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EFMLG

AD-HOC REPORT ON NON-BANK LENDING AND ALTERNATIVE INVESTMENT FUNDS

The European Financial Markets Lawyers Group (the “**EFMLG**”) is a group of senior legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in the EU. The members of the Group are selected amongst lawyers working for major credit institutions based in the EU who are active in the European financial markets. The Group is hosted by the European Central Bank.

We refer to the Report issued by the European Banking Authority (the “**EBA**”) on 8 April 2022 setting out the findings and advice on digital finance in response to the European Commission’s request (the “**EBA Report**”). The EBA Report identifies various risks and concerns pertaining to non-bank lending and contains specific policy proposals that address them.

We would like to express the EFMLG’s support for the policy directions of the EBA Report and in this respect, we would like to especially stress the following points¹:

1. Non-bank lending is a reality and cannot be ignored: The factual situation – Market trends – The digitalisation of services as a catalyst for financial innovation

Over the course of the past ten years, the credit market has been experiencing a significant transformation. The need for an optimised allocation of market participants’ resources resulted in the development of non-bank lending. Financial markets have benefited from this development on a social and economic level. To date, non-bank lending has become a fast-evolving branch of finance.

¹ For the drafting of this Report/Letter we took into consideration especially a) the EBA Final Report on response to the non-bank lending request from the Call for Advice (of the European Commission) on digital finance dated of 8 April 2022, b) the IOSCO Report on Decentralized Finance of March 2022, and c) ESMA’s Opinion “Key Principles for European Framework on Loan Origination by Funds” dated 11 April 2016. From the literature on the subject matter, we would like to make special mention to the study of Promitheas Peridis titled “Alternative Lending: Risks, Supervision and Resolution of Debt Funds”, 2022, which we found very useful in our analysis.

Increased requirements regarding capital and strict regulatory tools for the supervision of credit institutions may lead to the transfer of risk to non-banks. Collective investment undertakings (notably alternative investment funds, “AIFs”), which are more risk-neutral and enjoy more leeway than the heavily regulated credit institutions, are willing to finance SMEs and micro-enterprises. Although the latter are highly reliant on bank lending, they may lack adequate access to bank financing, especially in those Member States whose banking systems are confronted with high NPL ratios. From this point of view, facilitating the SMEs’ and micro-enterprises’ access to credit while offering investors an opportunity to create profits at the same time, is important within the framework of the Capital Markets Union Action Plan as well. This is because such access would, ultimately, open the door for a transfer of resources from the capital markets to businesses and the real economy (including employees) in general.

Financial innovation is an important catalyst for this evolution. The AIFs open to lending activities are mostly evolving by using platforms and technological innovation. For instance, among others, Credit AIFs utilise lending platforms to find either potential borrowers, to whom they intend to extend credit, or prospective investors, to whom they transfer existing loans mostly for deleveraging and liquidity management purposes. New technologies and the digitalisation of financial services present more opportunities for new players to enter local EU markets. New credit intermediaries have emerged, and new lending models facilitated by online platforms are becoming more widespread. This concept of lending based on digital platforms providing an online market, which allows lenders to trade directly with borrowers, is not institutionalised in European law, except for crowd-lending strategies covered by the Crowdfunding Regulation.

Most of these novel financial products and services which are emerging and distributed on a cross-border basis by non-bank lenders replicate more traditional financial services and activities, but under weaker regulation; thus, they entail increased risks. However, financial innovation appears to present many similar risks to market integrity, investors, and financial stability as do the more “traditional” financial products and services. In this context, loan originating funds do tackle the need for lending of some market participants and do offer investment opportunities. At the same time, however, by being less regulated and less risk averse than the banking sector, they may also create risks for the financial system and damage investors. Despite that, the EU has not yet introduced a harmonised mandatory regulatory framework applicable to non-bank entities providing credit.

2. The EU legislative framework

Non-bank lending is largely un-harmonised across the EU. The structure of non-bank lending activities in the EU is varied; it includes a variety of activities and supervisory practices as regards the authorisation and registration of these activities in each Member State.

In some Member States, specific authorisations or registrations are necessary for non-bank institutions and entities to undertake lending activities. Such entities have thus to be specifically licensed to grant loans. Multiple types of authorisation regimes are implemented in the EU Member States, which are tailored to different kinds of non-bank lenders.

In particular, the requirements may differ on the basis of the specific entity (entity-based) or the specific activity (activity-based) to be authorised. However, some Member States combine entity-based requirements with activity-based requirements. For instance, leasing or factoring services may be provided, apart from credit institutions, only by entities licensed to carry out this specific lending activity. Other services would require additional licenses and a separate licensed entity. In this case, to unlock the full range of credit granting activities, investors are obliged either to establish a fully-fledged credit institution or to establish multiple single-purpose financial institutions – each entitled to provide only certain types of credit – thereby facing multiple costs, which may render their business plans unviable.

In other Member States authorisation is possible for multiple activities for a given entity: non-bank entities have a licence which allows them to carry out a wide spectrum of lending activities together with other types of financial or non-financial activities.

In some other cases, lending activities may be unregulated and thus not subject to any prudential or conduct requirements. In the absence of express activity restrictions, entities can carry out lending activities without prior authorisation being necessary for the conduct of such activities.

From an EU law perspective, the cross-border dimension of non-bank lending is crucial in the context of the single market. The fragmentation of the relevant legal framework across the Member States negatively affects the single market and impairs its functioning. First, it impedes a more extensive cross-border activity. Second, it results in limited visibility over cross-border activities. Third, it creates legal uncertainty, and, at the same time, it may lead to market participants' illegal behaviour which cannot be easily detected.

Therefore, it is important to identify the issues related to the provision of lending services by non-banks, in order to confront any impediments in the functioning of the single market, identify the micro- and macro-prudential risks associated with this activity, tackle legal uncertainty, and prevent the distortion competition.

Some of these issues are the following:

- **Regulatory arbitrage:** While some Member States apply the same macro-prudential tools for both non-bank lenders as well as for banks, regulatory arbitrage risks may arise if borrower-based measures are exclusively applicable to banks and are not extended to non-bank lenders. In such a case, there may be the incentive to bypass the restrictions by buying up loans to households issued by non-bank lenders. On the other hand, because credit institutions and non-banks operate differently regarding their activity as credit intermediaries, transferring or applying the strict banking legal framework to AIFs engaged in loan origination activities would not be an effective means to reduce the lending risk associated with non-banks' credit intermediation activities. Among others, this would contradict the fundamental principle of "same business, same risks, same rules", as AIFs, even if engaged in loan originating activities, are not necessarily exposed to the same risks as credit institutions. In any case, just obliging AIF Managers ("**AIFMs**") to comply with strict capital requirements, would not foster financial stability.
- **Home-host issues:** When lending is carried out nearly entirely through digital means, it is difficult to determine whether these activities are carried out based on the freedom to provide services or the right of establishment. For this reason, identifying the authority that is competent to supervise these activities is a difficult task.
- **Transparency, reporting, and disclosure:** Absent reporting obligations for cross-border lenders, home and host competent authorities may lack information pertaining to the lending activities and the performance of cross-border lenders.
- **Level playing field issues in light of the increased use of digital platforms:** The increased use of digital platforms and divergent rules applicable in the Member States may disrupt the level playing field.

3. Minimum common requirements needed for all non-bank lenders conducting business in the EU

Non-bank lending poses specific and unique challenges for the legislator and the regulators to consider. This is reflected in the EBA Report, as well as in the IOSCO Report of March 2022 on Decentralized Finance, as it was already the case in ESMA's Opinion "*Key Principles for European Framework on Loan Origination by Funds*" of 11 April 2011. According to the latter, creating a level playing field would lessen regulatory arbitrage and enable national authorities to assess the functioning of non-bank lenders and their impact on capital markets.

Taking into consideration the absence of non-bank lending regulation in the EU and, as already mentioned, the negative impact which this un-harmonised approach has on the single market, the EFMLG believes that the EU legislation should address this issue by means of enacting rules on non-bank lending introducing minimum common requirements applicable for all non-bank lenders conducting business in the EU.

The EFMLG supports the principle "Same business, same rules". As regards activity-based legislation, this principle should apply to all entities, regardless of whether they are credit institutions, regulated financial institutions, or non-regulated institutions. Hence, the set of requirements for credit for consumers or relating to residential immovable property should be met by all institutions and entities offering these services. In general, the consumer protection framework has to remain fit for all market players, whether credit institutions or not.

4. Lending by Alternative Investment Funds

The EBA Report mentioned above is very broad and covers different kinds of business models of non-bank lending ranging from consumer peer-to-peer ("**P2P**") lending to loans originated by financial institutions or other regulated entities. The present EFMLG ad-hoc report of does not pretend to cover all dimensions of this wide topic. Instead, we focus on exploring a regulated regime and what the most appropriate and practical tools are which would enable and foster credit provision. This in turn would diversify the currently limited funding sources for SMEs.

In this context, we acknowledge that a fully-fledged multi-activity financial institution with unlimited lending firepower, entitled to European passport rights, based on the minimum harmonisation principles, would be beneficial for the internal market. We recognise, however, that such a regulatory reform would probably require

considerable time and effort of the European legislator. This is owing to the complexity and likely controversy that would arise from the fragmentation and lack of harmonization of the pertinent regulatory EU landscape. A further consideration in this respect is the existence in many Member States of single purpose financial institutions, each entitled to the exercise of specific lending activities (e.g. financial leasing, factoring etc.).

For the following reasons we focus here on a specific form of non-bank lending which is carried out by Credit AIFs under the management of regulated AIFMs (a vehicle which could cover market needs to a significant extent):

- (a) the AIFMs, as regulated AIFs' managers, are already institutionalised; thus, credit vehicles, as Credit AIFs, under the management of an AIFM, will have significant potential to establish a fully-fledged EU private credit market;
- (b) there are pending legislative initiatives underway as regards both the establishing of a harmonized framework for loan originating funds under the AIFMD II Draft Directive and the fine-tuning of Regulation (EU) 2015/760 on European long-term investment funds (the "**ELTIF Regulation**").

In this sense, as a line of action to attain the proposed minimum common requirements applicable for all non-bank lenders conducting business in the EU, within the **entity-based regulation**, in order to address the lack of adequate non-bank financing for SMEs, the EFMLG supports the following proposals:

4.1. Amendment of Directive 2011/61/EU on AIFMs

The EFMLG suggests enhancing and expanding the scope of Directive 2011/61/EU on AIFMs (the "**AIFMD**"), in order for the Directive to also expressly cover the provision of lending, by credit AIFs managed by AIFMs, for which the European passport would apply, allowing the creation of loan-originating funds with a European passport. In some Member States AIFs are entitled to grant loans, thus acting as a substitute for bank lending. In other Member States, however, where the provision of loans is kept to regulated entities, this cannot be the case. A reform of the Directive, allowing the provision of loans by credit AIFs managed by AIFMs, for which the European passport would apply (both for the AIF as a product and for the AIFM), is thus advisable.

In that respect, the EFMLG supports the EU Commission's proposal on AIFMs active in credit markets released on November 2021 and the subsequent EU Council final compromise text of June 2022, as the most practical and appropriate tool for the realisation of a common European regime on non-bank lending. While the draft

Directive is currently in its trilogue phase, both texts seem to constitute a solid basis permitting the exercise of non-bank lending activities in all EU Member States in a single and harmonised manner in a regulated environment². In this context, we believe that the new regime should establish the right of Credit AIFs, including loan originating funds, under the management of AIFMs, to extend credit to all Member States under a European passport, in order to foster their cross-border activity, which could in turn contribute to the creation of a single private credit market across the EU. That is not in our view adequately stipulated in the current AIFMD II Draft Directive.

4.2. Supervision and Regulation of Credit AIFs / Loan Origination AIFs

In the context of the proposed institutionalisation of Credit AIFs, loan origination should be clearly and comprehensively defined and be confined to closed-end AIFs managed by regulated entities (the AIFMs). The activation of such Credit AIFs, being subject to a regulatory regime to be appropriately developed, does not entail inherent disproportionate risks for the financial system. Thus, their establishment in the whole European single market should be promoted, taking into consideration the benefits they can provide. Alternative lending should be rather regarded as complementary to the banking system, since it is addressed to different market participants, mostly falling out of the credit institutions' focus.

Credit AIFs should operate under transparency, liquidity, risk management and risk retention rules, enhanced supervision mechanisms, and crisis management tools. These mechanisms could reduce the risks associated with alternative lending, lessen regulatory arbitrage and potentially prevent the disruption of the wider financial system, if any of the said risks are realised. This set of reforms should not only cover loan origination activities but equally loan restructuring/participation and loan servicing activities.

² However, the Compromise Text's recitals seem to allow the imposition of further restrictions in Credit AIFs by provision of national law. In particular, pursuant to the Compromise Text's recitals: *"the provisions laid down in this Directive that are applicable to AIFMs that manage loan-originating AIFs should not prevent Member states from setting forth national product frameworks that define certain categories of AIFs with more restrictive rules. These national rules should apply to the AIF established in the Member State that has decided to exercise the discretion to the extent that these rules are more restrictive than the general provisions laid down in this Directive"*. Although that derogation seems reasonable with regard to consumer lending, we are of the view that it should be interpreted narrowly for all other types of credit, as the imposition of divergent national law restrictions to the Credit AIFs' lending activities could hamper their potential cross border activity and thus the creation of a single EU private credit market.

Particular importance should be given to the establishment of macro-prudential tools as macro-prudential risks are important if the non-banking activity affects the macroeconomic environment. These may lead to less contagion and spill over risks between the Member States themselves and between the Member States and the EU as a whole. Admittedly, the AIFMD was not designed to cover the macro-prudential risks posed by credit AIFs. In this context, we support the ECB's Opinion of 9 August 2022 on the AIFMD II Draft Directive³ on the need for more elaborate macro-prudential tools "*applied ex ante as a means of reducing risks to the financial system that are posed by AIFs*"⁴. Therefore, designing a more elaborated systemic macro-prudential risk management framework, to assist non-bank lenders to manage systemic risk stemming from the AIFs' credit activity, is necessary. In this context, appropriate regulatory tools to trace, assess and reduce the macro-prudential risks of such lending activity, such as risks of excessive leverage and structural vulnerabilities, as well as to cover servicing and risk processing activities, should be developed. This framework should entail crisis prevention tools as well as crisis management tools⁵.

We do not suggest the application of the same strict capital rules and supervisory mechanisms which apply to credit institutions to credit AIFs and their managers, since Loan Originating AIFs have neither access to deposits or other repayable funds from the public, nor to standard central bank liquidity, are less interconnected with the rest of the financial system and generally pose lower risks to financial stability than banks.

Finally, AML/CTF rules, as well as conduct of business and transparency rules should apply both to Credit Funds as well as to credit institutions on an equal basis. This is the case for example for disclosure and transparency rules, rules on mis-selling practices,

³ ECB's Opinion of 9 August 2022 on the proposal for a directive as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds (CON/2022/26) (2022/C 379/01).

⁴ The same need is addressed by the EU Commission, as well as the ECB and the ESRB, namely, to expand the EU macro-prudential policy in order to cover alternative lending, through the proportional enactment of liquidity, leverage and other macro-prudential tools, capable of influencing the cost and the availability of credit over the economic cycle and tightening the credit underwriting standards of the loan originating funds. EU Commission, "Consultation Document Review of the EU macro-prudential policy framework, August 2016, 41; ECB, "Contribution to the European Commission's Consultation on the Review of the EU Macroprudential Policy Framework", December 2016, [https://www.](https://www.ecb.europa.eu/pub/pdf/other/revieweumacroprudentialpolicyframework201612.en.pdf)

[ecb.europa.eu/pub/pdf/other/revieweumacroprudentialpolicyframework201612.en.pdf](https://www.esrb.europa.eu/pub/pdf/other/20161024_ESRB_response_EC.en.pdf); ESRB, "Response to the European Commission's Consultation Document on the 'Review of the EU Macro-Prudential Policy Framework'", October 2016, https://www.esrb.europa.eu/pub/pdf/other/20161024_ESRB_response_EC.en.pdf.

⁵ In the case of systemically significant Credit AIFs, the further introduction of crisis prevention and management tools should be examined, considering that loan-originating funds generally do not have access to public backstops or central bank liquidity.

and complaint handling. In that respect, the progressive digitalisation of financial services has led to new market developments, new ways of product, investment and services promotion, and new financial and lending products which may not be adequately captured by the existing framework.

4.3. Amendment of the ELTIF Regulation

In the same vein, overhauling the role of the European Long Term Investment Funds (hereinafter “**ELTIFs**”) should be considered. The ELTIFs are the only type of AIF directly regulated at EU level and equipped under EU Law with passport rights enabling them to provide – across the EU – all types of financing (including credit) to certain eligible qualified portfolio undertakings, irrespective of any contrary national law restrictions. However, despite the ELTIFs’ potential to boost retail investors’ commitment to long-term investments and establish a cross-border private credit market for crucial late-stage growth financing to SMEs, the inherent regulatory constraints imposed by the ELTIF Regulation hamper the ELTIFs’ attractiveness to investors and *a fortiori* their potential cross-border activity.

In this regard the EFMLG supports the European Commission’s proposal for a Regulation amending the ELTIF Regulation as regards the scope of eligible assets and investments, the portfolio composition and diversification requirements, the borrowing of cash and other fund rules and as regards requirements pertaining to the authorisation, investment policies and operating conditions of ELTIFs of 25 November 2021⁶, on which the European Parliament and the Council have reached agreement on 19 October 2022⁷. In our view, this set of reforms could constitute a decisive first step towards the transformation of alternative lending into a “resilient market-based finance”.

⁶ Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2015/760, COM (2021) 722, final 2021/0377 (COD), available at: <https://eurlex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0722>.

⁷ <https://www.consilium.europa.eu/en/press/press-releases/2022/10/19/european-long-term-investment-funds-provisional-agreement-reached/>.