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Insights

AIFMD II LEVERAGE LIMITS AND SINGLE BORROWER EXPOSURE RESTRICTION

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SUMMARY

AIFMD II[1]introduces substantial changes to the EU-wide regulatory framework for alternative investment fund managers ("AIFMs") that was established under AIFMD. The changes cover a wide range of areas but will have a particularly significant impact on funds that originate loans. Among the new rules on loan origination activities are leverage limits and single borrower exposure limits which are particularly relevant for the use of back-leverage by private credit funds operating in the EU. These new rules will also be relevant for AIFMs in the UK managing credit funds located in the EU.

WHICH FUNDS ARE WITHIN SCOPE?

The leverage and single borrower exposure limits apply to "loan-originating AIFs", which are defined as alternative investment funds ("AIFs") established in the EU whose investment strategy is mainly to originate loans or whose originated loans have a notional value that represents at least 50% of their NAV.

AIFMs of loan-originating AIFs will be required to ensure that the AIFs adhere to the new limits. Private credit funds with an authorised AIFM in the EU are therefore within scope.

WHAT ARE THE NEW LEVERAGE AND SINGLE BORROWER EXPOSURE LIMITS?

The leverage limits are set at 175% for open-ended AIFs and 300% for closed-ended AIFs, expressed as the ratio between the AIF's exposure and its NAV[2]. Exposure is calculated using the commitment method under the AIFMD Level 2 Regulations. While AIFMD II does not itself make any changes to the commitment method as established under the original AIFMD framework, ESMA has previously noted the merit of considering amending the calculation methodology in light of recommendations published by IOSCO in 2019, making further changes in this area possible.

The recitals to AIFMD II also make clear that national regulators have latitude to impose stricter leverage limits if they deem it necessary in order to ensure the stability and integrity of the financial system.

In addition, AIFMD II also provides that when an AIF originates loan, the notional value of the loans originated to a category of single borrowers by the AIF does not exceed in aggregate 20% of the capital of the AIF.

WHICH BORROWERS ARE COVERED BY THE SINGLE BORROWER EXPOSURE RESTRICTION?

The single borrower exposure restriction applies to loans originated to financial undertakings, AIFs and UCITS.

AT WHAT LEVEL DO THE LEVERAGE LIMITS APPLY?

The leverage limits apply at the level of the AIF itself. However, it is currently unclear what approach regulators will take to leverage introduced elsewhere within funding structures. For example, while it is anticipated that lending at a portfolio company level would fall outside scope, the picture is less clear for back leverage introduced at an SPV level beneath the level of the AIF, particularly where the SPV’s liabilities may be in part guaranteed by the AIF. Further guidance on this issue may be issued before the deadline for implementation (see below), although there is a risk that any such guidance could be conservative in nature such that lending SPVs established by an AIF would also be caught (i.e. they would not benefit from the same treatment as portfolio companies in this respect).

ARE THERE ANY EXCLUSIONS?

There is an exclusion for borrowing arrangements that are fully covered by contractual capital commitments from the AIF’s investors. The leverage limits also do not apply to loan-originating AIFs that solely originate shareholder loans[3]not in excess of 150% of the AIF’s capital.

WHAT OTHER RULES ARE BEING INTRODUCED?

The leverage limits and single borrower exposure restriction are just part of a broader regime under AIFMD II regulating loan origination activities by AIFs. Among the other new requirements are measures relating to (i) concentration limits, (ii) risk retention, (iii) loans to connected parties, (iv) attribution of loan proceeds, and (v) risk management policies and procedures.

WILL THE CHANGES APPLY IN THE UK?

Following Brexit, the UK has established a domestic regime which generally maintains the regulatory framework in AIFMD as implemented at the end of the Brexit transition period (though earlier this month proposals were published to streamline the UK regime). The UK is no longer directly subject to EU law and the changes introduced in AIFMD II will not be binding on the UK. Nor does it appear likely that the UK will adopt domestic legislation mirroring the AIFMD II changes. This means that fund managers in the UK will not be directly subject to the requirements. However, where UK fund managers provide portfolio management services to EU AIFs under delegation arrangements, in practice they will need to comply with the new rules in their capacity as the delegate of the EU AIFM subject to the AIFMD II requirements.

The rules on loan origination activities as drafted are not expressly stated to apply to non-EU funds that market to investors in the EU. However, we have seen EU regulators take an increasingly expansive approach to interpreting the application of EU regulatory requirements in a cross-border context (for example in relation to sustainability disclosures under SFDR[4]) and it is possible that this approach may be reflected in future guidance.

WHEN DO THE LEVERAGE LIMITS COME INTO EFFECT?

AIFMD II entered into force on 15 April 2024. EU member states have until 16 April 2026 to implement the majority of the Directive, including the leverage limits and other rules on loan origination activities.

There are grandfathering provisions for pre-existing AIFs (i.e. that were established before 15 April 2024), which will be deemed to comply with the leverage limits until 16 April 2029, or indefinitely provided they do not raise additional capital. However, during the grandfathering period pre-existing AIFs must not increase their leverage beyond the new limits, or if they already exceed the limits, increase their leverage any further. This means that AIFs established between now and 16 April 2026 will need to comply with the new rules from the time they are implemented in each relevant jurisdiction.

HOW DOES AIFMD II TAKE EFFECT?

AIFMD II is not a standalone piece of legislation but instead will take effect by amending the original AIFMD and the UCITS Directive, which are the core pieces of legislation governing the operation of fund managers in the EU. As well as the new requirements for loan originating activities, AIFMD II also introduces changes relating to delegation arrangements, liquidity risk management, supervisory reporting, and the provision of depositary and custody services.

AIFMD II contains mandates for ESMA to develop a number of Level 2 measures in the form of technical standards, as well as to produce guidelines on certain topics. These will provide further detail and clarity on how the rules will apply in specific areas. Although ESMA has started its consultation process for some of the technical standards (including in relation to open-ended loan-originating AIFs), none are yet in final form. It will therefore be some time before the full extent of the new AIFMD II requirements is clear.

AIFMD II is not the only piece of recent EU legislation that may impact private credit funds. The CRD VI Directive, which was published in the Official Journal in June 2024, imposes a licensing requirement on non-EU lenders advancing loans to borrowers in the EU in certain circumstances. This licensing requirement is primarily applicable to third country credit institutions (i.e. firms that accept deposits and then lend to customers) and will not directly apply to fund managers and other non-bank lenders. However, there is a sense that the previously stable "rules of the road" and approaches taken by EU regulators and advisers in relation to cross-border lending may change in line with any guidance on how CRD VI will be interpreted for in-scope lenders. So even non-bank firms who are lending into the EU should be carefully monitoring how these rules develop and plan for contingencies.

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[1] The updated Alternative Investment Funds Managers Directive, Directive (EU) 2024/927 of the European Parliament and of the Council of 13 March 2024 ("AIFMD II").

[2] The 300% leverage limit equates to a leverage advance rate of approximately 66%, and the 175% limit equates to approximately 43%.

[3] A loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5 % of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking.

[4] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector ("SFDR").

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MEET THE TEAM

Matthew Baker

London

matthew.baker@bclplaw.com
+44 (0) 20 3400 4902

Damien Luqué

Paris

damien.luque@bclplaw.com
+33 (0) 1 44 17 76 90

William Trotman

London

william.trotman@bclplaw.com
+44 (0) 20 3400 4738