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Allen & Overy briefing paper

*Loan origination and loan restructuring by
German AIFs – new administrative
practice of the BaFin*

Ever since the financial crisis of 2008/2009, lending activities of non-banks – including investment funds – have become more important. Regulators and legislators initially regarded this with some concern, dubbing the lenders as “shadow banks” and calling for tougher regulation.

Now, the picture has changed, at least in Europe, and finally also in Germany. On the one hand, legislators have realised that the decrepit infrastructure in many EU countries can only be refinanced with the help of the private sector, notably insurance companies and pension funds. On the other hand, these investors are looking for the famous “risk-free 4%” return on invests, which in these days are hard to find. Private loans offer attractive yields, allowing institutional investors to meet their yield objectives.

In March this year, the German financial services regulator (**BaFin**), which supervises banks, asset managers and insurance companies, released new rules allowing insurance companies to invest into funds that exclusively invest into non-securitised loan receivables. This was a major step forward and has been widely greeted by investors and the fund industry alike.

However, when it comes to lending to borrowers in Germany, funds and other lenders had to cope with the licence requirements for lending under the German Banking Act (*Kreditwesengesetz* – **KWG**). If a fund wanted to act as lender, it either had to cooperate with a fronting bank, or it had to purchase loan receivables in the secondary market. The restructuring or prolongation of such loan receivables also proved to be tricky, as again licence requirements were triggered.

Now, on 12 May 2015, BaFin published an administrative information letter explaining a change in its administrative practice in relation to the granting as well as the restructuring and prolongation of loans and loan receivables for the account of Alternative Investment Funds (**AIFs**).¹ Certain (closed-end) AIFs may now originate loans, whereas other (open-end) AIFs – and these are the more important ones – are permitted to restructure and prolong loan receivables acquired for the account of these AIFs, subject to certain limitations.

The change in the administrative practice is due to the European legal situation (eg loan originating funds are now expressly permitted in Ireland, Malta and Latvia), as well as in consideration of current discussions by the European Securities and Markets Authority (**ESMA**). These changes can be considered as a significant paradigm shift as the granting of loans and the restructuring and prolongation of loan receivables by AIFs are now to be seen as part of collective investment management and are therefore permissible in Germany to the extent that they are consistent with the provisions of the German Investment Code (*Kapitalanlagegesetzbuch* – **KAGB**).² The former limitation on the basis of the KWG is no longer upheld – at least not for German AIFs and their AIF Management Companies (**AIFMs**).

In this respect, the BaFin recommends that AIFMs wishing to originate and/or restructure loans and loan receivables comply with certain minimum requirements for the granting of these loans and the acquisition and restructuring or prolongation of non-securitised loan receivables, as well as for the granting of shareholder loans for the account of an AIF, until the corresponding legal provisions come into effect.³ BaFin's recommendations should already be followed now when structuring AIFs intending the granting or investment into loans for the account of the AIF as the BaFin made it very

¹ Internet reference:
http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/WA/ae_150512_kreditfonds_aif.html.

² Internet reference:
http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2015/meldung_150513_verwaltungspraxis_kreditfonds_en.html.

³ Internet reference:
http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2015/meldung_150513_verwaltungspraxis_kreditfonds_en.html. Shareholder loans are not in the scope of this briefing paper.

clear that if an AIF and its AIFM respectively do not follow these recommendations, they will have to modify their business and that of the managed AIF when the amended KAGB enters into force.

This briefing paper describes the current administrative practice before explaining the new administrative practice of the BaFin regarding loan origination and loan restructuring by or for the account of an AIF in more detail.

Summary

- Loan and/or debt strategies are increasingly popular with institutional investors. Until March 2015, the acquisition of non-securitised loan receivables by some AIFs was permitted, but effective management has quickly come up against regulatory limits. Loan origination was generally not permitted by or for the account of an AIF.
- Pursuant to the new BaFin administrative information, not only the restructuring of loans but also the granting of loans for the account of particular AIFs now form part of collective asset management and thus fall outside the limitations set by the KWG.
- The BaFin's administrative information solves important problems for the industry and investors, such as the question of whether and when the restructuring of loans of AIFs requires permission under the KWG.
- BaFin clarifies that certain – closed-end – AIFs may now even grant loans themselves and directly (without any fronting bank) pursuant to the KAGB. This is a real innovation and an important signal for Germany as a fund location.
- Open-end AIFs are not permitted (recommendation) to originate loans but may now restructure acquired loan receivables. However, this easing was not for free: such open-end AIFs which were permitted to invest up to 100% in loan receivables in the past are now limited to 50% regarding their investment in loan receivables.
- In any event, the risk and liquidity management of AIFMs investing in or originating loans for the account of AIFs must be appropriate. At the very least, the loan originating AIFs and their AIFMs respectively must comply with credit procedures that are similar to the ones for banks.

Background

As mentioned above, under the administrative practice hitherto applicable, the granting of loans for the account of AIFs (and other investment funds) was generally not permitted. The administrative practice was based on section 32 (1) sentence 1 of the KWG which stated that anyone wishing to conduct lending business in Germany commercially or on a scale which requires a commercially organised business undertaking requires a written licence from the BaFin. In practice, the administrative practice of the BaFin meant that a fund could “grant” loans only by using a fronting bank that granted the loans and then immediately sold it to a fund.

Whereas the origination of a loan was generally not permitted, the acquisition of loan receivables by certain AIFs was permitted (eg Other Investment Funds (*Sonstige Sondervermögen*) or Special-AIF with fixed investment guidelines (*Spezial-AIF mit festen Anlagebedingungen*)). The situation got tricky when such an acquired loan receivable had to be restructured as this was generally considered as loan origination resulting in the licence requirement; only in very limited circumstances the BaFin conceded that “emergency restructuring” was not to be seen as a KWG-licenseable activity.

New administrative practice

The change in the administrative practice of the BaFin is predominately influenced by recent statements by an ESMA officer, published in ESMA's Report No. 1, 2015 on Trends, Risks and Vulnerabilities in European Union (EU) securities markets, where fund investments in loan receivables and loan origination were deemed permissible.⁴

In amending its administrative practice, the BaFin has acknowledged that the granting of loans as well as loan restructuring and prolongation by AIFs are now deemed to be part of collective investment management and are therefore permissible to the extent that they are consistent with the provisions of the KAGB. Accordingly, the provisions of the KAGB need to be considered *lex specialis* in relation to the provisions of the KWG as the granting, restructuring and prolongation of loans for the account of AIFs qualify as collective asset management activities, which are not governed by the KWG and are therefore exempt from banking licence requirements.

Granting, restructuring and prolongation of loans – effectively limited to closed-end funds

A consequence of the change in the administrative practice of the BaFin is that both the origination as well as the subsequent restructuring and prolongation of loans for the account of AIFs would generally be permitted for those AIFs for which the KAGB does provide no or only limited product requirements, namely:

- Open-end general Special-AIF under section 282 of the KAGB;
- Hedge funds under section 283 of the KAGB;
- Closed-end Special-AIF under section 285 of the KAGB; and
- All Special-AIFs and Public-AIFs which fall under sections 2 (4), (4a) and (4b) of the KAGB (registered *de minimis* AIF⁵).

However, the BaFin recommends that only closed-end funds should originate loans – effectively limiting loan origination to closed-end funds. This administrative practice of the BaFin differs from the original ESMA interpretation as no differentiation has been made between open-end Special-AIF and closed-end Special-AIF in the ESMA publication. In addition, the BaFin confirmed that loans cannot be originated for the account of an UCITS.

The granting of loans for the account of (closed-end) AIFs is subject to further recommendations (which should be followed):

- **Risk Management:** A requirement that will result in some practical issues is that AIFMs should establish and implement proper risk management regarding the risks for the (closed-end) AIFs originating loans. The BaFin expects those AIFMs which manage loan originating AIFs to comply with requirements and procedures similar to the ones for banks, ie in particular, segregation of duties and credit voting, loan processing and granting, loan payout, intensified loan management, treatment of problem loans, risk provisioning, early detection of risks, risk classification procedures and (internal) reporting.
- **Risk-spreading:** While risk-spreading is normally not a requirement for closed-end AIF, the AIFM should spread the risk for the loan originating AIF, ie the AIF should have several borrowers for the loans originated by the (closed-end) AIF. This may in practice be a burdensome exercise if the AIFM has to consider several borrowers in one group or from a risk point of view as one borrower and if the AIFM has to identify and monitor a group of connected clients.⁶

⁴ Internet reference: http://www.esma.europa.eu/system/files/esma-efs_trv_1-15_526.pdf.

⁵ Registered AIFs/AIFMs are not further discussed in this briefing paper.

⁶ Banks have solved this difficulty by using the so called “*Evidenzzentrale*” of the German Bundesbank, which collects all major borrowers and creates “groups of connected clients” (*Kreditnehmereinheiten*) for information purposes.

- **Conflicts of interest:** Furthermore, the AIFM should not grant loans to persons or companies on account of (closed-end) AIFs if the granting of such loans may lead to a conflict of interests which non-granting would have avoided; the BaFin focuses in particular on loans for the account of the AIF to the AIFM, for the account of the AIF to the custodian and for the account of the AIF to delegates of the AIFM and the custodian. In the event that conflicts cannot be avoided, the AIFM has to take measures pursuant to section 26 (2) No. 3 of the KAGB for the investigation, settlement, observation and, if necessary, disclosure of this conflict of interests.
- **Leverage restrictions:** The leverage of the AIF should be restricted; however, the BaFin does not impose a strict limit but rather mentions, inter alia, the Irish loan originating funds which can leverage up to 200%. We expect more information on leverage limits in the amended KAGB.
- **No consumer loans:** No loans should be granted to consumers for the account of (closed-end) AIFs. However, the BaFin is, to some extent, undecided in this regard as the BaFin points out that if such consumer loans are originated, these must comply with the consumer loan information requirements.
- **No deposit-taking:** The AIF and its AIFM respectively should not at the same time grant to and receive loans from the public, as this may lead to the fund being regarded as a credit institution within the meaning of Regulation EU No. 575/2013 (Capital Requirements Regulation – CRR).⁷
- **Avoiding maturity mismatches:** Long-term loans originated by the AIF should not be financed by short-term loans. AIFMs which manage (closed-end) loan originating AIFs can restructure such loans and can also acquire loan receivables and restructure them under the same requirements as open-end AIFs can restructure loan receivables acquired for the account of those (open-end) AIFs (cf. hereafter).

Purchasing and restructuring/prolongation of non-securitised loan receivables under the product regulations of the KAGB

As a further consequence of the change in the administrative practice of the BaFin, the restructuring and prolongation of loan receivables is now also permitted for such (open-end) AIFs, for the account of which loan receivables can be bought; this covers the following open-end AIFs:

- Other Investment Funds pursuant to section 220 of the KAGB (*Sonstige Sondervermögen*);
- Micro Finance Investment Funds pursuant to section 222 of the KAGB (*Mikrofinanzinstitute*);
- General open-end Special-AIF pursuant to section 282 of the KAGB;
- Special-AIF with fixed investment guidelines pursuant to section 284 of the KAGB (*Spezial-AIF mit festen Anlagebedingungen*); and
- Hedge funds pursuant to section 283 of the KAGB.

However, this welcome change has come with a price: open-end Special-AIFs (in particular, but not limited to, the important Special-AIF with fixed investment guidelines) should only invest up to 50% of their NAV into loan receivables. This is a setback compared to the former situation where such open-end Special-AIFs could be fully invested into loan receivables.

This regression is of particular importance for AIF-investors which are German insurance companies. The recently amended Investment Ordinance (*Anlageverordnung*) makes investments into Special-AIF being invested up to 100% into loan receivables an eligible asset for the restricted assets. Now the KAGB has struck back, limiting this possibility to 50% of the NAV, insofar as German funds are concerned.

⁷ Regulation 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, Internet reference: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0575&from=DE>.

This 50% limit should not be relevant for the Special-AIF having invested up to 100% into loan receivables before 12 Mai 2015, but this limit should be considered when establishing a fund thereafter. It remains to be seen which grandfathering provisions will be included in the amended KAGB.

Continuing need for clarification – EU, EEA and third countries

The new administrative practice of the BaFin can be considered as a significant paradigm shift and might lead to positive impacts as it opens up new possibilities to use closed-end AIFs as a vehicle for direct lending to German borrowers without the requirement to use a fronting bank. Open-end and closed-end AIFs now have certainty that they may engage in the restructuring of loan receivables. Taking into account that the material scope of application is per se limited to German AIFs, however, some outstanding issues need to be clarified in order to create certainty.

In particular, a question arises in relation to non-German funds granting cross-border loans to German borrowers. As stated by the BaFin, the granting as well as the restructuring and prolongation of loans for the account of AIFs are to be seen as part of collective investment management and are therefore permissible to the extent that they are consistent with the provisions of the KAGB. By taking into consideration that the provisions of the KAGB pertain to the implementation of the Alternative Investment Fund Managers Directive⁸ (AIFMD) in Germany, EU-AIFs, too, should be permitted to grant, restructure or prolong loans for German borrowers, if they have the EU-passport for collective investment management in Germany.

However, while German law must not discriminate against EU funds, given the harsh consequences of engaging in lending business without the required licence, as an EU-AIF, one should probably seek a clarification from BaFin before lending to German borrowers.

Further, a question arises with regard to German AIFMs intending to offer cross-border lending to borrowers in other EEA countries. Clarification is needed in particular if other EEA member states do not take into account the ESMA interpretation which deems loan origination for the account of AIFs permissible.

Under German law, a licence requirement would not be triggered if a German borrower has addressed a non-EU-AIFM without previously being approached by the non-EU-AIFM (reverse solicitation). Conversely, this means that a licence requirement might be triggered if the non-EU-AIFM (not able to use the EU-passport for its collective investment management and not subject to interpretation of EU laws) targets German borrowers in order to offer cross-border lending frequently and on a commercial basis.

Allen & Overy is happy to advise you in relation to this topic as well as further regulatory issues.

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⁸ Internet reference: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32011L0061&from=EN>.

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