German regulator publishes new investment guidance for German institutional investors

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German institutional investors, like most institutional investors worldwide, are subject to strict regulatory requirements as to the types of investments they are allowed to make. In Germany, the Bundesanstalt für Finanzdienstleistungsaufsicht (the German Federal Financial Supervisory Authority, or the "BaFin") is responsible for issuing, updating and clarifying said requirements for German institutional investors.

Following the implementation of the Solvency II Directive within the European Union, Germany applies a two-tier regulatory regime to its regulated institutional investors. On the one hand, the investments by large insurance undertakings are now subject to the Solvency II regime, a more liberal regime, which imposes the "prudent person principle" to the investments by large insurance undertakings. On the other hand, investments by small German insurance undertakings, German pension schemes (Pensionskassen) and, with minor deviations, German pension funds (Pensionsfonds) do not fall within the scope of Solvency II, but continue to be subject to the stricter requirements set forth, inter alia, in the German Ordinance on the Investment of Guarantee Assets of Pension Plans, Funeral Insurance Schemes and Small Insurance Undertakings (Anlageverordnung, or "AnlV"). Moreover, investments by many of Germany's liberal professions pensions schemes (Versorgungswerke) and other retirement schemes also regularly apply the rules and requirements set forth in the AnlV as well as any regulatory guidance issued by the BaFin thereto.

Documents to beinformed:

- Newsletter 11/2011 (VA) in German

Please note that the fact that investments by large German insurance undertakings are now subject to the above-mentioned prudent person principle under Solvency II does not necessarily mean that such insurance undertakings completely ignore the AnlV. In practice, many large German insurance undertakings continue to apply the AnlV as a guiding standard when applying the prudent person principle under Solvency II to their investments.

In 2017, the BaFin published a consultation draft of its most recent circular addressing certain unanswered questions regarding the AnlV. Almost one year after the publication of this draft consultation, the BaFin issued its new guidance in its new investment circular (the "Circular"). Not much has changed compared to the consultation draft, but what little changes have been made in the final version are important, particularly for private equity funds.

By way of clarification, most German regulated institutional investors have different "buckets" out of which they undertake investments. The largest bucket is the so-called guarantee assets (Sicherungsvermögen), however, this bucket is also subject to the most regulatory requirements and supervision, including the AnlV. In its Circular, the BaFin describes how, in its opinion, the AnlV is to be applied to the investment of said guarantee assets. The Circular is specifically addressed to those institutional investors that are not subject to the Solvency II regime. However, as already stated above, the Circular will also be helpful for those institutional investors subject to the Solvency II regime and the prudent person principle.

New "bail-in" debt category

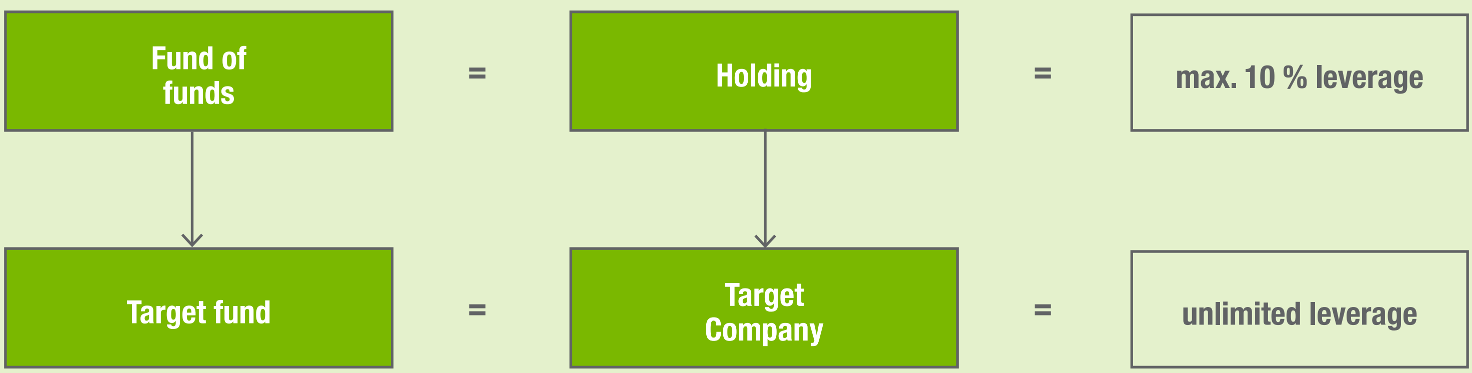
One of the new rules in the Circular is the BaFin's administrative view of the "bail-in" debt instruments. These new rules affect the investments by insurance companies and pension funds in certain debt instruments that are issued by institutions subject to the Capital Requirements Regulation (i.e. mainly credit institutions and investment firms). In the event of the insolvency of the issuer, these debt securities are subject to a statutory subordination to other claims. In the Circular, the BaFin requires a quota for such debt securities to have a maximum ratio of 25 % of the guarantee assets. Investments acquired before January 1, 2017, do not have to be counted towards the bail-in ratio.

Borrowing by private equity funds

It was not clear for quite some time whether German regulated institutional investors could invest their guarantee assets in private equity funds that incurred debt, i.e. whether such an investment in a private equity funds that incurred debt was still an "eligible investment" for the guarantee assets. In particular, it was not clear whether, to what extent, for which purpose and/or for which length of term, private equity funds could borrow and still remain an eligible investment for the guarantee assets of a German regulated institutional investor. The BaFin has now clarified in its Circular that borrowings by private equity funds is fundamentally permissible, in particular for the pre-financing of capital calls. However, no limitations as to the amount or length of term of any borrowings are provided in the Circular.

The BaFin has also stated in the Circular that a short-term borrowing of up to 10 % of the value of the AIF is generally permitted at the level of a fund of funds. In our opinion, this rule is meant to limit the use of leverage both at the level of a holding company as well as at the level of a fund of funds.

Please note that, in our opinion, borrowings for the pre-financing of capital calls by a fund of funds do not fall under this 10 % limit and should not be counted towards this limit. These loans are covered by the investors' undrawn capital commitments and are usually repaid when the capital is called and paid in by the investors. The loans do not increase the investment level. Usually, such borrowings will be short-term financing, the amount of which does not exceed the undrawn capital commitments.



Investments by open-ended special AIF with fixed investment conditions

The Circular has also introduced some changes for investments in so-called “open-ended special funds with fixed investment conditions” (offene Spezial-AIF mit festen Anlagebedingungen) by regulated German institutional investors. Special funds are funds that allow only institutional investors to invest; private individuals must be specifically prohibited from investing in the fund documentation. Such funds are also considered to be eligible for the guarantee assets of regulated German institutional investors and are often used to bundle their investments. However, in order to be an eligible investment for the guarantee assets, the investments by the open-ended special funds with fixed investment conditions itself need to satisfy certain requirements and limitations.

While the special fund regime has been liberalized by previous German legislation, the Circular has imposed additional requirements on special funds limiting some of that leeway. For example, the Circular now limits investments in securities and derivatives by an open-ended special fund with fixed investment conditions only if these securities and derivatives are within a UCITS-compliant framework, i.e. if they satisfy the statutory restrictions applicable to UCITS (Undertakings For The Collective Investment Of Transferable Securities).

Moreover, the Circular allows open-ended special funds with fixed investment conditions to invest no more than 20 % in non-listed companies, including interests in closed-ended private equity funds. In addition, open-ended special funds with fixed investment conditions may invest no more that 30 % of their value in non-securitized loan receivables and precious metals. Investments in open-ended funds which do not observe the same restrictions as the investing fund may also not exceed 49 % of the fund’s value. A 49 % threshold also applies to investments in real estate and real estate funds.

Finally, the Circular states that in order to remain eligible for the guarantee assets of a German regulated institutional investor, an open-ended special funds with fixed investment conditions may not invest in closed-ended funds, i.e. in funds that do not grant an annual redemption right. However, this statement gives rise to some confusion as UCITS, i.e. highly regulated retail funds that are subject to EU-wide unified regulatory and investor protection requirements, are allowed to invest in closed-ended funds. It is therefore surprising as to why closed-ended target funds are allowed for UCITS but not for open-ended special funds with fixed investment conditions when German regulated institutional investors may invest in both types of funds. It is our opinion that the BaFin’s statement is not intended to restrict investments in closed-ended funds that qualifiy as non-listed companies or UCITS-compliant securities.

Investments in real estate funds

Generally, both closed-ended and open-ended real estate funds (but not open-ended retail funds) have been eligible for the guarantee assets since March 2015, and specifically the “real estate quota” therein, provided that such funds were limited to investing (directly or indirectly) in real estate assets, were domiciled within the EEA, managed by a licensed EU-based management company and limited their loan-to-value to 60 %. However, the management of the real estate assets would require, and therefore the fund documentation would specifically allow, such real estate funds to invest in other assets necessary for the management of the real estate assets. While it was clear that in practice, such investments in other assets were necessary for management purposes, the fact that this question was never addressed and clarified by the BaFin gave rise to some uncertainty. Finally, the BaFin has clarified in its Circular that a real estate fund may also invest in such other assets for management purposes without jeopardizing its eligibility for the guarantee assets of a German regulated institutional investor.

Conclusion

The guidance regarding private equity fund and private equity fund of funds is now clearer and, in our view, essentially sound. However, while the BaFin has finally provided some guidance for investments by German regulated institutional investors, the Circular does not go far enough and fails to address and clarify a number of still unanswered questions, or even gives rise to new questions, which could alleviate the due diligence and investment process by German regulated institutional investors.

be in touch: Any questions? Please do not hesitate to contact us!

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