New Legal Framework Regarding Loan Funds in Germany

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BaFin, the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht) last year eased its administrative practice with respect to loan origination and loan restructuring activities of alternative investment funds (AIFs). This change – set forth in a May 2015 interpretative decision (BaFin Guidance) – was welcomed by the German fund industry as it mirrors similar initiatives adopted in other EU Member States that have created legal frameworks for loan origination funds. The change addresses concerns of investment managers, who had struggled with the fact that they were restricted from restructuring or extending the duration of loans originated by third parties and that were subsequently acquired by AIFs managed by German managers, even if such restructuring activities would have been in the best interests of investors.

Following the BaFin Guidance, the German legislator responded by enacting the UCITS V Implementation Act (Act), which amended the German Capital Investment Code (Kapitalanlagegesetzbuch, or KAGB) and the German Banking Act (Kreditwesengesetz, or KWG) in relation to loan funds. The Act, which entered into force on 18 March 2016, provides an ability for certain types of AIFs to originate loans to German borrowers, thereby creating an alternative to the more traditional – but cumbersome – loan origination mechanisms previously used.

This article summarizes key changes regarding the operation of German loan funds introduced by the Act. For further information regarding the BaFin Guidance, please refer to Dechert OnPoint, New Guidance from the BaFin on Debt Funds, available at https://www.dechert.com/New_Guidance_from_BaFin_on_Debt_Funds_05-20-2015/.

Impact on German AIFs and their Managers

Acquisition of Unsecuritized Loan Receivables

Prior to the BaFin Guidance, loan origination and restructuring activities were often considered to be credit business, and in principle required a banking license under the KWG. The acquisition of unsecuritized loan receivables was permitted both for German AIFs limited to certain professional investors (Special AIFs) and certain types of German domestic retail AIFs. However, the BaFin Guidance suggested that investment by open-end Special AIFs which are subject to certain investment restrictions broadly used by German institutional investors (Special AIFs with Fixed Terms) in unsecuritized loan receivables should not exceed 50% of the aggregate capital of such AIFs. This recommendation was criticized by market participants and industry associations, particularly since certain types of retail AIFs (which would typically be subject to greater restrictions, given their investor base) were still allowed to invest a much higher percentage of their capital in unsecuritized loan receivables.

The Act does not adopt the BaFin recommendation – the regime for Special AIFs with Fixed Terms remains unchanged, and such AIFs are permitted to invest up to 100% of their capital in unsecuritized loan receivables.

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Restructuring and Extension of Duration of Unsecuritized Loan Receivables

In practice, prior to the BaFin Guidance, management companies (Kapitalverwaltungsgesellschaften, or KVGs), as well as foreign investment managers operating pursuant to an outsourcing mandate from a German KVG, often faced the risk that restructuring a loan could constitute a breach of the German Banking Act, even if this would have been advisable in investors’ best interest. As a result, the only remaining option may have been to sell an unsecuritized loan receivable, with the result that many potential market participants in fact did not engage in this asset class in the context of German funds.

Following much discussion, the Act has adopted the BaFin Guidance and now provides that German Special AIFs can vary loan terms without such activity deemed to be the granting of a loan that would require prior authorization pursuant to the KWG. Due to this change, it is now possible for KVGs to more efficiently manage unsecuritized loan receivables in which they invest for a Special AIF with Fixed Terms and other AIF types, and to act in investors’ best interests if a restructuring becomes necessary.

Granting of Loans (Direct Lending)

Prior to the BaFin Guidance, the granting of loans by, or for the account of, an AIF required a banking license under the German Banking Act and was in principle impermissible. An exemption applied only to the making of certain shareholder loans for the account of certain types of AIFs.

The Act: (i) amends the KWG in that the granting of loans as part of collective portfolio management by a KVG is no longer covered by the concept of banking transactions, and therefore is excluded from the KWG; and (ii) amends the KAGB to now permit the origination of loans by specific fund types, provided that certain requirements and restrictions are complied with.

In summary:

- It is possible for AIFs that qualify as specific fund types – such as European long-term investment funds (ELTIFs), European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF) – to originate loans.

- Investment funds established as German closed-end special AIFs benefit from the most far-reaching changes. As had already been suggested in the BaFin Guidance, it is now possible for closed-end Special AIFs to grant loans to third parties not associated with the investment fund (External Loans). Such AIFs are subject to a leverage limit of 30% of the total capital commitments, and a concentration limit whereby not more than 20% of the aggregate committed capital may be extended to a single borrower. Further, the BaFin recommendation that closed-end Special AIFs should not be allowed to grant loans to consumers was also adopted. A more flexible regime applies to shareholder loans.

2 The ELTIF regime was established pursuant to the regulation on European long-term investment funds (Regulation (EU) 2015/760). The aim of the ELTIF is to increase the pool of capital available for long-term investment in Europe and in particular for infrastructure projects, small- and medium-sized enterprises, research and development and education. An ELTIF can be marketed both to professional investors and retail investors under a European passport. It is, however, subject to certain investment and borrowing restrictions. For further information, please refer to Dechert OnPoint, Your Guide to European Long-Term Investment Funds (ELTIFs), available at https://www.dechert.com/Your_Guide_to_European_Long-Term_Investment_Funds_ELTIFs_05-31-2016/.
Open-end Special AIFs with Fixed Terms remain unable to grant External Loans, but can grant shareholder loans.

Closed-end retail AIFs are permitted to grant shareholder loans under certain restrictions, but not External Loans.

The legal situation regarding open-end retail AIFs has not changed. They are still not permitted to grant loans, except in the case of real estate funds granting loans to real estate companies.

UCITS remain unable to grant loans.

**Risk Management Requirements**

Since the origination of loans and the acquisition of unsecuritized loan receivables involves specific risks, the KAGB stipulates additional organizational requirements for KVGs that grant loans or acquire unsecuritized loan receivables.

A KVG that grants loans or invests in unsecuritized loan receivables for the account of an AIF must have adequate structures and procedures in place covering, in particular, credit processing, the management of non-performing loans, and the early detection of risks.

These are minimum requirements in terms of risk management, as to which further guidance is awaited from the BaFin. The legislative history of the Act indicates that such requirements, if suitable, will follow the Risk Management Requirements (MaRisk) for banks.

Shareholder loans are exempted from these requirements. This exemption is intended to take into account the practical requirements, especially in the areas of private equity, venture capital and for structuring special purpose vehicles.

**Impact on EU and Non-EU AIFs/AIFMs**

**EU AIFs/EU AIFMs**

The cross-border origination of loans by EU AIFs and EU AIFMs into Germany is permitted without needing to obtain a banking license under the KWG, insofar as such “lending activity” is part of the permitted investment management activities (kollektive Vermögensverwaltung) of such an EU AIF/AIFM.

However, the investment, leverage and risk management restrictions referred to above that are applicable to German AIFs and AIFMs, based on the wording of the changes implemented by the Act, do not apply – this provides an advantage to a non-German EU AIF that is managed by a non-German EU AIFM, as compared to a German AIF or a German AIFM.

We understand that the German legislator has made this distinction because it expects the home Member State of the non-German EU AIF or non-German EU AIFM to impose some form of qualitative risk management obligations or at least some form of “regulatory oversight” that is broadly comparable to the additional German requirements. The recent ESMA opinion for a common European framework to apply to loan origination activities by AIFs will likely address these requirements. For further information, please refer to Dechert OnPoint, ESMA Lends Support for a Harmonised European Framework for Loan Origination Funds, available at
Although the wording of the new German law refers only to “lending activities” of an EU AIF/AIFM, it may be argued that loans granted by a controlled subsidiary of an EU AIF (which is typical in a cross-border loan origination structure) should benefit from the exemption to obtaining a banking license.

**Non-EU AIFs/AIFMs**

For non-EU AIFs/AIFMs (such as U.S. managers managing U.S. or Cayman funds that intend to originate loans to German borrowers), the exemption under the KWG for the cross-border origination of loans into Germany only applies if the relevant AIF may be sold in Germany based on a prior notification procedure with respect to semi-professional investors. However, a notification procedure in relation to professional investors (which is subject to a lighter regime) is not sufficient.

In this regard, the legislator wanted to ensure that the non-EU AIF/AIFM must be subject to effective public supervision, and that the AIF/AIFM must comply with the requirements of the AIFM Directive. This is meant to ensure a level-playing field with EU AIFs/AIFMs. However, this requirement seems impracticable since it will likely exclude non-EU AIFs/AIFMs that are generally not in compliance with the framework of the AIFM Directive.

**Summary**

The ability for AIFs to originate loans presents a significant contribution to financing the real economy and offers a meaningful expansion of indirect investment opportunities for certain groups of investors. Adjusting the regulatory framework with regard to German AIFs and EU AIFs/AIFMs should be welcomed and creates legal certainty in this market segment, which is also of interest for investors who are in search of alternative fixed income asset classes. The statutory changes should further encourage the establishment of German loan funds and foreign funds focusing on the German market, as well as the assignment of relevant mandates to specialized managers.

However, the changed framework for non-EU AIFs/AIFMs seems impracticable since, in our view, the requirement of a notification procedure including the minimum standards for semi-professional investors is likely to exclude non-EU AIFs/AIFMs that are not in compliance with the framework of the AIFM Directive. Such non-EU investment managers may consider using EU AIFs to enter the German loan and investor market.

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