

Client Update

New German Legislation Paves the Way for Debt Funds

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As from March 18, 2016, alternative investment funds (“AIFs”) benefit from a new German legislation allowing direct lending in Germany. This new legislation (the “New Legislation”) provides a detailed legislative framework for a fundamental change to the administrative practice announced in 2015 by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, “BaFin”) that opened door for loan originating funds.

Under the New Legislation, loan origination by AIFs is considered part of the collective asset management business of AIFs. As consequence, an AIF is no longer required to obtain a banking license under the German Banking Act (*Kreditwesengesetz*, “KWG”) if it conducts loan origination business. The same applies to loan restructurings, including any extension of maturity, which previously also necessitated obtaining a banking license. German AIFs, however, must comply with additional requirements under the German Capital Investment Act (*Kapitalanlagegesetzbuch*, “KAGB”), as implemented into the KAGB by the New Legislation.

The New Legislation can be expected to further increase direct lending by debt and mezzanine AIFs to German borrowers significantly as it provides more certainty as to the exemptions from the banking license requirements, although it subjects German AIFs to significant additional red tape.

APPLICATION OF THE NEW LEGISLATION TO GERMAN AIFs AND AIFMS

Under the New Legislation, German AIFs and their respective alternative investment fund managers (“AIFMs”) that are subject to the KAGB are allowed to conduct loan origination business if they comply with the following requirements:

- Loan origination is only allowed for closed-ended special AIFs, i.e., AIFs in which only professional and semiprofessional investors are allowed to invest and which do not grant any redemption rights prior to the end of their terms. An investor is considered as semiprofessional if it is sophisticated and experienced and invests at least EUR 200,000 in such AIFs. UCITS are still not permitted to conduct loan origination business.
- Open-ended special AIFs still are not allowed to conduct loan origination, but they nevertheless benefit from the New Legislation as they may now restructure or extend the terms of loans that have been acquired by such AIFs in the secondary market. In contrast to BaFin's previous position, the restructuring or extension of acquired loans by open-ended special AIFs is not considered "loan origination."
- AIFs may not grant loans to consumers.
- The use of leverage by a loan originating AIF is limited to no more than 30% of the aggregate amount of the contributed and committed capital of the AIF that is available for investments after deduction of any costs and expenses that are borne by the investors. Any borrowings by companies in which these AIFs are invested must be taken into account in such calculation on a pro rata basis in accordance with the participations held.
- In order to comply with the risk diversification requirements of the New Legislation, loan originating AIFs may not grant loans to one borrower having an aggregate principal amount in excess of 20% of the aggregate amount of the contributed and committed capital of the AIF that is available for investment after deduction of any costs and expenses that are borne by the investors. In this respect, it is not clear in the New Legislation whether the 20% limitation only limits the amount of loans originally granted by the AIF or also includes loans acquired by the AIF in the secondary market.
- In addition to the above requirements applicable to the AIFs, AIFMs that engage in loan origination or acquire and restructure loans for the account of an AIF are subject to:
 - Certain minimum requirements for risk management, yet to be specified in a regulation. It is expected that such risk management requirements will reflect the risk management requirements for loan origination business of banks; and
 - The reporting obligations for large exposure loans in accordance with the provisions of the KWG, i.e., loans in a principal amount of €1 million or more.

APPLICATION OF THE NEW LEGISLATION TO EU AND FOREIGN AIFs AND AIFMS

With respect to European AIFs and AIFMs and non-European, or so-called foreign, AIFs and AIFMs, the New Legislation introduces specific exemptions from the banking license requirements under the KWG for AIFs and AIFMs primarily or exclusively engaging in loan origination business. According to the New Legislation, the following applies:

- AIFMs and AIFs from other EU Member States may engage in loan origination business in Germany without being required to obtain a banking license. In addition, the New Legislation does not require AIFMs and AIFs from other EU Member States to comply with the specific requirements set out in the previous section. The loan origination business of such AIFMs and AIFs is only subject to the applicable regulations in their home states;
- The same generally applies to foreign AIFMs and AIFs, provided that the relevant AIF is admitted for distribution in Germany in accordance with the provisions of the KAGB. However, this does not apply to AIFs whose admission for distribution in Germany is based on a so called “private placement regime” which only allows the distribution of the relevant AIFs to professional investors (Sec. 330 of the KAGB). This exclusion was introduced later on in the legislative process and is based on the fact that the private placement regime does not require the AIFMs managing such AIFs to be subject to effective regulatory supervision or otherwise fully compliant with the AIFM Directive.

In practice, European AIFs often do not grant their loans directly, but via subsidiaries in Luxembourg in order to optimize their tax structure. In general, Germany does not impose withholding tax on interest payments across the border, even if the interest is paid to an affiliate. There are, however, several exceptions to this rule. In particular, only “straight interest” loans qualify for zero withholding, while “hybrid debt”, notably debt which is tied to performance factors like profitability or revenues, does trigger withholding taxes.

The New Legislation is silent as to whether the use of such subsidiaries complies with the new rules. However, BaFin has indicated informally its interpretation that the use of such subsidiaries as special purpose lending vehicles generally should not have any impact on the legal analysis under the KWG and KAGB. Instead, BaFin would look at the AIFs and AIFMs behind such vehicles.

OUTLOOK

BaFin's change of administrative practice in 2015 already had some impact on the German direct lending market and attracted AIFs to the German lending market. While the New Legislation creates a sound legal basis for the activities of German AIFs and their respective AIFMs engaging in the loan origination business, the associated restrictions might turn into a competitive disadvantage for them compared to their competitors based and regulated in other EU Member States that are not subject to such extensive limitations. It also remains to be seen whether any additional guidance issued by BaFin, and BaFin's future administrative practice, will introduce additional restrictions.

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Please do not hesitate to contact us with any questions.