Debt Funds – A Regulatory Challenge?

Referent:
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„Finanzmärkte neigen dazu, Risiken lange zu unterschätzen; und danach neigen sie dazu, diese Risiken zu überschätzen."

(Wolfgang Schäuble, IWF/World Bank Spring Summit April 2012)

(Quelle: http://www.wolfgang-schaeuble.de/index.php?id=35)
Debt Funds – Regulatory Landscape

– Regulatory Challenge

– We live in a regulatory decade, not to say in the regulatory century
Concept of Debt Funds

– "Debt Funds" are not a legally defined term but need at the first stage be considered as an economic phenomenon.

– This economic phenomenon needs to be subject to legal scrutiny.

– Thesis: We cannot easily define Debts Funds as a positive legal phenomenon, but we can segregate this from other legal phenomena.
Economics (1)

– Non-Bank-Investors purchase debts

– Investment is not effected by market volatility

  – Interesting for conservative investors who don't want to take equity risk and need steady returns
  – Investment in Debt Funds adds stability to Investment portfolio
Economics (2)

– Debt Funds can provide liquidity based on the duration of the underlying

– Freedom to withdraw money when required

– Useful to create a well balanced portfolio
Structure of Debts Funds

- Inventor
- Corporate Servicer
- Debtors
- Cash Manager
- Fronting Bank
- Investment Vehicle

INVESTORS
How can we characterize Debt Funds? – A negative approach

– Interesting: Some Debt Funds definition approaches are negative approaches

– Debt Funds ≠ Securitisation Vehicle

– "Originator" and "Holder" of the Debt Funds are different entities
Legal Landscape

– Old School Approach - The German national law as it stands

– MiFID

– CRD IV

– AIFMD
Old School Approach (1)

- § 1 Abs. 1 S. 2 Nr. 2 KWG (Credit business)
- § 1 Abs. 1a S. 2 Nr. 9 KWG (Factoring)
- § 32 Abs. 1 S. 1 KWG (Cross-Border)
Old School Approach (2)

- § 1 Abs. 1 S. 2 Nr. 2 KWG (Credit Business):
  … Banking business comprises …
  (2) the granting of money loans and acceptance credits
  (lending business),…

- no explicit BaFin Guidance

- BaFin Circular as of 08.01.2009
Old School Approach (3)

- § 1 Abs. 1 S. 2 Nr. 2 KWG (Credit Business)
  - Neither disclosed or undisclosed assignment nor true sale of debts do trigger regulatory license requirements within the meaning of "gewähren" according to § 1 Abs. 1 S. 2 Nr. 2 KWG
  - However, the direct granting of the loans may well constitute Credit Business
  - Market Solution: Fronting Bank, which assigns the loans to the Debt Fund
    - as it is an intraday exposure → no capital requirements
Old School Approach (4)

- § 1 Abs. 1a S. 2 Nr. 9 KWG (Factoring)
  … Financial services comprise …
  (9) the ongoing purchase of receivables on the basis of
  standard agreements, with or without recourse (factoring), …

- no explicit BaFin Guidance

- BaFin Circular as of 05.01.2009

- Market Solution
  - no standard agreements
Old School Approach (5)

- Extempore – My favourite

- § 32 Abs. 1 S. 1 KWG (Cross-Border)
  Anyone wishing to conduct banking business or to provide financial services in Germany commercially or on a scale which requires a commercially organised business undertaking needs written authorisation from BaFin; section 37 (4) of the German Act on Administrative Procedures (…) shall apply. …

- BaFin Circular as of 01.04.2005

- Market Solution
  – Passive Freedom of Services
MiFID I

– Debt Funds as a Financial Instrument?

– Sedes Materiae: Annex 1 Section C MiFID I

– No. 1: Transferable securities
  → depends on the structure of the investment instruments

– No. 2: Money-market instruments
  → probably not to be considered as Financial instruments within the scope of MiFID I
CRD IV

– Securitisation, Art. 4 Par. 1 No. 61

– Transaction or Scheme
– Credit Risk associated with risk exposure
– Tranche (No. 67)
– Payments depend upon the performance
– Subordination determines distribution of losses

⇒ Can a Debt Funds qualify as securitisation?
AIFMD / KAGB (1)

– Debt Funds to be qualified as a Fund within the scope of AIFMD?

– AIF?

– Exemption?
AIFMD / KAGB (2)

- AIF ?

  - AIF = Any collective investment undertaking, which raises capital from a number of investors, with a view to investing it in accordance with a **defined investment policy** for the benefit of those investors and which does not require an authorisation pursuant to Art. 5 of the UCITS Directive (Art. 4 AIFM Directive 2011/61/EU)
AIFMD / KAGB (3)

– Defined Investment Policy?

– ESMA Discussion paper as of 23.02.2012 No. 31 and BaFin Circular as of 14.06.2013 give indicative criteria whether a strategy is considered to be an investment policy or not, e.g.:

– Final form of the investment policy is fixed at the latest, by the time that investors' commitments to the entity become binding on them
– Investment policy is likely to be set out in a document which becomes part/is incorporated in/is referenced in constitutional documents of the entity
– Contractual relationship between the entity and the investor binds the entity to follow the investment policy
– Investment policy contains a series of investment guidelines, such as to invest only in certain categories, pursue certain strategies, invest in only particular geographical regions etc
– Investment policy is clearly set out and disclosed to investor
AIFMD / KAGB (4)

– Exemption?

– Securitisation Special Purpose Entities
  = Entities whose sole purpose is to carry on a securitisation or securitisations within the meaning of Article 1(2) of Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 (…) and other activities which are appropriate to accomplish that purpose; (…)

– Securitisation Special Purpose Entities excluded from the scope of the directive Art. 2 Par. 3 g)

→ Debt Funds can be exempted from a qualification under AIFMD
The Commission on Shadow Banking

– Barnier is not much better then McCreevy (unquoted quotation)

– Shadow banking is the system of credit intermediation that involves entities and activities that are outside the regular banking system. Shadow banks are not regulated like banks; they operate outside the regular banking system and yet engage in bank-like activities. (http://europa.eu/newsroom/calendar/event/447179/commission-adopts-communication-on-shadow-banking-and-proposes-draft-regulation)

– Will Debt Funds be regulated by the proposed EU legislation on Shadow Banking?
Another idea: ELTIF

- Will Debt Funds be regulated by the proposed EU legislation on ELTIF [COM(2013) 462 final 2013/0214 (COD)]?

- ELTIF = European Long -Term Investment Fund

- ELTIF can invest in different asset classes, such as
  - Equity or quasi-equity instruments issued by a qualifying portfolio
  - Debt instruments issued by a qualifying portfolio
  - Loans granted by the ELTIF to qualifying portfolio

→ Only EU AIFs shall be eligible for authorisation as an ELTIF
Path to go …

– Issues to be discussed
Which legal topics are left open?

– Solvency II
– Balance Sheet Items
  – IFRS / US GAAP
– Tax
  – VAT, Income Tax
    ➔ nothing new, however worth to be discussed
– Insolvency – will RRD apply?
– Data Protection