The German Schuldscheindarlehen

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Bloomberg-Kürzel: NRDR <GO>

Contents

Definition

Roots and brief overview

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The origins of the Schuldscheindarlehen (SSD) go back to the 19th century. In the last few years, the SSD has established itself as an important alternative in corporate financing on the capital market alongside syndicated loans and corporate bonds.

The Schuldscheindarlehen has established itself as an advantageous debt financing instrument

The Schuldscheindarlehen is generally understood as being a special form of loan contract pursuant to section 488 et seq. of the German Civil Code (BGB). Similarly to a conventional corporate bond, an SSD is therefore a favourite mid to long-term financial instrument used on a regular basis by many companies. Compared with the issue of a corporate bond, an SSD is far less onerous in terms of administrative requirements. Publicity and documentation costs are much lower and an external rating is not essential. Nevertheless, the implied rating of most Schuldschein issuers is in the investment grade category, since investors who are active in the market are fairly strongly bound to the issuer's credit rating in view of bond restrictions. In view of the current low interest-rate environment, however, this rule of thumb is breaking down slightly at present and even issuers with a weaker credit rating stand a good chance of a successful placement. To sum up, the SSD is a debt instrument which combines the properties of conventional bank loans and bonds. The SSD is especially interesting for companies which are extending their financing base beyond their relationship banks and looking for stronger public exposure. Schuldscheindarlehen are regarded by most investors (banks, savings banks, insurance companies, etc.) as a buy-and-hold investment.

Legal framework

Defining the Schuldschein in relation to conventional financing instruments

Schuldscheindarlehen not a security

A Schuldscheindarlehen (just like a syndicated loan) is not a security under the terms of section 2 no. 1 of the German Securities Trading Act (WpHG) nor under the terms of section 2 no. 1 of the German Securities Prospectus Act (WpPG), and it is not traded on the stock exchange. Consequently, it does not come under the requirement to issue a prospectus nor is the SSD subject to any public approval requirements.

Distinguishing SSDs from credits and bonds

A distinction has to be made between the Schuldscheindarlehen on the one hand, and the syndicated loan and the corporate bond on the other, in light of the former's legal and financial form. In terms of its fungibility, the Schuldscheindarlehen ranks between a corporate bond and a syndicated loan. Unlike bonds, Schuldscheindarlehen are not listed on the stock market but instead are traded over the counter (OTC) in the interbank market. The Schuldschein, which is issued through the SSD, thereby serves as a certificate of indebtedness evidencing the underlying loan (see section 344 of the German Commercial Code (HGB)) vis-à-vis the Schuldschein issuer. This Schuldschein must be signed by a legally authorised signatory of the debtor. It is not absolutely necessary to give the grounds for the liability. However, it is also possible to leave out such a "Schuldschein certificate". Issuing a certificate is not a legal requirement and it can be replaced by a contact or an assignment agreement.

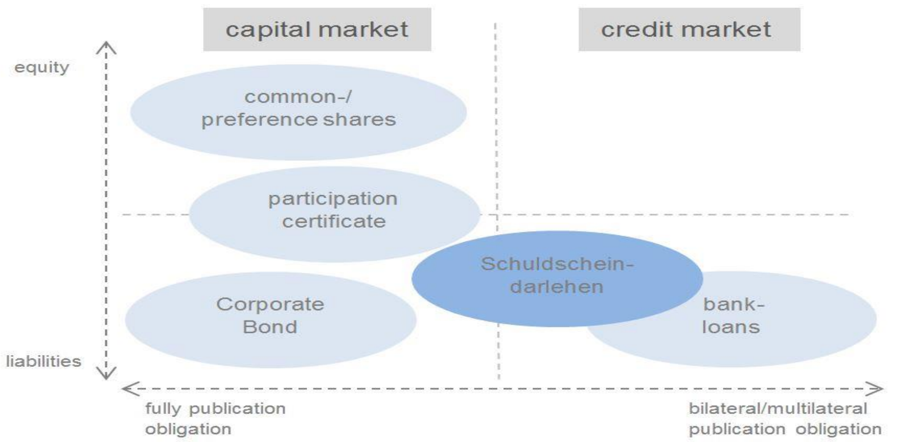
Schuldscheindarlehen seen as bond-like credit

The SSD is often seen as being a credit sharing similarities with a traditional bond, or a capital-market-like form of financing. However, it is important to bear in mind that the German Bond Act (SchVG) is not applicable to SSDs, since under civil law, neither the loan agreement, nor the Schuldschein issued are regarded as a bond under section 793 et seq. of the German Civil Code (BGB). The granting of a Schuldscheindarlehen mostly constitutes a banking transaction (under the terms of section 1 (1) sentence 2 no. 2 of the German Banking Act (KWG). Under section 32 (1) sentence 1 of the German Banking Act, granting SSDs commercially is only allowed in Germany with the written authorisation of the BaFin. According to the general interpretation, short-term Schuldscheindarlehen must be classified as money market instruments (under the terms of section 2 (1a) WpHG) and hence as a financial instrument (under the terms of section 2 (2b) WpHG)). However, in view of the absence of any organised or regulated market, most of the rules under the German Securities Trading Act (WpHG) are not applicable.

Schuldschein a bilateral loan agreement

Fundamentally, the inherent form of a Schuldscheindarlehen equates to that of a bilateral loan agreement and it must therefore legally (pursuant to section 488 et seq. of the German Civil Code (BGB)) be classified as a loan and not as a bond. In general, companies do not issue Schuldscheindarlehen themselves, but rather through a financial institution. The duties of the financial institution can be limited to that of arranger or, as is mostly the case, the company concludes the Schuldscheindarlehen direct with the bank in question who then sells it on to willing investors by way of an assignment or assumption of contract. Since there can sometimes be several dozen investors (and sometimes even more) involved in a Schuldschein transaction, it diversifies the liability side of the company in question and thereby reduces its dependence on individual lenders.

Schuldscheindarlehen – classification among financial instruments



Source: NORD/LB Fixed Income Research

Clauses & covenants

Statutory termination rights and covenants

Forms of securitisation

A Schuldscheindarlehen can be placed both as a senior secured debt and in unsecured form. In this respect, the covenants and reporting obligations hardly differ from those applying to a conventional credit financing. One particular feature in relation to corporate bonds is that an SSD with a fixed coupon can be terminated by the issuer after a period of ten years (ordinary right of termination), pursuant to the statutory right of termination (section 489 of the German Civil Code (BGB)).

Statutory termination rights

However, this right of early redemption only applies in the case of non-public sector issuers (such as companies or banks). If the Schuldscheindarlehen is issued at a variable rate of interest, then the loan contract can be terminated at any time by the borrower after a notice period of three months – based on section 489 (2). SSDs are, like other loans, repayable on agreed maturity dates, unless they have already been repaid in part or in full. Usually, the repayment amount at the end of the maturity of the respective Schuldscheindarlehen is the original loan amount.

Covenants agreed with lender to reduce risks

As a rule, Schuldscheindarlehen rank as senior unsecured and are issued without providing collateral. However, additional contractual arrangements – "covenants" – are usually agreed to minimise risks for lenders. The inclusion of covenants tends to increase as the size of the company and its liquidity diminishes. Additional contractual restrictions are entirely the norm in order to limit the basis risk, not least as a result of the extension of the group of borrowers to include non-investment grade borrowers in the case of companies with a non-investment grade rating. The internationalisation of the Schuldscheindarlehen is leading to the inclusion of relevant covenants in line with international norms. These covenants can be any of those also included in bond documentation or in the international market for syndicated loans. Apart from the obligatory contract elements such as the parties to the contract, loan amount or interest rate, the following clauses are among the standard clauses.

Explanatory notes on a number of important covenants

<u>Negative pledge:</u> undertaking by the issuer not to encumber certain assets as collateral for financial liabilities (e.g. pledges of any kind, mortgages, assignment of claims).

<u>Pari passu:</u> an agreement that liabilities will always be of equal ranking with all current, future or not subordinated payment obligations.

<u>Change of control:</u> extraordinary right of termination of the lender in the event that over 50% of the shares or voting rights in the borrower are held or exercised by another person.

Cross-default clause: Option to terminate in the event that the borrower defaults on another liability arising from financial contracts, falls into arrears, terminates these early, etc.

Cross-acceleration clause: In contrast to a cross-default clause (where the event of a reason for termination suffices), the cross-acceleration clause assumes the termination of a loan.

Financial covenants: the borrower and possibly also the guarantors must be able to demonstrate that they are staying above set ratios. In most cases, these include the equity ratio, the leverage ratio and the interest ratio.

Advantages and disadvantages

Schuldscheindarlehen – a comparison

In addition to its many advantages, a Schuldscheindarlehen also has disadvantages compared with other financial instruments. In the following, we propose to look in more detail at the pros and cons of the SSD in relation to syndicated loans and bonds.

Pros	Cons
Broader investor group than in the case of syndicated loans	Lack of anonymity of lender
Terms of the loan can be agreed between issuers and individual lenders	Statutory right of termination of borrower
Minimal documentation requirements hence much lower costs	Insufficient (statutory) regulations in the event of restructuring
Only reporting obligations vis-à-vis investors (no publicity obligations)	Internal credit analysis of all investors required
Less time-consuming	Achieving target issue volume not guaranteed in view of limited information
Low minimum volume from EUR 20-25m	No liquid secondary market
No need for external rating	Transfer of ownership only possible through assignment
Much lower transaction costs	Greater range of reoffer spread in view of longer marketing period
Accounting as per IFRS at amortised cost and not at fair value	Lack of market transparency
Tranching option: SSDs can be split into smaller loans	
Stable issue spreads in volatile market phases	

SSD transaction

Timeline of a Schuldschein transaction

Schuldschein transactions go through a structured process

SSDs can be issued within a very tight timeframe in view of existing requirements and a lean documentation. The actual preparation phase begins once initial discussions have taken place between the issuer and the arranging bank. As a rule, it lasts two to four weeks and key points of the financing are summarised in an indicative term sheet. Once the mandate has been assigned, the documentation is prepared and credit research is carried out. The SSD documentation which is partly negotiated in parallel is generally around 20 pages long. Once marketing starts, the paperwork, consisting of investor term sheet, credit research, documentation and financial documentation on the company, is distributed to the investors. The latter then initiate their own in-house credit process independently from each other (individual scrutiny of all risks), which is completed once the necessary committee resolutions have been obtained along with a firm acceptance of the invitation to join the group of investors. The period between the mandate being issued and disbursement of the loan is usually around six to ten weeks, which is quick in relation to the time it takes to organise bond issues and syndicated loans.

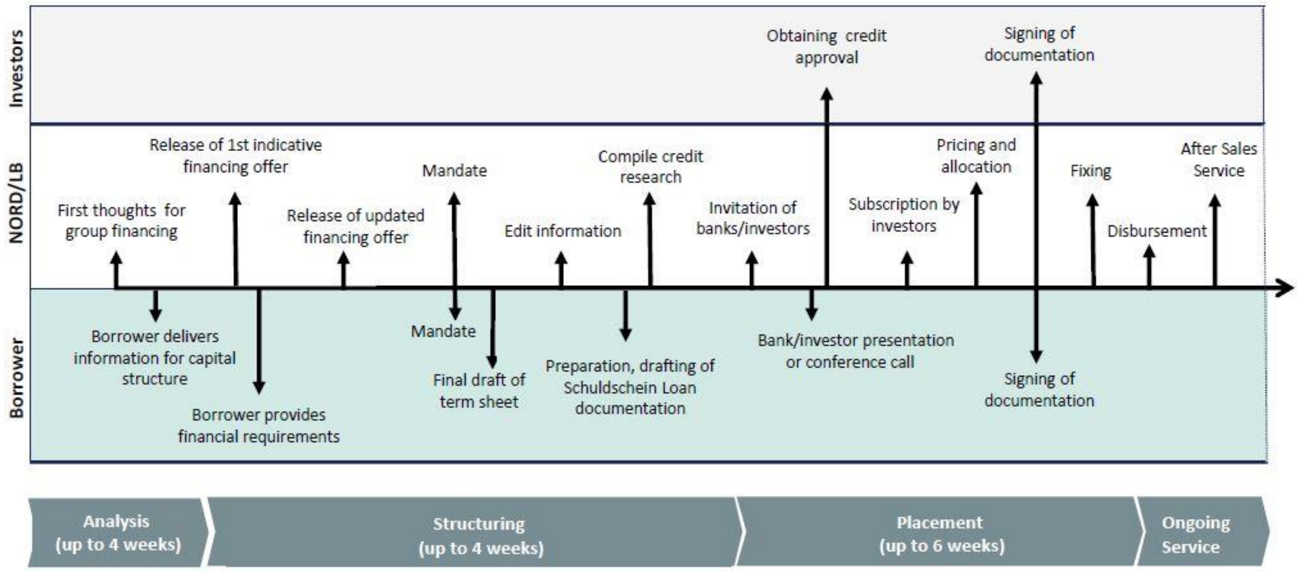
Pricing

The pricing of SSDs is similar to the pricing of syndicated loans or bonds. Main pricing drivers are beside the credit worthiness of the issuer the maturity time as well as spread levels of benchmark issuers.

Credit research

SSD investors are traditionally buy-and-hold investors. The investor base is more interested in the credit-worthiness of the Schuldschein issuer than driven by relativ-value aspects. Therefore marketing of SSDs plays an essential role in a successful placement of a Schuldschein. The positioning of the issuer in combination with a sound credit story are of main interest.

Schematic representation of a Schuldschein transaction



Source: NORD/LB Origination Corporates

Accounting

Approaches under different accounting standards

Analyst:
Christopher Kief

Investors can generally recognise investments in Schuldscheindarlehen at amortised cost (nominal value) under both IFRS/IAS (IAS 39 and IFRS 9) and the German Commercial Code (section 341c HGB). As a credit product which is not listed, the regulator does not see any accounting requirements at fair value in this respect as would be the case with a corporate bond or another type of security. This avoids any impact on the profit and loss, since changes in fair value have absolutely no effect on the valuation (unless they involve a permanent reduction in value). At this point, we would like once again briefly to look at forthcoming amendments which will arise once IAS 39 is replaced by IFRS 9 with effect from 1 January 2018. Under IAS 39, financial assets and liabilities are classified and valued based on four different forms:

Accounting at amortised costs means P&L stability

- financial assets at fair value through profit or loss (FVtPL)
- held-to-maturity (HtM)
- loans and receivables (LaR)
- available-for-sale financial assets (AfS)

Schuldscheindarlehen quasi bilateral credit agreements

In legal terms, conventional Schuldscheindarlehen are nothing other than a bilateral loan agreement, meaning that they can be classified under the category of loans and receivables in all cases. When investing in a Schuldscheindarlehen, investors are always pursuing a buy-and-hold investment approach, which means among other things only a limited availability of a secondary market and hence insufficient liquidity. Under IAS 39, where the intention is to hold an asset until maturity, it would also be conceivable to classify it in the held-to-maturity category.

SSDs also likely to enjoy preferential accounting treatment under IFRS

As part of the amendment of the accounting rules for financial instruments, in future, under IFRS 9 only three classification categories will be used:

- amortised cost (AC)
- fair value through other comprehensive income (FVtOCI)
- fair value through profit or loss (FVtPL)

It will only be possible to value a financial asset at amortised cost (AC) once the contractual cash flow terms have been met and if the business model is based on the collection of payments of interest and principal. The cash flow terms will be deemed to have been met if the contractual cash flows are due at set dates and include exclusively payments of interest and principal. Accordingly, the payments must have the characteristics of a conventional loan relationship. In our view, only genuine debt instruments are directly eligible for an AC classification and hence also Schuldscheindarlehen.

Accounting as per HGB

For issuers and investors who can only report under German accounting rules under the German Civil Code (BGB), Schuldscheindarlehen are generally recognised under the item "other liabilities" pursuant to section 266 (3) C. 8 of the German Commercial Code (HGB) (issuer) or, because of the fundamentally long-term nature of the financing instrument, under "other loans" pursuant to section 266 (2) A.III.6 HGB (investor).

Issue does not trigger a compulsory IFRS accounting

The issue of a Schuldscheindarlehen does not result in the mandatory application of IFRS for capital-market oriented group parent companies (section 315a HGB), unlike in the case of the issue of a corporate bond in an organised market (under the terms of the WpHG). This is mostly relevant for SME issuers and family-owned firms which are not seeking to report under international accounting rules.

IAS 39 versus IFRS 9

IAS 39: Financial Instruments: Recognition and Measurement		
Classification	**Valuation**	**FV Changes**
Fair value through profit or loss (FVtPL)	FV	IS (P&L)
Available-for-sale financial assets (AfS)	FV	OCI
Held-to-maturity (HtM)	AC	-
Loans and receivables (LaR)	AC	-

IFRS 9: Financial Instruments: Recognition and Measurement		
Classification	**Valuation**	**FV Changes**
Fair value through profit or loss (FVtPL)	FV	IS (P&L)
Fair value through profit or loss (FVtOCI)	FV	OCI
Amortised cost (AC)	AC	-

Market conditions

Strong growth for CSSDs

Corporate Schuldscheindarlehen benefiting above all from M&A transactions

The market for Corporate Schuldscheindarlehen (CSSDs) has seen strong growth in the last few years. In this context, 2015 was a record issuance year (based on Reuters league table: EUR 19.7bn), driven mainly by a sharp increase against the previous year in the volume of M&A activities from German and European companies. In the end, we counted 107 transactions last year. As regards acquisition financings, CSSDs help generate the necessary funding without having to use existing credit facilities (in full), ensuring that there is still a high degree of financial flexibility even after the takeover has been successfully completed.

CSSDs as a sensible alternative to conventional bank loans

As a result of the global financial crisis in 2008 and resulting limitation of bank lending, the CSSD has earned recognition as a sensible alternative to conventional refinancing through the credit market. In the past, this asset class was dominated far more by public-sector issuers and by the financials sector. In our view, regulatory conditions for credit institutions (Basel III) and related higher capital requirements for conventional credit business are likely to support the expansion trend for CSSDs. In addition, there is a general trend towards disintermediation among European corporates in line with the Anglo-Saxon model. A large proportion of issuers are diversifying their existing sources of funding through CSSDs and thereby reducing their traditionally strong dependence on their relationship bank, although they are maintaining these business ties which sometimes go back a long way.

Proportion of issuers with an external rating relatively small

The proportion of CSSD issuers with an external rating (S&P, Moody's and Fitch) is usually fairly small (15% in FY 2015), since it is mainly SMEs which turn to the Schuldschein market. However, the credit quality remains at a very high level, as illustrated by the fact that there are not many credit events. The costs of a primary market transaction are much lower than those incurred with a bond placement in view of the absence of a prospectus requirement and generally far less onerous documentation requirements. Many SMEs, but also family firms or non-listed large companies do not yet meet the reporting requirements (legal/supervisory) which apply as standard for AGs or in the case of a bond issue, for example. CSSD issuers are therefore subject to less comprehensive disclosure obligations and publicity obligations can be agreed with each investor.

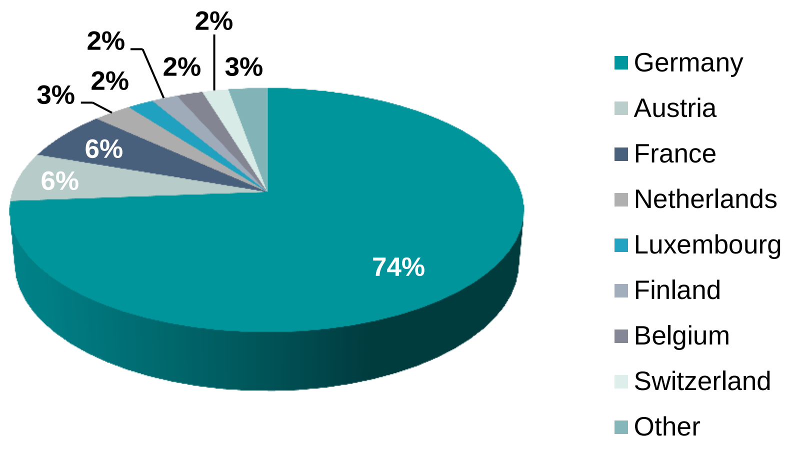
Diversification of funding

In general, initial information and financial indicators/annual reports are passed on to potential investors upon presentation of a confidentiality agreement. Established capital market participants (large caps) use CSSDs in order to diversify their funding and generally use this financing instrument opportunistically, but then on a scale that is relevant for the market as a whole. The focus here is mainly on penetrating new investor groups which should differ quite consciously from the normal buyers of corporate bonds in the same companies. Moreover, the contractual flexibility of CSSDs (e.g. tranching) in respect of maturity, coupon and currency is the main focus of attention for both parties (investor & issuer).

Increasing internationalisation on the investor and issuer side

Apart from German-speaking countries which are traditionally active in CSSD transactions, a growing number of companies from the Benelux and the UK are entering the SSD market with debut issues, underlining the growing internationalisation both on the issuer and investor front. The PP (private placement) market in Germany is organised in by far the most professional manner in Europe in terms of its development, a fact which also gives foreign issuers an incentive to issue a CSSD under German law. The euro PP, which is mainly used by French issuers and a handful of Italian or Belgian corporates as well as by the MARF in Spain is seen as an only approximately comparable European alternative to fixed-income markets. However, neither counterpart comes anywhere close to the issue volume and issue frequency of the German PP market. On the investor front, foreign market participants are on a carefully targeted search for European credit replacement transactions with companies which have not concluded any (public) corporate bonds or syndicated loans.

Issuers by country of origin in FY 2015 (%)



Source: NORD/LB Fixed Income Research

Insurance companies still have strong exposure in the CSSD market

Investor groups are mainly banks, savings banks and insurance companies. According to statistics from the German Insurance Association (GDV), loans amounted to a total of 22.7% of the investment of primary insurers in 2014, of which however, credit relationships with banks and states accounted for the bulk. In the "Principles for the Granting of Loans of Companies by Insurers" published by GDV, the requirements in terms of debtor credit rating are either an external rating in the investment grade category (at least BBB-) or meeting specific financial ratios (cash flow ratios, debt ratios and accounting ratios), which are geared to the methodology used by the international rating agencies.

Spreads & secondary market

Possibilities and limitations for the pricing

There is no liquid secondary market

Transactions in the CSSD secondary market are always processed as OTC transactions since there is no organised stock-exchange trading for this asset class. A price quotation – generally from German financial institutions – is therefore available strictly on demand only. At first glance, the lack of secondary market liquidity seems irrelevant since CSSD investors are mostly investing on a buy-and-hold basis. However, in view of a historically high outstanding volume of EUR 69bn (FY 2015), the lack of liquidity can definitely also be seen as a minus point. CSSDs are sold via assignment in accordance with section 398 et seq. BGB, which means that a suitable counterparty steps in instead of the investor. Compared with conventional loans, the transfer is contractually simplified in the case of CSSDs, among other things by agreeing in advance to an assignment in order to comply with the properties of a capital market instrument.

Pricing close to capital market pricing – geared to existing bonds or CDS spreads

The pricing of CSSDs does not follow a standard method since there are big differences in terms of the capital market professionalism of the various issuers. SME issuers above all generally have no outstanding benchmark bonds or traded CDS which could be used for the purpose of a representative spread indication. However, in contrast to bilateral or syndicated loans, the level of CSSD spreads is geared much more to risk premiums in the capital market. Based on our observations, though, general risk sentiment has a less strong impact on primary market activities than in the case of corporate bonds (i.e. even when market sentiment is more risk averse, it is still possible to place CSSD successfully). In addition, the issue cycle is also less marked by seasonal fluctuations (e.g. the summer break).

CSSDs vs. bonds - comparison of individual risk premiums

If we compare the individual components of the CSSD spread with those of a similar corporate bond (based on identical parameters), then it is fair to assume that the general credit risk should be the same. There are differences far more in respect of the premiums for liquidity and credit spread risks. The limited fungibility of CSSDs goes hand-in-hand with a heightened liquidity premium in relation to a bond issue. On the other hand, the advantageous accounting rules for CSSDs lead to fair value-induced and issuer-related adjustments which can always occur when recognising a corporate bond at fair value. The CSSD transactions which we observed in 2015 and 2016 demonstrate the trend that established issuers were often able to carry out issues at spread levels which were below those of the bond reference curve. In this context, it seems that investors assign a stronger weighting to the largely eliminated credit spread risks than the illiquidity of the CSSD secondary market. Further strong investor demand is illustrated by the fact that many CSSDs are oversubscribed when they are issued. Consequently, we do not see any sign of increasing saturation on the demand front. This should generally also lead to a reduction in issue spreads.

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