Fund Finance

2018

Second Edition

Contributing Editor:
Michael C. Mascia

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Overview

The most significant developments in the German funds finance market in recent years are the new regulations reflecting the German Federal Financial Supervisory Authority's ("BaFin") changed view 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 the limited partnership agreements allowing the funds to take up subscription credit facilities.

Debt funds in Germany

Recent changes in regulations for debt funds

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) in 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 not required anymore, provided the

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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.

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

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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.

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 not using 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 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 as a business activity from a German tax perspective,

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which would have negative tax consequences. For this type of funds, 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 by way of a 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

With the implementation by the German legislator of the requirements for granting loans, the reference values for the borrowing limits and restrictions on encumbrances with respect to closed-ended retails AIFs were also amended and brought in line to reflect developments at a European level. Now the reference value, instead of the net asset value used before, is also the Investment Capital. The aim of the legislator was to have a less volatile reference value than the NAV, to provide more comfort to investors. As the amount itself was not to be changed, but only the reference value, the restrictions were accordingly adjusted from 60% to 150% of Investment Capital.

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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.

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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Patricia Volhard
Tel: +49 69 2097 5150 / Email: pvolhard@debevoise.com
Patricia Volhard is a partner in Debevoise's Frankfurt and London offices. Her practice focuses on advising private funds on a range of regulatory issues. Ms. Volhard is one of Europe's leading private funds regulatory lawyers, and has played a prominent role in the ongoing development of the area, in part through involvement in Invest Europe. She is the former chair of its Tax, Legal & Regulatory Committee, as well as the current chair of its Financial Services/Regulatory Working Group. She is also a member of the Investment Management Consultative Working Group of the European Securities and Markets Authority (ESMA); the Legal Committee of BVK, the German private equity association; the Alternative Credit Technical Group of the Alternative Investment Management Association; and the Regulatory Committee of the Listed Private Equity Association.

Klaudius Heda
Tel: +49 69 2097 5241 / Email: kheda@debevoise.com
Klaudius Heda is an international counsel in Debevoise's Frankfurt office. His practice focuses on financings and restructurings, capital markets transactions and corporate law. Mr. Heda represents corporate entities, private equity sponsors and financial institutions in a wide range of cross-border transactions. He has extensive experience in corporate financing, intra-group financial transactions, structured finance transactions and real estate financings.
Mr. Heda is a member of the bar in Frankfurt am Main. His native language is German and he is fluent in English and Polish.

Lennart Lorenz
Tel: +49 69 2097 5220 / Email: llorenz@debevoise.com
Lennart Lorenz is an associate in Debevoise's Frankfurt office. His practice focuses on advising sponsors of private investment funds, including private equity, real estate, infrastructure, venture capital and credit funds as well as fund of funds, on all aspects of regulatory matters, fund formation as well as secondary transactions.
Mr. Lorenz is a member of the Frankfurt Bar Association. His native language is German and he is fluent in English.

Debevoise & Plimpton LLP

Taunustor 1, 60310 Frankfurt am Main, Germany
Tel: +49 69 2097 5000 / Fax: +49 69 2097 5555 / URL: www.debevoise.com

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