

Important change to German administrative practice in relation to loan originating funds

Overview of change to administrative practice

On 12 May 2015, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) announced significant changes to its administrative practice with regard to loan origination as well as restructuring and prolongation of loans by investment funds (Reference number WA 41-Wp 2100 - 2015/0001).

Given that there has been an increasing focus within Europe on alternatives to bank-based credit, the growth of funds investing in loans is one of the most consistent trends in the EU fund industry with assets under management multiplying fivefold in the last two years, albeit from a low base. Loan origination funds, which look to source loan assets for their investment portfolio by directly originating loans (rather than investing via loan participation or assignment), are a key component.

Previous administrative practice

Due to the fact that BaFin previously took the view that loans for or by investment funds were generally not permitted (see section 98 para 4 of the German Capital Investment Act (*Kapitalanlagegesetzbuch*, KAGB)), the origination of loans was solely permissible with a respective banking licence under the German Banking Act (*Kreditwesengesetz*, KWG) or if an exception could be relied upon such as granting a loan based on the freedom to provide passive lending by a non-German fund.

The new administrative practice

By way of changing its administrative practice, BaFin now understands loan origination as well as loan restructuring, i.e. changes to the conditions of a loan after its acquisition, to be part of collective asset management and consequently loan origination and loan restructuring will generally be permissible. As a result, the KAGB will supersede the KWG (see section 2 para 1 no. 3b and para. 6 no. 5a KWG) and a

banking licence is no longer required for loan originating funds.

Legal basis of the change in BaFin's practice

BaFin's change of view is based on a revised interpretation of section 93 para 4 KAGB in the light of conformity with European provisions. Whereas loan originating and restructuring is not permissible for UCITS (undertakings for the collective investment in transferable securities) according to directive 2014/91/EU, the AIFM directive 2011/61/EU does not generally contradict the permissibility of these activities by funds. Moreover, in recent European legislation (such as the EuVECA Regulation, the EuSEF Regulation and the draft ELTIF Regulation) the permissibility of loan origination for account of funds is generally foreseen. BaFin is now in line with the European supervisory authority (ESMA) which already deems loan originating funds to be permissible.

Implications for non-German funds

In its publication, BaFin does not make any reference to non-German funds. However, based on the principle of non-discrimination at least EU funds should be able to grant loans to German companies, provided they are subject to similar requirements as German funds.

This means that a fund with its registered seat in any EEA member state and managed by a management company (*Kapitalverwaltungsgesellschaft*) having obtained an AIFM licence should be able to rely on the same administrative practice. However, such fund would most likely also be subject to the same requirements (as described below) as a German fund.

BaFin requirements for the granting of loans by funds

Based on the assumption that the KAGB will be amended in the short term in the light of investor protection to provide regulations for loan originating funds as well as to avoid systemic issues arising in

relation to "shadow banks" (*Schattenbanken*), BaFin strongly advises that all respective fund managers adhere to the following recommendations:

- loan origination should be restricted to closed-ended special AIFs;
- loans may not be granted to consumers and to such persons where the granting of loans would lead to a conflict of interest;
- the use of leverage should be strictly limited and simultaneous borrowing from the general public and granting of loans by funds is not permissible, as this would cause conflicts with the rules of the Capital Requirements Regulation 575/2013/EU (CRR/CRD IV);
- risk diversification and management in accordance with the BaFin circular 10/2012 in relation to Minimum Requirements for Risk Management (MaRisk BA), dated 15 August 2014, must be in place as far as it applies to the origination of loans;
- a liquidity reserve must be held (although it is difficult to see why a closed-ended fund which is

fully funded by equity commitments would need to maintain a liquidity reserve).

Conclusions in particular for non-German funds

Generally, the new administrative practice is a very important and welcome change, providing clarity to the market at least for German funds. However, BaFin has not yet given any clear guidance as to non-German funds providing loans to German borrowers. Given that BaFin has stipulated some relatively problematic requirements, such as the obligation to maintain a liquidity reserve (which will not be attractive to fund investors) and to comply with the specific risk management requirements, it remains to be seen if these requirements are enforced in a sensible manner. If not, non-German funds in particular may continue to rely on the passive lending exception or investing by way of purchasing bonds.

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