

# Schuldscheine – a global alternative product of the future?

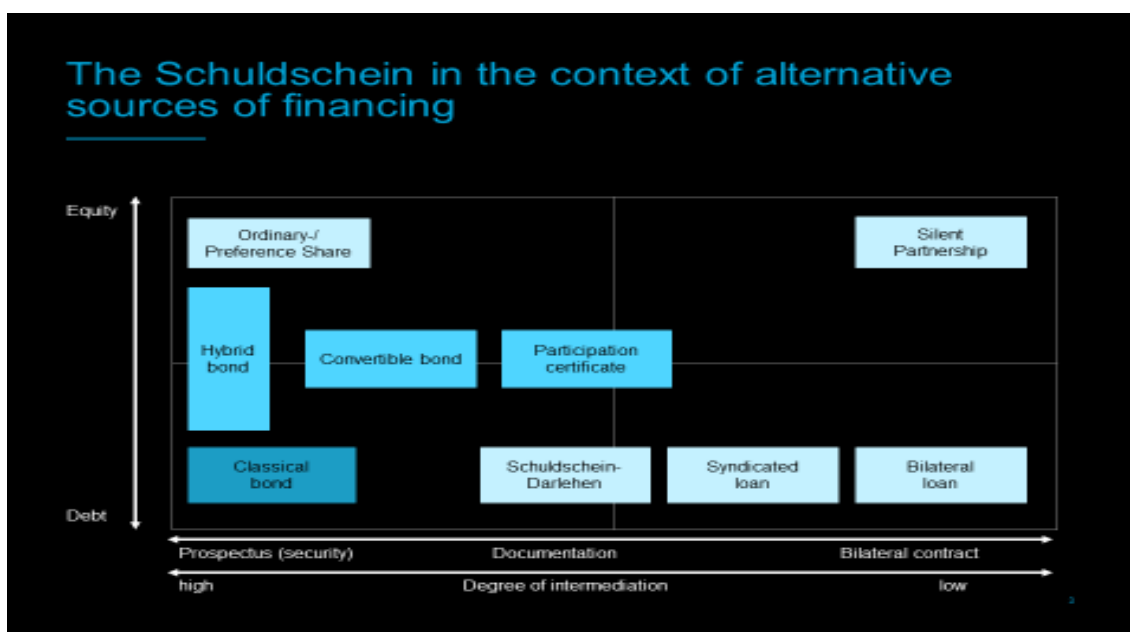
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Schuldscheine, no longer exclusively German products, are gaining international popularity as issuers and financial institutions realise their efficiency, flexibility and propensity for innovation. In the face of uncertainty in some public debt markets, Schuldscheine may present a valuable alternative mode of finance, but what are these products, and why are they attracting so much attention?

## What are Schuldscheine?

A Schuldschein (plural Schuldscheine) is a privately placed, typically unsecured medium to long long-term<sup>1</sup> debt obligation typically governed by German law, which fundamentally comprises of a loan agreement (a 'Schuldscheindarlehen' ("SSD")) and a certificate of indebtedness evidencing such loan agreement (a Schuldschein)<sup>2</sup>. Such certificate must not necessarily be a separate document, but the loan agreement itself, i.e., the documented SSD. Though not expressly legally defined, Schuldscheine are considered a hybrid financial product, somewhere in between a syndicated loan, a privately placed bond and a loan participation note.



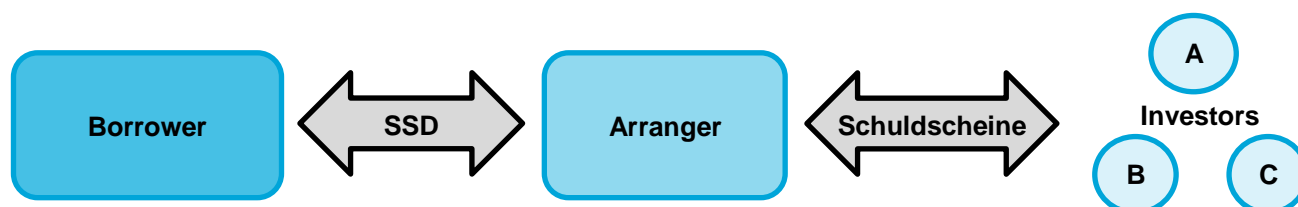
<sup>1</sup> The majority of 'Schuldschein' loans have a term of between five and ten years. One of the reasons being that a statutory call right applies to Schuldschein loans with a term of more than ten years.

<sup>2</sup> Especially in the international market, the term Schuldschein is often used synonymously for the SSD, the actual loan.

Despite being structured as similar as possible to a security, *Schuldscheine* are not considered securities for the purposes of either EU<sup>3</sup> or German securities law<sup>4</sup>, so there is no obligation for borrowers to produce a prospectus prior to the sale of the instruments, and *Schuldscheine* may neither be cleared through a clearing system nor listed on a stock exchange.

In a typical *Schuldschein* structure, an arranging bank agrees the underlying SSD with a borrower, and then sells *Schuldscheine* on in tranches to other banks and institutional investors.

### A typical '*Schuldschein*' structure



As *Schuldscheine* do not constitute securities, a transfer of the *Schuldscheine*, (in contrast to traditional securities)<sup>5</sup>, is facilitated by way of assumption of contract or by assignment of the underlying SSD<sup>6</sup>. Also, in comparison to traditional loans, the transfer of SSDs is contractually simplified due, among other things, to consent to the assignment being given in advance. In this respect, it conforms to the characteristics of a capital markets instrument, especially in regards to fungibility<sup>7</sup>.

### The benefits of *Schuldscheine*

Parties tap the *Schuldschein* market for a variety of reasons, but the main inducements from the perspective of the issuer are as follows:

- **Cost savings.** *Schuldscheine* are designed to be extremely efficient, both in terms of time to complete and transaction cost. Importantly, *Schuldscheine* entail very concise and standardised documents running to a few pages at the most, in stark contrast to the multi-hundred page prospectuses needed for a publicly traded notes issuance. Further, because *Schuldscheine* are not generally considered securities nor traded on a regulated market, issuers save on the time and cost of having a prospectus approved, listed and rated. Additionally, as SSDs are not listed on a stock-exchange, there are no follow-up requirements concerning a listing and Directive 2013/50/EU does not apply<sup>8</sup>. Once the SSD has been tapped, there are no ongoing reporting requirements to the public but only those vis-à-vis lenders and only as agreed in the SSD. This cost efficiency means borrowers looking for smaller quantities of capital are not faced with transaction costs that make a publicly traded bond issuance unviable.
- **Investor diversification.** Both borrowers and lenders can diversify their investor base/loan portfolio through *Schuldscheine*. *Schuldscheine* connect borrowers that may not choose to access the traditional capital markets with institutional investors who do not typically participate in syndicated loans. For borrowers, the cost of capital in a *Schuldschein* may be lower than for a loan from their core banking group, and investors may obtain a higher yield than would otherwise be available from a public bond. Spreads on five-year *Schuldscheine* issued in 2017 were almost double the spread on comparable bonds.
- **Improve debt maturity profile.** Another advantage of *Schuldscheine* is their ability to be offered to investors in tranches with different maturities if desired. Offering varying maturities in parallel improves the maturity profile of the borrower's financial liabilities, in contrast to a bond or loan requiring a bullet

<sup>3</sup> i.e. the EU Prospectus Regulation (Regulation (EU) 2017/1129).

<sup>4</sup> *Schuldschein* are not negotiated, traded or marketed like traditional securities, such as a public bond.

<sup>5</sup> Which are transferred (in accordance with the principles of property law), by transferring the relevant certificate or by entering them into an electronic register (if issued in global note form).

<sup>6</sup> Which is why no *bona fide* acquisition is possible for SSDs.

<sup>7</sup> This is necessary, as investors often require SSDs to be transferrable practically without any restrictions due to regulatory reasons.

<sup>8</sup> The Transparency Directive.

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repayment on a single date. Further, Schuldscheine can also be taken out in tranches with different fixed interest rates and even, if appropriate, with mixtures of fixed and floating interest rates.

- **Flexibility.** As Schuldscheine are privately placed with a relatively small number of investors, the products can be tailored much more closely to individual investor's needs and the process is more collaborative between issuers and investors than a public bond issuance. Financing can also be raised with discretion, if needed, as no public announcement relating to any Schuldschein completion is generally required.
- **Low minimum issue amount.** Compared to bonds, which are hardly ever issued in an amount below €100m, individual SSDs can be taken out in amounts as low as €15m. Due to time and cost savings in the transaction process, SSDs are a suitable gateway capital markets instrument, especially for borrowers with relatively low funding requirements. However, this instrument is flexible enough to accommodate a full range of sizes, including (and which we have seen in the domestic market frequently) benchmark sizes.

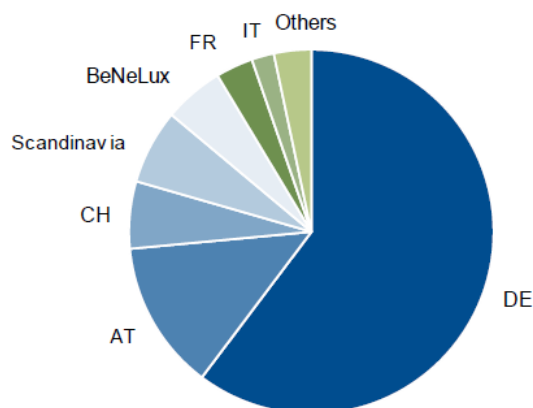
For these reasons, Schuldscheine are becoming an increasingly popular alternative to the more mainstream loan and bond market products, even beyond their native Germany.

## Beyond Germany – the internationalisation of Schuldschein

While in the past, traditional Schuldschein market participants were mainly public sector entities and unrated investment-grade German companies as borrowers, with regional German banks acting as arrangers and investors, now, these parties are diversifying substantially. Borrowers nowadays come from all lines of industries from the small- to mid-market companies with a good credit standing, to well-known companies. The group of investors on the other hand mostly consist of insurance undertakings, industry pension schemes and pension funds. Besides that, investment funds and Pfandbrief banks (banks issuing covered bonds), traditional savings banks and commercial banks play a tremendous role as investors. Regarding these institutional investors, SSDs are highly attractive mid- to long-term investments due to the favourable treatment afforded to them under German and international accounting regulations, and also their concise and flexible documentation.

Geographically, both borrowers and lenders are now increasingly located outside of Germany in spite of the governing law for Schuldscheine being German law. As Schuldscheine are widely regarded as a suitable quasi capital markets instrument to tap the capital markets (in particular, for first time borrowers/issuers), the pool of non-German Schuldschein arrangers is growing year after year, and these arrangers bring a raft of domestic clients to the market. The SSD is establishing itself as an important new development in the debt markets and has become a frequently used alternative to syndicated loans and bonds issues. After initially spreading to Austria and Switzerland, Schuldscheine have now gained popularity in countries including France, Benelux and Scandinavia as well as CEE. The Nordic region is now particularly ascendant for Schuldscheine due to a combination of relatively poor public debt market conditions and willingness of institutional investors to gain exposure to credit-worthy Nordic companies.

### Geographical distribution of SSD transactions in 2018

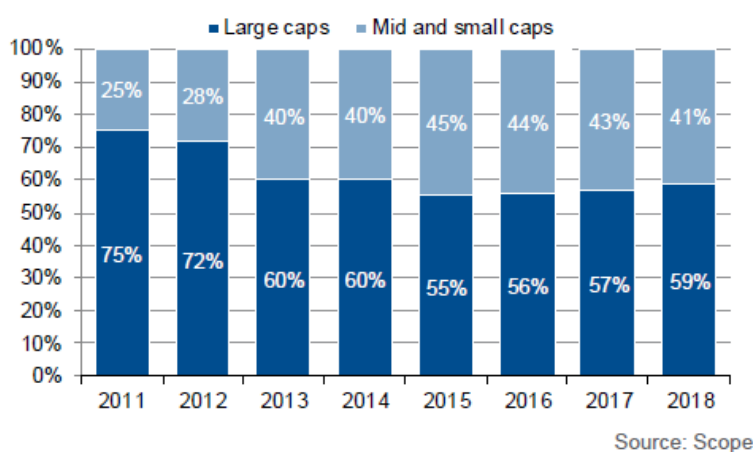


Source: Scope

The next geographical expansion for Schuldscheine may be to the Mediterranean states of Italy, Spain and Portugal, now that perceived country risk associated with these jurisdictions is less acute. From Italy, significant transactions last year involved two Italian household names, while from Spain, a major utility made a strong debut issuance in 2016 and is set to return to the market this year. Now US and Asian lenders have started targeting Schuldscheine as a new growth market, meaning Schuldscheine opportunities are now truly global.

The types of Schuldscheine borrower are also moving beyond their traditional base. Though originally designed for and used by large listed corporates with pre-existing debt issuance programmes, smaller private entities are now utilising Schuldscheine to take advantage of their low transaction costs where entry barriers to the public capital markets are too high. This trend is beneficial for both borrowers seeking a diversified creditor pool and investors looking for higher yields, but investors should ensure appropriate diligence procedures are in place to verify that companies turning to the covenant-light Schuldschein is not a proxy for financial difficulties<sup>9</sup>.

### Proportion of SME v large cap SSD transactions (in no. of transactions)



### Retention of German law

Despite the product’s internationalisation, most market participants still opt to govern Schuldschein contracts with German law, which they are free to do even if neither the borrower nor arranging bank have their corporate seat in Germany. Though by no means mandatory, choosing German law provides contracting parties with relative certainty as to how disputes would be settled in court, due to the body of established jurisprudence and understanding of the product in Germany. Parties also have comfort that Schuldscheine are not typically considered securities under German securities law, alleviating the burden of having to produce a Prospectus Regulation-compliant offering document among other things. Finally, parties can utilise standardised Schuldschein documentation which has been developed by the Loan Market Association.

If market participants opt to govern their Schuldscheine with the laws of ‘untested’ jurisdictions, aside from having less certainty as to the outcome of disputes, they must also consider possible regulatory requirements for issuing Schuldscheine in the relevant jurisdiction. Though Schuldscheine are not considered securities under the German securities regime, their classification and any regulatory implications in other jurisdictions may vary.

### LMA Schuldschein Templates

In light of the growing market and demand for a standard format, a Loan Market Association produced recommended templates for Schuldschein loan agreements (the “**LMA Schuldschein Documents**”) which aim to represent a reasonable and balanced position for the interests of both lenders and borrowers.

<sup>9</sup> Some high profile, recently collapsed companies utilised Schuldscheine financing structures in the run up to their insolvency.

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The LMA Schuldschein Documents, available in both German and English, have been prepared on established typical format of a Schuldschein loan agreement and serve as a useful starting point for preparing contract documentation. There are currently two Schuldschein documents available on the Loan Market Association's website, one with, and one without, an integrated (downstream) guarantee and each may be used to create a stand-alone contract. Regardless of the language, the LMA Schuldschein Documents are governed by German law. It is important to note that, though the documents themselves are relatively short in nature and are underpinned by German civil law provisions.

## New directions – digital and sustainable Schuldscheine

In addition to the advantages listed above, a real sweetener of the product is its propensity for innovative applications, which is turbocharging the product's popularity.

### Digital payments platforms and blockchain

Among the hottest topics in finance is digitalisation. The flexibility and relatively lower regulatory restraints on Schuldscheine mean they are well suited for arrangement via platforms utilising financial technology (“**Fintech**”) and software based on blockchain. Such platforms make the placing and payment processes involved in Schuldscheine even more efficient, and central marketplace-style platforms for borrowers and arrangers as well as investors to transact have also started to open.

Last year, we advised VERBUND on its certified green Schuldschein issuance which was placed entirely using vc trade's fintech platform<sup>10</sup>. The digital platform supported all major transaction processes, including mandating, structuring, documentation, marketing, settlement and post-settlement. The life cycle management of a transaction can also be done on vc trade, as every issuance remains on the platform until maturity. For issuers, such as VERBUND, the digitalisation of these processes reduces issuance and liquidity costs, reduces placement risks and enables smaller issuance volumes. Upon completion, VERBUND stated that using the fintech platform had reduced their issuance costs by 40%.

Blockchain-based platforms are also starting to develop, and 2018 saw the first 'end-to-end' blockchain-settled Schuldschein being issued<sup>11</sup>, and a number of high-profile deals have followed<sup>12</sup>. We currently advise a group of banks establishing a platform for the administration of the life cycle of the Schuldschein by using distributed ledger technology (“**DLT**”)<sup>13</sup>. Such digital platforms are expected to provide even more impetus for market growth: they make the already cheap products even cheaper to issue, opening the door to institutional investor funding for an even greater field of issuers. As a result of the proliferation of fintech platforms, Schuldscheine are more frequently being utilised by smaller capped entities.

### Sustainability-linked ‘Schuldscheine’

Another topic at the top of many agendas in the finance community is sustainability, and the global demand for green debt is exponentially increasing. The flexibility of Schuldscheine enables issuers to build in innovative structures such as sustainability linkage into their offerings. A German group, for example, recently entered into a sustainability-linked Schuldschein, whose interest coupon will vary according to the company's change in sustainability rating, as determined by an external rating provider. The issuer stated that this structure enabled it to fund itself less expensively than it otherwise would.

Sustainability-linked debt is one of the most important tools in the global shift to a low carbon economy, as it incentivises issuers to measurably transition their business models in favour of sustainability wherever they currently sit on the environmental impact spectrum. All improvements to sustainability are ‘additional’ to the status quo. Despite the market's hesitancy to adopt this structure into public bonds, Schuldschein is proving able to cater to the demand for more sustainability-linked debt, and issuers are in turn rewarded in terms of lower costs of capital.

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<sup>10</sup> <https://www.whitecase.com/news/press-release/white-case-advises-verbund-first-green-bond-issued-digital-platform>

<sup>11</sup> <https://www.erstegroup.com/en/news-media/press-releases/2018/10/23/paperless-ssd-blockchain-alias>

<sup>12</sup> <https://www.bbva.com/en/bbva-and-madrids-government-close-the-first-blockchain-powered-sustainable-schuldschein-loan/>

<sup>13</sup> <https://tokenpost.com/Four-banks-trial-blockchain-platform-finledger-for-processing-promissory-note-loans-1958>

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## The alternative product of the future?

The Schuldschein market is still in its relative infancy outside Germany, but their increasingly apparent utility is leading to a rapid expansion. Their hybrid status between loans and privately placed bonds means they draw the benefits of each – the flexibility of loans and closer to the lower cost of capital of bonds. For smaller capped companies, Schuldscheine offer a route to funding from institutional investors that might have prohibitive entry barriers under mainstream structures, making the market more inclusive and diversifying the portfolios of yield-seeking investors.

Schuldscheine are also in many ways an ideal delivery vehicle for developing innovations, such as fintech and blockchain technology, which are set to have a revolutionary impact on the finance sector once the technologies are further developed. As with other financial products, they may be ‘turned green’ by adhering to the Green Bond Principles/Green Loan Principles, but may also be linked to sustainability performance-linked, through which borrowers can effectively be paid to become more sustainable<sup>14</sup>.

Due to their flexibility and the simplified contractual framework, Schuldscheine can also be taken out in secured form for real estate, mortgages, shares, receivables and any other form of underlying collateral. This way, Schuldscheine become increasingly useful for investors requiring tailor made solutions, especially in regards of regulatory investment requirements this demonstrates the flexibility and broad scope of Schuldscheine.

As global markets develop and technology advances, financial products must adapt to suit changing needs of the market participants they serve. Signs are showing that Schuldscheine can meet this challenge, and are set to be a key product delivering the transactions of the future.

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<sup>14</sup> For more on sustainability-linked products, please see: <https://www.whitecase.com/publications/alert/it-pays-be-sustainable-new-cornerstone-green-revolution>