

New BaFin Practice on Lending Business conducted by Alternative Investment Funds

The German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "**BaFin**") has declared in a statement dated 12 May 2015 that it intends to modify its existing administrative practice to permit the granting, restructuring and prolongation of loans by alternative investment funds ("**AIFs**"). It is likely that this permission will only extend to closed-ended special AIFs (*geschlossene Spezial-AIFs*) as further legislation is on its way.

Licensing requirements under the German Banking Act (*Kreditwesengesetz*)

Pursuant to section 32 (1) sentence 1 of the German Banking Act (*Kreditwesengesetz*, "**KWG**"), anyone wishing to conduct banking business or to provide financial services in Germany commercially or on a scale that requires a commercially organised business undertaking requires a license by the BaFin. Licensable banking business includes, *inter alia*, lending business (*Kreditgeschäft*), which is defined in section 1 (1) sentence 2 no. 2 KWG as "the granting of money loans or acceptance credits".

The term "money loans" is interpreted with a view to the statutory definition of loan agreements in section 488 of the German Civil Code (*Bürgerliches Gesetzbuch*). This definition (and, thus, the licence requirement) generally covers any type of loans, including syndicated loans and/or loans to corporate borrowers.

While the acquisition of an existing loan in principle does not trigger the licence requirement (provided that the buyer does not assume an obligation to make further advances), the prolongation or the restructuring of a loan, such that the prolongation or restructuring is effectively commensurate to the granting of a new loan, generally also qualifies as lending business.

Administrative practice to date

In view of the above, the administrative practice to date has been to qualify the conduct of lending business (including

the prolongation and/or restructuring of existing loans) by AIFs as inadmissible, subject to certain exemptions in respect of shareholder loans for the account of certain AIFs.

Accordingly, all AIFs were limited to the acquisition of (fully drawn) existing loans and, in addition, had limited options available, when a loan needed to be restructured or prolonged.

BaFin statement of 12 May 2015

In its statement issued on 12 May 2015, BaFin has announced significant changes to its administrative practice.¹

Revised administrative practice

In line with a view expressed by ESMA, BaFin now qualifies the granting, restructuring and prolongation of loans to be part of the collective asset management carried out by AIFs and therefore as permissible, if also compatible with the product regulation for the relevant type of AIF as set forth in the German Capital Investment Act (*Kapitalanlagegesetzbuch*, "**KAGB**") implementing AIFMD² in Germany. In this context, BaFin confirms that the

¹ http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/WA/ae_150512_kreditfonds_aif.html?nn=2819248

² Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

provisions of the KAGB prevail over the KWG and that, as a consequence and in contrast to its past administrative practice, also the permissibility of any granting, prolongation or restructuring of a loan is no longer to be assessed by reference to the KWG. In fact, the granting, restructuring and prolongation of loans is permitted for AIFs to the extent AIFs are permitted pursuant to the provisions of the KAGB to invest in such loans. Pursuant to the BaFin statement such AIFs are:

- open-ended special funds (*allgemeine offene Spezial-AIF*, section 282 KAGB);
- hedge funds (which are a sub-form of open-ended special funds (*Hedgefonds*, section 283 KAGB);
- closed-ended special funds (*geschlossene Spezial-AIF*, section 285 KAGB).

As regards open-ended public real estate funds (*Immobilien-Sondervermögen*, section 230 KAGB), loan origination is only permitted to the extent shareholder loans are concerned and the BaFin statement has not introduced any changes in this regard. There are also no changes with respect to UCIT funds which will continue to be restricted from conducting lending business.

Further changes to come and BaFin's "recommendations"

General

According to the BaFin statement, the German legislator intends to amend the KAGB in order to provide for specific rules relating to loan origination, prolongation and restructuring by AIFs. In this respect, BaFin recommends to adhere to the standards set forth in its statement immediately, even though such amendments have not yet been enacted.

Loan origination by closed-ended special funds only / restructuring permissible by open-ended funds

According to BaFin, such rules will restrict loan origination to closed-ended special AIFs and exclude all other AIFs. However, open-ended special AIFs which are, to date, already permitted to acquire (but not to originate) loans will be permitted to prolong and restructure such loans. This is in particular relevant for open-ended special funds with specified investment conditions (*offene Spezial-AIF mit festen Anlagebedingungen*, Section 284 KAGB), which invest in loans in the course of secondary transactions and which have so far been in a dilemma, when the

restructuring of a loan was required or useful. It is unclear whether this "restructuring privilege" also applies to open-ended public AIFs.

Further requirements

BaFin recommends not extending loans to consumer loans but technically they are not excluded from investment. No loans may be extended if this results in a conflict of interest. Further, the leverage of the AIF should be restricted and the fund should not at the same time grant loans and receive loans from the public, as the latter could lead to the fund being regarded as credit institution within the meaning of the Regulation EU No. 575/2013 (Capital Requirements Regulation, "CRR").

In addition, the asset manager of the AIF must have appropriate risk management systems in place and must invest in assets that can easily be sold to provide minimum liquidity. Finally, long term loans should not be financed by short term credit to avoid maturity mismatches and criteria for risk diversification (such as single obligor concentrations) should be established. In addition, the AIF's risk and liquidity management is required to be adequate for the purposes of granting, prolonging and restructuring loans.

New 50% rule for open-ended special funds and hedge funds

With respect to the liquidity management of open-ended special funds, there is a requirement that only up to 50% of the assets of such funds are invested in loans. It is not clear how this "50% rule" will interact with the "30% rule" which has so far been applied to special funds held by insurance companies. While some market participants had expected that following the amendment of the investment ordinance (*Anlageverordnung*) such old "30% rule" was to be abolished, BaFin's insurance supervisory department has until now continued to apply such 30% limit.

Open questions

While the change in BaFin's administrative practice is highly welcomed by the funds industry, some uncertainties still remain, e.g. with regard to open-ended special funds with specified investment conditions (*offene Spezial-AIF mit festen Anlagebedingungen*, Section 284 KAGB).

While these funds may, upon the investors' consent, acquire existing loans and, hence, are in accordance with BaFin's revised administrative practice permitted to also prolong and restructure such loans, it is unfortunate that open-ended special funds with specified investment conditions (*offene Spezial-AIF mit festen*

Anlagebedingungen, Section 284 KAGB) still seem not being permitted to originate loans (even with investors' consent). Open-ended special funds with specified investment conditions (*offene Spezial-AIF mit festen Anlagebedingungen, Section 284 KAGB*) belong to the fund category which is by far most widely used by German institutional investors, providing for several advantages, e.g. transparency under insurance supervisory law, a tax exempt status and the consolidation exemption under German GAAP. If other fund categories are used, such as special funds in accordance with section 282 or section 285 KAGB (typically not being *per se* tax exempt), additional structuring may be required from a tax and insurance supervisory law perspective.

Even more compelling are the aspects of non-German funds originating loans cross-border to German borrowers.

While the statement dated 12 May 2015 refers to German funds only, BaFin's conceptual understanding that the granting, restructuring and prolongation of loans are part of the collective asset management services carried out and that the provisions of the KAGB implementing the AIFMD in Germany prevail over the KWG would lead to the consequence that at least EU-AIFMs, having passported their collective asset management services to BaFin would then also be permitted to originate, prolong or restructure loans for German borrowers. An explicit statement from BaFin would be desirable in this respect.

An open question is also under what conditions other EU-AIFMs and non-EU AIFMs may now be permitted to prolong, restructure or even originate loans on a cross-border basis for German borrowers. By way of general background, in accordance with the established administrative practice for banking supervision by BaFin under the KWG, if the lender has its registered office or ordinary residence outside Germany but targets the German market in order to offer lending on a cross border basis repeatedly and on a commercial basis to companies and/or persons having their registered office or ordinary residence in Germany licence requirements under German law need to be observed. However, if the relevant German borrower has not been approached by the non-German lender but rather the German borrower has requested the services without any prior solicitation no licence requirements would be triggered.

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