irrespective of whether such issue of debt instruments entails the obligation to publish a prospectus (under Belgian prospectus regulations).

If the credit manager were to engage in granting credit for its own account and in a public solicitation of funds in Belgium, it would in principle fall within the scope of the Belgian banking law and be subject to a requirement to obtain a banking license.

Specifically regulated lending activities such as consumer lending or mortgage credit will require licences under the specific Belgian provisions relating to consumer credit and/or mortgage credit. Leasing of movable or real property requires a license under specific Belgian regulations. Furthermore, a specific legal framework applies when granting credit to Belgian SMEs.²² Although the SME financing rules do not prescribe licencing requirements, this legal framework contains (i) conduct of business rules (e.g., the obligation to act in good faith and equitably, certain information duties during the pre-contractual phase and provisions on refusal of credit); (ii) provisions on early repayment of credit facilities; and (iii) a prohibition of abusive clauses.

Other than the license rules summarised above, there are no specific licensing requirements for pre-lending activities. Note that when granting credit to SMEs, certain rules apply to the pre-contractual phase (mainly information obligations).

ii. Barriers to non-bank lenders in this jurisdiction

In principle, a withholding tax of 30% is due on interest payments, subject, however, to exemptions available under applicable Belgian law. Belgian law provides for numerous withholding tax exemptions, and we expect that an exemption from withholding tax on interest payments would apply.

Given that there is no specific regulatory framework for loan origination funds, the set-up of such funds would need to be reviewed in detail under applicable Belgian rules implementing the AIFMD.

²² A legal entity is not considered as an SME if it exceeds two or more of the following thresholds as regards the last and the preceding accounting year (criteria to be applied on a consolidated basis with respect to groups of companies): (i) number of employees working for the legal entity (annual average): 50; (ii) annual turnover: EUR 9,000,000; and (iii) balance sheet total: EUR 4,500,000.

iii. Summary of requirements for loan funds in this jurisdiction

	Belgium 
Fund structure	No specific regulation for loan origination funds, AIFs would need to comply with the applicable Belgian framework for AIFs. A specific and more stringent regime applies for AIFs that finance themselves through a public offer of securities in Belgium (so-called public AIFs, as compared to institutional AIFs who only target institutional investors).
Leverage limits	No specific regulation for loan origination funds, AIFs would need to comply with the applicable Belgian framework for AIFs.
Exposure limits	No specific regulation for loan origination funds, AIFs would need to comply with the applicable Belgian framework for AIFs.
Maturity and lock-ups	No specific regulation for loan origination funds, AIFs would need to comply with the applicable Belgian framework for AIFs.
Risk management	No specific regulation for loan origination funds, AIFs would need to comply with the applicable Belgian framework for AIFs.
Credit restriction	Consumer lending, mortgage lending and lending to SMEs is specifically regulated.
Other features	N/A

United Kingdom

i. Typical structures used by non-bank lenders in this jurisdiction

The UK is a comparatively straightforward jurisdiction from a regulatory perspective for private credit managers seeking to originate and make loans to commercial businesses. Typical structures used include UK, EU or third country AIFs, SPVs owned by such AIFs or securitisation or SPV vehicles being used as warehouse structures for CLO vehicles.

For pre-lending/loan origination activities, there is no banking licence or regulatory requirement in the UK. Invitations and inducements to engage in making loans (such as finding borrowers or origination activities) should not be caught by the UK financial promotion regime as primary lending is not considered to be an investment activity for these purposes.

For primary lending activities, there are unlikely to be any legal or regulatory licensing or authorisation requirements in the UK where a fund (or an SPV owned by a fund) is granting loans to UK borrowers.

ii. Barriers to non-bank lenders in this jurisdiction

There is withholding tax in the UK on interest payable by UK borrowers to non-UK lenders, absent an exemption or mitigation such as a double tax treaty. There is also a lack of choice of local fund vehicle structures in the UK on the corporate side in order to benefit from available tax exemptions and tackle changes in securities regulations which impact loan origination.

iii. Summary of requirements for loan funds in this jurisdiction

	United Kingdom 
Fund structure	Closed-ended or, in limited circumstances, open-ended (with redemption arrangements carefully matching the liquidity of the underlying loans).
Leverage limits	N/A
Exposure limits	N/A
Maturity and lock-ups	N/A
Risk management	Typical AIFMD requirements. Fund manager expected by its home Member State NCA to have, as part of its authorisation, policies to enable it to operate with respect to originating and managing loans.
Credit restriction	N/A
Other features	N/A

Chapter 4

Conclusion



Non-bank lenders already play a key role supporting European businesses by providing the finance they need to invest, grow and create new jobs. The lending activity undertaken by non-bank financial institutions does not give rise to the same potential risks as those which can arise from the traditional lending sector. Lending by credit institutions can transform short term deposits into long term loans, with an inherent liquidity mis-match and, if the institution is “too big to fail” wider systemic risk. Non-bank lenders raise capital from predominantly professional investors who have a greater capacity than bank depositors to understand the risks of their investment. Most non-bank lenders use closed-ended funds with longer redemption periods. This means that they are unlikely to pose the same risks as credit institutions to the stability of the financial system should they fail.

The regulatory considerations identified by policymakers in relation to non-bank lenders are generally well addressed by existing regulation of the alternative investment management sector. Additionally, we are not aware of any actual or potential harm to investors or borrowers arising from non-bank lenders that would necessitate further regulation beyond what is already provided for under existing regulation and supervision.

Although there has been a significant growth of non-bank lenders over recent years, alongside the growth in private credit more generally, the sector is still relatively small in comparison to the traditional forms of lending. Further growth of non-bank lenders will require policymakers to adopt a proportionate approach towards the regulation and supervision of the sector.

The imposition of unnecessary regulatory requirements on non-bank lenders at the current time would risk stunting the development of the market and reduce access to finance for European borrowers. As the market continues to develop, and more data becomes available, we would welcome further dialogue between policymakers and industry on how to support the sustainable development of the market, but we do not feel that further regulation or guidance is necessary at the current time.

Our members have identified several barriers within EU Member States that restrict the ability of non-bank lenders to operate (as outlined in chapter three of this paper). The ACC believes that national policy makers’ efforts should be focussed on removing these barriers in the individual Member States and supporting the growth of non-bank finance. We are encouraged to see that in a number of jurisdictions, this trend towards incremental improvement and reform has taken hold as non-bank lending regulations have continued to evolve dynamically, responding to market feedback.

It is essential for the dialogue that has taken place between policymakers, supervisors and industry to continue. This will allow us to promote knowledge sharing and understanding between stakeholders. The focus of this dialogue should now be on how to; (i) remove the barriers to finance flowing from the capital markets to European businesses, (ii) facilitate knowledge sharing between stakeholders on non-bank lending in Europe; and (iii) ensure non-bank lending benefits borrowers and enhances the financing of innovation throughout Europe. This will catalyse the growth of non-bank lending and support economic growth.



About ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 140 members that manage over \$350bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

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About Allen & Overy

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Fatima Al-Quaiti

Senior Professional Support Lawyer, London, Asset Management, Allen & Overy

Ellen Cramer-de Jong

Partner, Amsterdam, Asset Management, Allen & Overy

Francesco Guelfi

Partner, Milan, Regulatory & Tax, Allen & Overy

Brice Henry

Partner, Paris, Regulatory & Asset Management, Allen & Overy

Frank Herring

Of Counsel, Frankfurt, Regulatory & Asset Management, Allen & Overy

Sylvia Kierszenbaum

Partner, Antwerp, Regulatory & Asset Management, Allen & Overy

Salvador Ruiz Bachs

Partner, Madrid, Regulatory & Asset Management, Allen & Overy

Jean-Christian Six

Partner, Luxembourg, Asset Management, Allen & Overy

Nicholas Smith

Director, Alternative Credit Council

Members of the ACC Alternative Credit Technical Group



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