Update Investment Funds

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Loan originating AIFs – investment funds now permitted to grant loans

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The German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) announced in its interpretative decision dated 12 May 2015 that it has changed its administrative practice with regard to investment funds granting, restructuring and extending the period of loans. BaFin thereby follows the approach recently taken by other EU Member states which have already embraced the concept of investment funds originating loans either by announcing respective administrative guidelines or by establishing specific national regulations.

BaFin's previous administrative practice and its limiting impact

Up to now, German investment funds were allowed to invest in unsecuritized loans; they could not, however, engage in direct lending. The restructuring and extension of loans, also, was subject to strict requirements, as this was eventually regarded by BaFin as engaging in lending business pursuant to the German Banking Act (*Kreditwesengesetz* – KWG). As a result, German investment funds were at a market disadvantage in relation to foreign investment funds which were exempt from these restrictions to the extent they acted within the scope of the freedom to provide requested services (also referred to as "reverse solicitation").

BaFin's new administrative practice

With the change to BaFin's administrative practice, the origination, restructuring and extension of loans by investment funds is now considered as permissible activity within the fund management performed by the AIFM. As a consequence, investment funds are allowed to grant, restructure or extend the period of loans without requiring a banking license under the KWG, provided that loans are eligible assets for the investment fund concerned pursuant to the rules set out in the

German Capital Investment Code (*Kapitalanlagegesetzbuch* – KAGB).

Only certain investment funds may engage in direct lending

According to BaFin's new administrative practice, the following investment funds may originate loans: General Open-Ended Special AIF (Sec. 282 KAGB), Hedge Funds (Sec. 283 KAGB) and Closed-Ended Special AIF (Sec. 285 KAGB); also Special AIF and Public AIF managed by an AIFM which is registered pursuant to Sec. 2 para. 4, 4a or 4b KAGB (Small AIFM). The existing provisions concerning direct lending by German Public Real Estate Funds (Sec. 230 KAGB) remain unchanged. With regard to other German investment funds, the origination of loans remains prohibited. This includes UCITS, Other Investment Funds (Sec. 220 KAGB) and Open-Ended Special AIF with Fixed Investment Rules (Sec. 284 KAGB). To the extent these funds may permissibly acquire unsecuritized loans, however, the new administrative practice of BaFin also applies. Loans may therefore be restructured or extended within the parameters set forth by BaFin.

BaFin recommendations in light of expected legislative amendments

BaFin further announced in its interpretative decision that the German legislator intends to adopt detailed provisions concerning the origination, restructuring and extension of loans by investment funds. In light of these anticipated changes to the KAGB, BaFin recommends that AIFM, when considering the granting of loans on behalf of their funds, already take into account the following restrictions which are likely to be adopted by the German legislator:

- Only Closed-Ended Special AIF should originate loans
- Loans should not be granted to consumers
- Loans should not be granted in case of a conflict of interests
- The AIF originating the loan should make use of leverage only to a very limited extent
- The AIF originating the loan should not take deposits from the public

- The requirements for lending business set out in the MaRisk (Circular 10/2012: Minimum Requirements for Risk Management (MaRisk)) should be complied with
- Maturity transformation should be avoided with regard to the short-term financing of long-term loans
- The exposure to individual borrowers should be restricted in order to ensure risk diversification
- A minimum liquidity reserve should be maintained

BaFin recommendations also apply to investment funds managed by Small AIFM

According to BaFin, the above recommendations also apply to investment funds managed by Small AIFM within the *de minimis* exemption, even though these AIFM are not subject to all of the organizational requirements set out in the KAGB. It is therefore likely that the anticipated legislative changes will also apply to investment funds managed by Small AIFM.

Finally, it can be taken from the BaFin recommendations that under the new regime, Open-Ended Special AIF might only be allowed to invest up to 50 % of their net assets in unsecuritized loans.

Assessment and practical impact

Despite the restrictions laid down in the BaFin recommendations, BaFin's new administrative practice opens up new possibilities for investment funds to engage in direct lending without having to use a fronting bank or to implement subordination clauses in loan agreements. The setting up of a Special AIF managed by a Small AIFM, for example, will provide an efficient way to engage in direct lending. This is likely to be of particular interest for bank-independent investors such as family offices and portfolio managers. Furthermore, BaFin's new administrative practice will presumably have a positive impact on foreign investment funds which envisage the granting of loans in Germany or the restructuring or extension of loan agreements entered into with German debtors.

It remains to be seen, however, if and to what extent the German legislator will limit the possibilities opened up by BaFin for investment funds to engage in direct lending.

AIFM which already consider the granting of loans for their funds should include loan origination as eligible investment into the fund's investment guidelines and amend the investor

document pursuant to Sec. 307 KAGB accordingly before granting loans on behalf of the fund.

Conclusion

BaFin's new administrative practice opens up interesting possibilities for flexible investments in loans by German and foreign investment funds. In light of the anticipated legislative changes, however, a close coordination with legal counsel is recommended in order to avoid that newly set-up business models have to be readapted after a short period of time.

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