Credit funds
Just another product option for alternative investment funds?

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A revision to German Federal Financial Supervisory Authority (BaFin) administrative practices, as well as the implementation act of the UCITS V directive, has broadened the scope for setting up credit funds in Germany in the form of Alternative Investment Funds (AIF).

The additional options available to market participants—depending on their individual situation—should now be considered: investment management companies (KVGs) have gained additional business potential through the use of credit funds, however they must guarantee a MaRisk-compliant (minimum requirements for risk management) credit choice and processing model. Banks now have the opportunity to not only increase the risk on their own books, but also to act as an agent for KVG activities. The latter entails selling their credit know-how without having to submit themselves to the necessary requirements in terms of their own capital. Credit funds open alternative investment avenues to institutional investors and above all to insurers, pension schemes and pension funds.

The characteristic traits of fund types defined under the German term "Kreditfonds"—or under English terms such as "credit funds," "loan funds," or "debt funds"—are not yet clear-cut. The methods for setting up such funds vary greatly but each includes a fundamental minimum investment of the funds in un-secured credits. Currently, in addition to the laws and legal initiatives that exist at the European level (e.g., European Long-term investment Funds (ELTIF), European Social Entrepreneurship Funds (EuSEF), European Venture Capital Funds (EuVECA) regulations or the European Securities and Markets Authority (ESMA) opinion on "Loan originating AIFs" as of 11 April 2016), credit fund precursors also exist at the EU member state level (e.g. in Ireland), which define the legal bases for loan acquisition, as well as, for the original granting of loans on behalf of investment funds. In principle, these funds can be sold to professional investors in Germany within the scope of the EU passport. According to information that recently became available, the status in Luxemburg is that there is neither a specific legal basis nor any guidelines from the Luxembourg supervisory authority (CSSF). Therefore, existing funds restrict themselves to the secondary market for loan acquisitions.

Legal framework for credit funds in Germany

In Germany, the launching of credit funds was allowed even before BaFin had revised its administrative practices or the draft of the UCITS V Implementation Act had been published. However, investment funds could only acquire loans amounting to up to 30 percent of the net asset value of the fund on behalf of "special funds" until the Kapitalanlagegesetzbuch (KAGB) came into force on 22 July 2013, though only the acquisition of loans on the secondary market or using a fronting bank was permitted. It was BaFin's view that granting loans (loan origination), as well as, restructuring or prolongation events, constituted credit transactions and were therefore illegal banking transactions for investment management companies according to § 1 para 1 No. 1 KWG (German Banking Act). For this reason only a few credit funds have been established in Germany until now.

The wording of the regulation and its interpretation based on new European laws could also be applied to loan origination within collective portfolio management

On 12 May 2015, BaFin issued a circular (WA 41-Wp2100 – 2015/001) in which it changed the previous practice with reference to a derogation rule in the KWG (§ 2 para 1 No. 3b KWG). According to the circular, investment management companies (KVGs) were allowed to grant loans, as long as, they were part of the process of collective portfolio management. The KWG derogation rule was originally devised for the security deposit business, which is considered to be a banking business under German law. When the investment act was established, no one viewed the granting of loans as a possible part of collective portfolio management. However, the wording of the regulation and its interpretation based on new European laws (e.g., loan origination being permitted under the EuVECA and EuSEF regulations), could also be applied to loan origination within collective portfolio management. In the context of the German implementation act for the UCITS V directive (the draft version passed by the Federal Parliament), the legal framework for funds' investment opportunities in loans will now be extended through changes in the KWG and KAGB (German Capital Investment Act). § 2 para. 1 No. 3b. The KWG is being changed insofar as the derogation regarding collective portfolio management has been explicitly extended to permit loan origination.

The BaFin circular clearly stated that the credit business will continue to be a regulated business due to the necessity to protect the market. This means that investment management companies do not have to obey the solvency rules that apply to banks. However, they must comply with the associated organizational and risk management rules as stipulated in the minimum requirements for risk management of banks ("MaRisk," BaFin circular 10/2012 (BA) dated 14 December 2012, currently under revision), insofar as they pertain to the credit business (BTO 1 credit business and BTR 1 credit risks). In the KAGB, the new legal basis for special regulations regarding the operational and organizational structure of credit businesses was constructed by adding the new paragraph 5a to § 29 KAGB-E. There are exceptions for credit according to the UBGG (German law for companies participating in non-listed companies), for loans made to real estate companies granted by open-end real estate funds or for shareholder loans e.g., in the private equity area. Under this rule, special requirements for risk management will apply to nearly all AIF investment management companies (AIF-KVGs) that will grant future loans on behalf of the AIF or invest in non-securitized/certificated loans.

AIF-KVGs will need to establish structures for loan processing (including loan extensions), loan processing controls, and the handling of problem loans as well as procedures for early risk diagnosis, appropriate for the type and scale of their business. According to the UCITS V Implementation Act, the "€1 million credit report," as defined by §14 KWG, shall also be filed by AIF-KVGs.

Additional requirements arise regarding loan origination. The scope of application for loan origination is restricted under the German implementation act for the UCITS V directive (adaption of § 20 para. 9 KAGB draft bill) as follows:

- Loan origination on behalf of UCITS is prohibited.
- Loan origination is allowed for AIFs, provided that it is permissible under the European regulations governing European Venture Capital Funds (EuVECA), European Social Entrepreneurship Funds (EuSEF), and European Long-Term Investment Funds (ELTIF); or the AIF is a domestic closed-end Special-AIF that fulfills the requirements in the new para. 2 of § 285 KAGB draft bill (see below regarding closed-end funds). Additionally, according to § 285 para. 3 KAGB draft bill, shareholder loans can be granted by closed-end or open-end Special-AIFs.
- Changes to the conditions regarding loan origination or acquisition (restructuring/ prolongation) are excluded from the aforementioned provisions and restrictions for loan origination, which means that they are permitted in general; meanwhile, this regulation also now applies again to open-end Special-AIFs, after they were previously excluded in the federal government draft law.
- External investment management companies (KVGs) may grant cash loans to their parent, subsidiary or sister companies on their own behalf.

For closed-end Special-AIFs intending to allocate loans on the basis of fund assets in the future, further framework requirements arise from the UCITS V Implementation Act, and from the amended paragraphs 2 and 3 of § 285 KAGB draft bill:

- Leverage restriction: § 285 para. 2 KAGB draft bill stipulates that for closed-end Special-AIF loans, only credit accounting for up to 30 percent of the aggregated invested capital and the committed but uncalled capital may be borrowed.
- Loans may not be granted to consumers as defined under § 13 of the BGB (German Civil Code).
- Risk distribution/risk limitation: AIF-KVGs may only grant loans to a borrower up to the maximum total amount of 20 percent of the aggregated invested capital and the committed but uncalled capital of the closed-end Special-AIF.
- In contrast to the aforementioned limits, § 285 para. 3 KAGB draft bill stipulates that loans amounting to a maximum of 50 percent of the aggregated invested capital and the committed but uncalled capital of the open-end or closed-end Special-AIF (§§ 282 para. 2 sentence 3, 284 para. 5 KAGB-E), or amounting to a maximum of 30 percent of the aggregated invested capital and the committed but uncalled capital of a closed-end mutual AIF (§ 261 para. 1 No 8 KAGB draft bill) may be granted to associated companies (shareholder loans), provided that they are classified as subordinated loans or that they do not exceed the acquisition value (mutual funds) or the double acquisition value (special funds) of the respective share. Alternatively, subordinated loans of more than 30 percent of the capital may be granted to associated companies, provided that they are subsidiaries of the Special-AIF and that they themselves only grant cash loans under the aforementioned circumstances.
- Annual report, management report, audit: according to the new § 48a KAGB draft bill, AIF-KVGs registered according to § 2 para. 4 KAGB and granting loans according to § 285 para. 2 KAGB draft bill must prepare and provide an annual report for every closed-end domestic Special-AIF (including a balance sheet oath according to § 45 para. 2 No. 3 KAGB) and a management report. These documents must be certified by an auditor and made available to investors upon request. For the purposes of financial accounting, the regulations governing private limited investment partnerships (Investmentkommanditgesellschaften, InvKGen), especially § 135 para. 3 to 11 KAGB, apply accordingly. Further specifics regarding the content, scope, and presentation of the report are outlined in the KAPrüfbV (the Investment Management Audit Report Ordinance). For the purposes of accounting and auditing other investment funds administrated by accredited investment management companies, specific regulations for the credit business may be added to the KARBV (the Investment Accounting and Valuation Ordinance) and the Investment Report Regulation (KAPrüfbV) through existing powers to issue delegated acts. BaFin has also already proposed the inclusion of necessary changes to the respective rules in the ordinances in the context of the amendment to the KAGB act.

- Prevention of conflicts of interest: the codes of conduct in §§ 26 and 27 KAGB were devised to prevent potential conflicts of interest that could arise in the context of loan origination—additional legal regulations are not required.
- Organization and risk management: no additional regulations are necessary in connection with liquidity risk management (§ 30 KAGB). The new § 29 para. 5a KAGB draft bill was created for the purpose of defining the requirements pertaining to the organizational and risk management duties of KVGs for the granting of cash loans or for investing in unsecured loans. This should serve as a basis to explain the applicability and use by BaFin of the relevant rules that apply to banks under the MaRisk. Regarding the applicability of the rules in general, some exceptions were allowed, for example for loan investments by closed-end mutual AIFs or for loans granted to real estate companies on behalf of a real estate fund according to § 240 KAGB. Registered KVGs that have granted loans on behalf of investment funds have the legal obligation to observe the organization and risk and liquidity management rules.

Investment opportunities for individual fund types with regard to loans:

Fund Type	KAGB-E	Investment in loans	Loan granting/lending	Loan structuring	Shareholder loan
UCITS	§ 192	no	no	no	no
Open-end domestic mutual AIFs (other investment fund)	§ 221	yes	no	yes	no
Real estate special estate AIFs (granting loan to its real estate company)	§ 240	no	no	no	yes, as before
Closed-end domestic mutual AIFs	§ 261	no	no	yes	yes (conditional)
General open-end Special-AIFs	§ 282	yes (up to 100%)	no	yes	yes (conditional)
Open-end domestic Special-AIFs with fixed investment conditions	§ 284	yes (up to 100%)	no	yes	yes (conditional)
Closed-end Special-AIFs	§ 285	yes (up to 100%)	yes, under conditions (foreign financing up to 30%, no loan to consumers, max. 20% to each loan taker)	yes	yes (conditional)

In summary, on the basis of European legislation and also market practice in other European countries, the legislator believes that a further option for the funding of the real economy is being created through this action. At the same time, the legislator also wants to prevent the transfer of risky loan transactions to a less-regulated market area (shadow banks) by, for example, implementing the requirements for credit processes.

Consequences for market players

The new business area of allocating loans on behalf of an AIF will have different consequences for the various market players (banks, asset managers, institutional investors, and, where applicable, service providers) and provides them with different options. Institutional investors may have ample opportunity to generate profits (while at the same time accepting the risks), but these would have to be above the market level to actually be of interest to the investor. The VAG (German Insurance Supervision Act) determines the "regulatory" leeway insurance companies and pension pools will have when investing in credit funds, in connection with the investment ordinance or the new supervisory set of rules and regulations for insurance companies entitled Solvency II.

Issuing AIF-KVGs must appropriately organize their new "credit" business line. To this end, expertise within portfolio and risk management must be acquired regarding asset selection, diversification, asset assessment and so on. With regard to credit processing, the AIFM must comply with the MaRisk (Minimum Requirements for Risk Management), especially parts BTO 1 (credit business) and BTR 1 (credit risk) . To comply with this regulation, the KVG needs to establish an operating model for the credit business line. So the KVG has to weigh up the revenue prospects of the additional funds business against the mandatory investments for complying with the credit management regulations.

Rather than establish organizational frameworks and processes on its own, the KVG has the option to outsource the credit business to an external service provider. In this regard it will be important to ascertain whether the service provider has sufficient incentives to retain the credit fund processes (e.g., review business models, margins, etc.). In this scenario, the asset manager can simultaneously generate additional fund business and ensure the credit business is operating in a cost-saving and more efficient way through a specialized provider. However, the KVG must ensure that it has reached a certain competency level to comply with the existing requirements governing outsourcing.

On the topic of credit process outsourcing, there may eventually be new opportunities for financial institutions and especially for those with asset management subsidiaries. In one aspect, financial institutions could sell credit portfolios to a KVG or could place debtors with the KVG with whom they could arrange—in light of possible conflicts of interest—to take over credit processing. The KVG (subsidiary of a bank) finds one or more investors for the credit portfolio and issues the fund in accordance with their specifications. The advantage for the financial institution is that the risks of the credit business could be transferred and therefore, more efficient management of the institution's own funds and the relevant indicators according to CRD IV is possible. Apart from this, the arrangement enables the financial institution to maintain the relationship with the client/debtor, because the credit processing functions are still within the bank. It is therefore possible to increase and diversify the credit business without the strains of own funds requirements and independent of the bank's readiness to assume risks, offering a broader range of products and solutions with additional earnings from servicing (commission revenue) instead of interest revenue.

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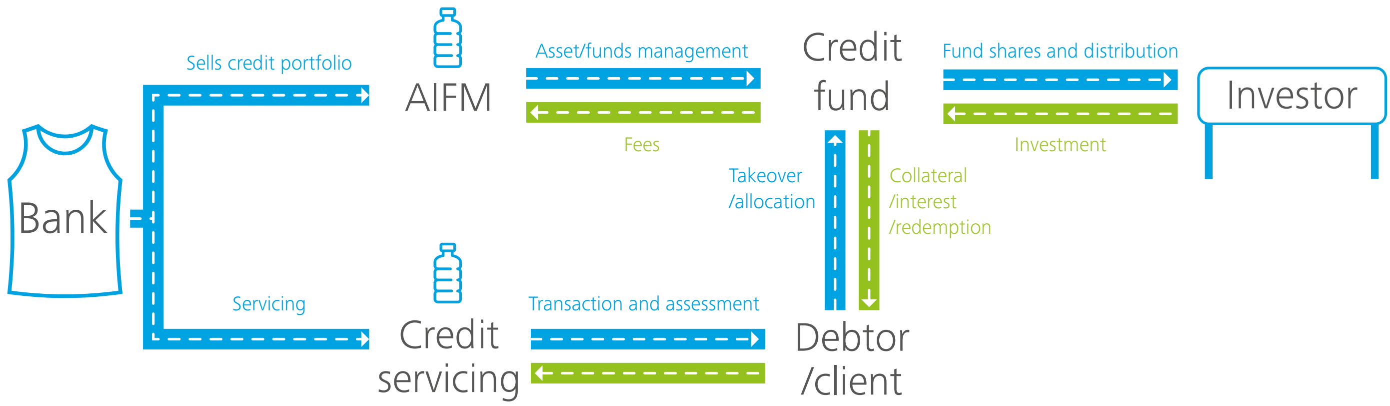
The following picture gives a schematic overview of the possible relationships between the market participants:



The extent to which credit funds establish themselves on the market (and also in relation to products that are already on the market) depends on the following parameters:

- The final legal framework in Germany, which must be designed so that there are incentives for all involved parties to invest in the product and so that there are no competitive disadvantages in comparison to the context in other European member states.
- Fund management expertise regarding the selection, structuring and management of the investments (by means of outsourcing where necessary).
- KVGs' ability to access senior debt portfolios with good risk/return ratios, in which institutional investors are most interested. In this context, cooperation with financial institutions may be advisable. However, possible conflicts of interest deriving from the cooperation with the bank must be considered.
- Distribution of the incentives/revenues between the involved parties: the financial institution as the originator of the debt claim, the asset manager, and the investors, as well as, the service provider, where applicable.
- Eventually, the supervisory authorities will take an interest in preventing an increase in credit fund scenarios that allow the transfer of credit risks in unsupervised market areas. It is expected that in Europe, frameworks for credit funds will be established to prevent systemic risks without a significant limitation of the possibilities for company and infrastructure financing. We will have to wait and see what the effects of possible compromises with the regulatory authorities will be. Our initial thoughts on this topic can be found in the ESMA report on trends, risks, and vulnerabilities (January 2015) and the ESRB (European Systemic Risk Board) paper on "Loan Origination by Investment funds." Here it remains to be seen what the effects and possible regulatory compromises will be for the development of loan originating funds.

Outlook

The market success of credit funds will depend on the regulatory constraints that lie ahead in the context of the standardization in the KAGB and the implementation in European law. On the market, credit funds will be competing with established products and, once again classified as eligible, the securitization market (Security Token Service (STS) certificate, true sale securitization). In relation to other (securitization) fund types, an AIF credit fund as defined under the German regulation will have some additional features. It remains to be seen how market participants will use the leeway offered and how the German framework will work in comparison to the credit fund alternatives of other European member states.

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To the point:

Due to a change of supervisory practice by BaFin and changes in German law by the UCITS V transformation act, loan funds as well as loan origination has been facilitated. In order to make use of the new rules, certain provisions are to be observed:

- Changes to the conditions of loans (restructuring/prolongation) are permitted
- Loan origination is only allowed for domestic closed-end Special-AIF
- For closed-end Special-AIF loans leverage is allowed, but only up to 30 percent
- AIF investment management companies which are launching credit funds do have to comply with the respective organizational and risk management rules as stipulated in the minimum requirements for risk management of banks (MaRisk)
- No granting of loans to consumers
- The AIF-KVG has to acquire expertise in the area of credit within the portfolio and risk management, as well as, in credit processing and needs to establish an operating model for the credit business
- Instead of establishing the organizational framework and processes on its own, the KVG has the possibility to source out parts of the credit business to a respective service provider; nonetheless a certain level of competency has to be retained to provide for an appropriate outsourcing controlling

Additionally, more liberties were retained or conceded, respectively, with regard to loans granted to property companies, subsidiaries or companies in which the fund holds a share.