Fund Finance

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Overview

The most significant developments in the German fund finance market in recent years are the new regulations reflecting the changed view of the German Federal Financial Supervisory Authority ("BaFin") on allowing debt funds (as well as insurance companies and certain other investors) to invest in leveraged funds. Since the changes to the debt funds regulations, we have seen increasing activity by debt funds in Germany.

There is also a growing interest by German funds in subscription credit facilities as a means of bridging the financing needs between capital calls. As opposed to the United States or the United Kingdom, the German market for subscription credit facilities is at a very early stage. Subscription credit facilities transactions are still rare and German banks do not seem to be engaging in this type of business yet. However, sponsors of German funds increasingly include provisions in limited partnership agreements, allowing the funds to take up subscription credit facilities.

Debt funds in Germany

Regulatory environment

Historically, Germany was not a good place to be for funds wishing to originate their own loans or restructure and/or extend the duration of loans originated by third parties, as these activities were (with few exceptions) restricted for funds, and only permissible after obtaining a banking licence (with a cumbersome licensing process) or establishing a work-around mechanism, which entailed a certain degree of legal uncertainty. Following ongoing concerns expressed by industry practitioners and lobbying groups, as well as to keep pace with European legislative developments, Germany has since opened up (a little) since 2016.

Back in March 2016, the German legislator – following a change in the administrative practice of the German Federal Financial Supervisory Authority ("BaFin") in May 2015 – amended the German Capital Investment Act ("KAGB") and the German Banking Act ("KWG") in order to permit certain alternative investment funds ("AIFs") to issue loans as well as restructure and extend the duration of unsecuritised loan receivables.

Prior to this change, the granting of loans by a German AIF would have required a banking licence under the KWG, which in practice was not a feasible option for an AIF. Instead, if the German AIF intended to originate loans, it would rely on a so-called fronting-bank model, where a fully licensed German bank granted the loans and then subsequently transferred the loan receivables to the German AIF. Utilising such fronting-bank model is now no longer necessary. A banking licence is no longer required, provided the specific AIFs meet certain requirements. Then, loan origination is no longer deemed a banking activity subject to the

KWG, but rather a "collective investment management activity", subject to the KAGB. The same can be said for restructurings, including maturity extensions of existing loans. The KAGB henceforth thus supersedes the KWG in this regard.

The most important restrictions and requirements introduced, to be met by German AIFs and their respective German AIFMs, in order for them to fall outside the requirements of the KWG, are:

- the AIF must be closed-ended and may only admit professional and semi-professional investors as investors ("*Spezial*-AIF"). An investor is considered semi-professional if it is sophisticated and experienced and invests at least €200,000 in such AIFs;
- the AIF may not grant loans to consumers;
- the AIF may not incur fund-level debt of more than 30% of its aggregate contributed and undrawn committed capital available for investments (after deduction of any costs and expenses borne by investors) ("Investment Capital");
- the AIF may not grant loans to any one borrower in an aggregate principal amount in excess of 20% of the Investment Capital; and
- the AIFM managing the AIF must also satisfy the following requirements:
  - certain risk-management requirements consistent with the risk-management requirements applicable to the loan origination businesses of banks; and
  - reporting obligations for loans in a principal amount of €1 million or more.

Unhelpfully, the German regulator takes the view that a German AIF may not provide any guarantees or other security – which can prove to be problematic in connection with subscription facilities.

EU and third-country debt funds

The above requirements only explicitly apply to German AIFs and German AIFMs. Consequently, EU AIFs and EU AIFMs may engage in loan origination in Germany without meeting any specific German requirements. The loan origination business of such AIFs is subject only to home state regulations.

Third-country AIFs (and their AIFMs), however, will benefit from the new rules only if they are admitted for marketing to semi-professional investors or retail investors in Germany. Such marketing approval requires that they agree to comply with all requirements under the KAGB which, in practice, only very few third-country AIFs/AIFMs are willing and able to do.

Loan origination by SPVs held by AIFs

One point of great debate within the industry was, and still is, whether or not Special Purpose Vehicles ("SPVs") held by AIFs may also benefit from the above exemption. The newly introduced wording in the law explicitly only exempts AIFs and AIFMs from the banking licence requirement, but is silent with respect to SPVs. This is unsatisfactory to say the least, as European AIFs often do not lend directly, but through wholly-owned SPVs. Until this point is further specified by BaFin or the German legislator, the better (and prudent) reading of the law is to – unfortunately – assume that licensing requirements of the KWG will apply to loans originated by SPVs.

Shareholder loans at fund level

In the course of the recent changes to the KAGB, new requirements regarding shareholder loans at fund level have also been introduced. The new requirements are less restrictive than the requirements for debt funds: not only closed-ended *Spezial*-AIFs, but also open-

ended *Spezial*-AIFs, as well as closed-ended retail AIFs, may generally grant shareholder loans. *Spezial*-AIFs (closed and open-ended) may grant up to 50% of their Investment Capital as shareholder loans to any entities, provided:

- such entities are subsidiaries of the *Spezial*-AIF;
- the shareholder loan is subordinated; or
- the shareholder loans granted do not exceed twice the amount of the acquisition costs of the equity stake held in the company.

Provided the *Spezial*-AIF itself does not take up loans in excess of 30% of its Investment Capital, it may grant subordinated shareholder loans in excess of the 50% threshold stipulated above.

The restrictions for closed-ended retail AIFs are a bit narrower than for *Spezial*-AIFs, as a closed-ended retail AIF may not grant more than 30% of its Investment Capital as shareholder loans, and the loans may not exceed the acquisition costs of the equity stake in the subsidiary.

Manager-related requirements

To comply with organisational requirements established by BaFin for German debt fund managers, including managers acquiring unsecuritised loan receivables on the secondary market, has proven to come with some difficulties. BaFin has essentially copied the risk management for German credit institutions without regard for the fundamentally different business model of banks and loan funds. Certain easements are provided for, notably when acting in concert with and relying on another regulated entity (e.g. a syndicated loan with an EU credit institution), and to take proportionality into account. What is proportional, however, has to be decided by BaFin on a case-by-case basis, introducing considerable uncertainty when setting up a German debt fund manager, as well as when expanding its business.

Subscription credit facilities

German funds are increasingly interested in subscription credit facilities as means of short-term bridging of financing needs between capital calls. Under a credit facility, borrowed funds typically can be made available within a day, while under a typical limited partnership agreement, capital calls may take 10 business days or more.

Regulatory environment

The use of subscription credit facilities or other means of financing by German funds was traditionally very limited, as fund financing may have a negative impact on the ability of certain investors to invest in funds due to possible regulatory constraints. Pursuant to the Solvency II regime, which came into effect in January 2016, EU insurance companies are subject to rules determining the risk weightings applicable to the different categories of assets they hold in order to calculate their prudential capital. Investments in private funds are generally subject to high capital requirements for such insurance companies. However, closed-ended EU funds that do not use leverage benefit from a special treatment for Solvency II purposes, which means that such funds are subject to lower capital requirements.

From a German law perspective, until very recently private equity funds were only eligible investments for regulated investors that are subject to the German Investment Ordinance (*Anlageverordnung*) (i.e., pension funds and small insurance companies) and those which, according to their internal rules, comply with the Investment Ordinance (insurance companies and certain pension schemes), if their borrowing was short-term and limited to 10% of the

value of the fund. Both restrictions were problematic, because the meanings of "value of the fund" and "short term" were unclear. Very helpfully, though, those limitations have been removed in the latest BaFin circular, and borrowing at the fund level is now permitted for bridging capital calls. Unfortunately, uncertainty remains with respect to a fund of funds, because BaFin has retained the 10% limitation, and the short-term requirement there.

Although the 10% limit has been abolished for private equity funds, it is still common to limit the ability of the fund under the limited partnership agreements to take up financing, up to 10% of the commitments only.

Moreover, under certain circumstances, i.e., if a fund is structured to be deemed not to be in business (*vermögensverwaltend*) under German tax law, taking up financing by German funds may be considered to be a business activity from a German tax perspective, which would have negative tax consequences. For this type of fund, there will often be provisions in the limited partnership agreements according to which taking up subscription credit facilities by the fund is permissible if and to the extent it does not constitute a business activity of the fund from a German tax perspective.

Financing and security structure

Subscription credit facilities typically take the form of a senior secured revolving credit facility secured by the unfunded capital commitments of the fund's investors. The facilities are subject to a borrowing base determined based on the value of the assigned/pledged commitments of investors satisfying specified eligibility requirements, with advance rates based on the credit quality of the relevant investors.

Subscription credit facilities are typically secured by a security interest in the unfunded capital commitments. The security package will usually require the general partner to delegate, assign, pledge or otherwise create a security interest over its right to issue drawdown notices (and the fund to assign, pledge or otherwise create a security interest over the right to receive capital contributions). It is also common to pledge the deposit account into which investors are required to fund their contributions. The fund's underlying investments are typically not part of the security package.

From a German law perspective, the security interest in the rights to the unfunded capital commitments can be established by way of a pledge or security assignment. While a pledge requires a written notification to the investors in order to perfect the security, a security assignment can be made on a silent basis (although a notice of assignment may provide the lenders with some additional comfort).

Recent discussions regarding subscription credit facilities

The recent discussions about subscription credit facilities within the international funds community, including the guidelines for the use of subscription facilities issued by the Institutional Limited Partners Association ("ILPA") in 2017, have been carefully noted in the German market.

So far, the impact of these ILPA guidelines has not dramatically changed the way the limited partnership agreement and the subscription credit facilities are structured. But we have noted in recent transactions that investors pay more attention to disclosure requirements in the limited partnership agreements, including information on: (i) the terms of the subscription credit facility and costs to the fund; (ii) the calculation of IRR (with and without the use of the facility); (iii) the balance of the facility; and (iv) the current use of the proceeds from the facility. The limited partnership agreement may also provide for a limit to the interest expenses payable by the fund.

Other developments

In December 2017, BaFin issued the long-awaited recast Capital Investment Circular for pension funds and schemes, in practice often also applied by insurance companies. After all signs pointed towards the conclusion that those regulated investors may continue, as before, to treat private debt funds that originate loans to portfolio companies with a "buy-and-hold" investment strategy like private equity funds, the wording of the final version of the Circular called the long-standing practice into question. In the absence of any further clarification on the issue, each AIF investment requires a thorough case-by-case assessment to ascertain whether regulated investors may allocate them to the private-equity quota.

The good news for private equity managers fond of subscription facilities is that the Capital Investment Circular has abandoned the hard cap borrowing restriction for directly-investing private equity funds. However, although there is no restriction any more, some wording remains, indicating that BaFin would prefer to see borrowing used for bridging capital calls. Unhelpfully, the 10% restriction remains in place for fund of funds.

Finally, on March 14, 2018, the European Commission published a Proposal for a Directive on Credit Servicers, Credit Purchasers and the Recovery of Collateral, with a view to reduce non-performing loans in banks' loan portfolios and promote the development of a secondary market by unifying applicable rules, increasing transparency and facilitating easier collateral enforcement. To avoid fracturing the market, the Commission suggests applying the new rules sweepingly to all loans originated by EU credit institutions, performing and non-performing. Inadvertently, however, the rules as proposed may throw a wrench in the operations of secondary loan funds, by forcing a regime on them that is ill-fitted for institutional loan purchasers. "Credit servicers" will be subject to an authorisation procedure and ongoing supervision. The definition is so broad that it may also cover a variety of asset managers.

Also, non-EU lenders, like secondary loan funds, would have to appoint a representative established in the EU that is responsible for compliance with the Directive. The heightened transparency banks would have to observe when transferring loans to non-bank lenders, against the current "buyer beware" market practice, could discourage them from working with alternative liquidity providers like loan funds. The treatment of loan syndications, in participation with EU credit institutions as well as non-EU and/or non-bank lenders, raises additional questions. Right now, it is still early in the legislative process and those problems can hopefully be ironed out when the Council and Parliament publish their comments on the Proposal.

The year ahead

There are ongoing efforts to try and convince BaFin and the German legislator that the current understanding of the law, whereby SPVs are not exempt from the banking licence requirement, is detrimental to the cause which the German legislator was trying to achieve with the amendments – namely promoting non-bank-based forms of financing. Not granting SPVs the benefits of the exemption thus essentially means that EU loan funds are currently restrained from entering the German loan market, as they are not able to utilise the structures they have in place. Softening the exemption up, to also include SPVs, would send a positive signal towards the loan funds market in Germany. Meanwhile industry organisations are working to address concerns regarding the proposed Directive with the European legislators, to introduce the perspective of institutional loan purchasers into the legislative process.

Given the increased use of provisions in limited partnership agreements allowing subscription credit facilities and low interest rate levels, we expect the German market for subscription credit facilities to develop and grow in the year ahead. The latest discussions regarding the effects of subscription credit facilities are unlikely to change the trend as such, but will certainly lead to more extensive disclosure obligations for the fund managers. We also expect US and UK banks to continue to dominate the subscription credit facilities market in Germany.

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