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association of the luxembourg fund industry

Private debt fund survey 2021

How Luxembourg leads the way for private debt

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Introduction

Camille Thommes
Director General of ALFI

As the rising star among the so-called alternative investments, private debt has shown sizeable growth rates year upon year. Private debt funds are fast growing themselves, but they also stimulate growth in the real economy, where other sources of financing do not suffice. They add to the diversity in funding and help to balance liquidity supply and demand for businesses of big and small size in a wide range of industry sectors, which makes private debt funds a cornerstone of the European Commission's Capital Markets Union initiative.

With its long-standing experience as an investment fund centre, but also in the fields of loan origination and secondary market trading, Luxembourg is a natural choice for initiators of private debt funds. Its track record and highly relevant expertise allow the Grand Duchy to lead from the front as a hub for private debt vehicles, and our survey shows that the demand for Luxembourg private debt funds continues to rise.

Valeria Merkel
Partner Audit, German Asset Management & Co-Head of Private Debt

Julien Bieber
Partner Tax, Alternative Investments & Co-Head of Private Debt

Fueled by regulation imposed on banks and growing investor awareness, the private debt market continues to go from strength to strength. As we see, investor appetite and the search for financing expand, private debt cements itself as a strong, highly diversified and in-demand asset class.

Throughout the global pandemic, investor expectations evolved with regards to this asset class. At the start, we saw the rise of opportunistic, distressed and special situation strategies. In the long run, however, these did not replace the continued robust growth of wider direct lending strategies in 45% of the funds surveyed with loan origination.

Private debt has not only penetrated the vast majority of investors' portfolios, but it continues to be extremely attractive for both international investors and fund managers. Unregulated special limited partnership (SCSp) and reserved alternative investment fund (RAIF) – two relatively recent fund vehicles – fully fit their needs.

The average growth in assets under management this year has reached +40.6%*, with the market now reaching €181.7 billion.** In line with last year's results, loan funds set up as RAIFs are forging ahead at a steady rate with again an +8% increase this year. The EU remains the geographical investment target of choice with 44% of respondents favoring it (the other preferred regions being other European countries for 28% and North America for 13%). This year, we were also quite curious about the state of the industry with regards to the ongoing SFDR classification with 33% Article 8 and 6% Article 9 funds among the funds surveyed.

When it comes to regulation, we expect further scrutiny from the European regulators alongside the review of the AIFMD, especially pertaining to - "(v) loan origination funds."

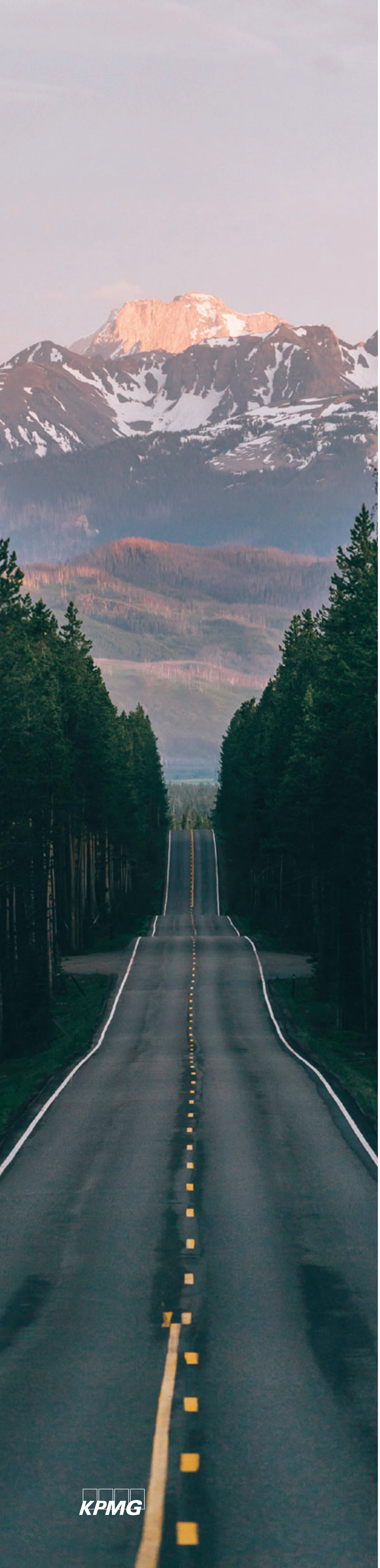
As we look to the future, the European Banking Authority (EBA) consultation will focus on specifying criteria to identify shadow banking entities in order to better control risks to the institution's solvency or liquidity. As far as tax is concerned, the EU interest limitation rules have been transposed into domestic law, and the Luxembourg tax authorities published a circular giving some clarity to market players. And finally, the modernization of Luxembourg's securitization law will allow for more flexibility and agility, facilitating CDO/CLO structures.

All of these actions have led to put Luxembourg as a leading jurisdiction when it comes to private debt. These relentless efforts provide attractive solutions to enable the market to reach its full potential.

Before we sign off, we would like to take a moment to thank all of those who took part in the 2021 Private Debt Fund Survey, especially to the depositaries and other market players who inspired us during our discussions.

And with that, we leave you to discover the full report.

* Average growth between June 2020 and June 2021 based on data provided by depositaries surveyed.
** Total assets under management based on data provided by depositaries surveyed. This does not cover all the market and only includes regulated funds and indirectly supervised investment vehicles, such as RAIF, SIF or SCSp AIF.



€181.7 billion*

Total AuM

*Based on data provided by depositaries surveyed. This does not cover all the market and only includes regulated funds and indirectly supervised investment vehicles, such as RAIF, SIF or SCSp AIF.

40.6 %

Average growth of AuM compared to last year

*Average growth between June 2020 and June 2021 based on data provided by depositaries surveyed.

88 % SCSp

Vehicle of choice for unregulated AIF debt vehicles

36 % RAIF

+16% compared to 2019

-11 % SIF

compared to last year

Source: KPMG/ALFI debt fund survey

Investment target

44 %
Region EU

28 %
Other Europe

13 %
North America

Investment strategy

+6 %
Distressed debt

+2 %
Loan origination

ESG

33 %
Article 8 SFDR

* For the funds for which we received the information, 33% of them promote environmental or social characteristics, or a combination of the two.

Source: KPMG/ALFI debt fund survey

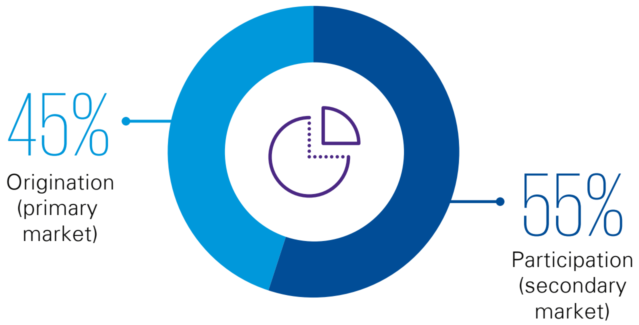
Fund structures

Debt fund categories

Depending on their investment strategy, debt funds can either be debt-originating funds or debt-participating funds:

- A debt-originating fund is, according to its investment strategy, allowed to grant (so called "loan origination or primary market") and restructure debts. In other words, it can amend debt conditions such as prolongation or deferral.
- A debt-participating fund is allowed to partially or fully acquire and restructure existing debts from third parties (i.e. banks and other institutions), either directly from the lender or in secondary markets where these debts are traded. According to its investment strategy, a debt-participating fund is not allowed to grant debts.

Figure 1:
Debt originating and debt participating funds



Source: KPMG/ALFI debt fund survey

Debt funds can be open- or closed-ended, depending on the type of investors and the underlying asset type. Similar to last year, the vast majority (78%) of Luxembourg debt funds are closed- ended (Figure 2).

Figure 2:
Open and closed-ended debt funds

Source: KPMG/ALFI debt fund survey

Regulatory framework

Regulated fund vehicles are authorized and supervised by Luxembourg's supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF), and also have an authorized AIFM. RAIFs are not authorized and supervised by the CSSF, but they are considered indirectly supervised as they must be managed by an authorized AIFM which is subject to direct supervision and reporting requirements to its local regulator.

Unregulated investment vehicles are also neither authorized nor supervised by the Luxembourg Supervisory Authority, but they are either exempted from the AIFM requirement as per Article 3 (1) of the AIFM law or have a registered AIFM as per Article 3 (2) of the AIFM law.

Regulated fund vehicles[1]

Ordered from least regulated to most, regulated debt fund vehicles (including RAIFs) can be structured as:

- Reserved alternative investment funds (RAIFs): funds subject to the law of 16 July 2019[2], as amended.
- Investment companies in risk capital (SICARs): funds subject to the law of 15 June 2004, as amended.
- Specialized investment funds (SIFs): funds subject to the law of 13 February 2007, as amended.
- Part II funds: funds subject to part two of the law of 17 December 2010, as amended.

Part II funds are available to all investor types. SIFs, SICARs and RAIFs are reserved for "well-informed investors". These are institutional investors, professional investors or others who can confirm they qualify for this status and either

(i) invest a minimum of €125,000 or

(ii) were assessed by a credit institution, investment firm or management company and certified of their ability to understand the risks of investing in the fund.

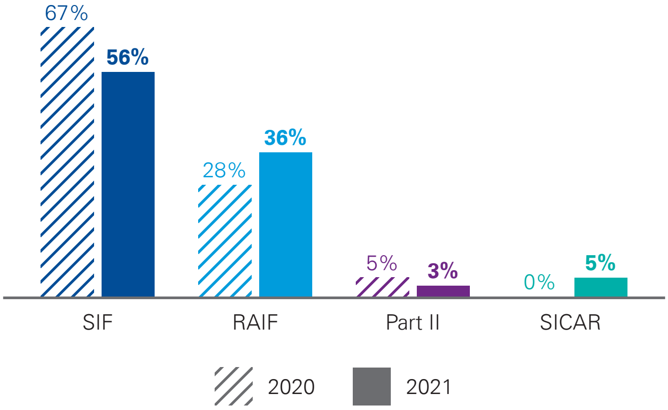
Eligible assets for Part II funds, SIFs or RAIFs are unrestricted, although Part II funds must receive prior CSSF approval of their investment objectives and strategy.

SICARs can only invest in securities that represent risk capital, as stated in the CSSF circular 06/241.

Part II funds, SIFs and SICARs are all subject to prior CSSF approval and authorization.

RAIFs are not subject to CSSF approval but must be managed by an authorized external alternative investment fund manager (AIFM), which must regularly report on the RAIF to its local regulator. In comparison, Part II funds, SIFs and SICARs are all subject to direct CSSF supervision.

Figure 3:
Regulated debt funds[3] by legal regime



Source: KPMG/ALFI debt fund survey

As seen in Figure 3[4], SIFs still dominate Luxembourg's debt fund market at 56%, followed by RAIFs (36%), SICAR (5%) and Part II (3%).

The popularity of SIFs with debt fund managers is due to their flexible investment policy and their regulatory regime. In addition, this vehicle is well known as it has been available for a decade.

Similar to last year, the percentage of debt funds set up using RAIFs continue to grow (i.e. +8%) and the percentage of funds set-up as SIF continue to decrease (i.e. -11%).

We expect RAIFs to continue this level of growth in the future.

Launched in 2016, the RAIF is an attractive alternative to the SIF. It has the same features and flexibility of the SIF, but is less regulated: only the RAIF's AIFM is subject to supervision and reporting requirements to its local regulator, removing the double regulation layer and allowing a quicker time to market.

Debt fund promoters rarely use SICARs, due to their restricted investment policy — they can only be used to invest in risk-bearing securities e.g. such as mezzanine bonds/notes.

1. RAIFs have been included in the list of "Regulated" investment vehicles for presentation purposes, although they are only indirectly supervised and neither authorized nor directly supervised by the CSSF
2. RAIFs have been included for presentation purposes, although they are only indirectly supervised and not authorized or directly supervised by the CSSF
3. Excluding UCITS and including RAIFs as indirectly regulated vehicles
4. Ibidem

Unregulated (and indirectly supervised) investment vehicles

Another important element of the debt fund market is unregulated investment vehicles.

Absence of CSSF's authorization and supervision

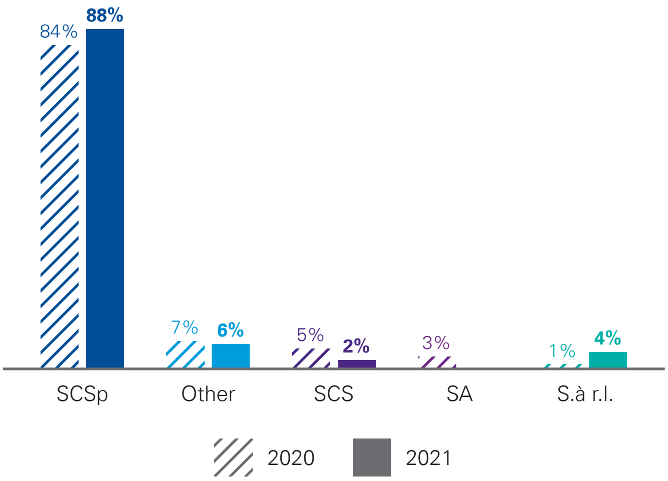
Contrary to regulated fund vehicles, unregulated investment vehicles are neither subject to any specific legal regime (e.g. UCITS, Part II, SIF, SICAR), nor subject to any CSSF prior authorization, reporting or direct supervision.

*Alternative Investment Fund ("**AIF**")*

Nonetheless, unregulated Luxembourg investment vehicles considered as AIFs (and thus falling within the scope of the AIFM directive) have to be managed by an EU AIFM and are subject to indirect CSSF supervision if they are managed by a Luxembourg AIFM (through the direct authorization and supervision of their AIFM).

AIFM falling within specific thresholds are only subject to a registration with the CSSF and lighter reporting requirements[5].

Figure 4: Unregulated (AIF) debt fund by legal regime



Source: KPMG/ALFI debt fund survey

Legal forms

Unregulated investment vehicles can be set up as limited partnerships (sociétés en commandite simple or SCSs), special limited partnerships (sociétés en commandite spéciale or SCSps), or as SOPARFIs (i.e. partnership limited by shares - Société en commandite par actions or SCA), public limited company (Société Anonyme (SA), private limited company (Société à responsabilité limitée (S.à r.l.)).

Securitization Vehicles (SVs)

Unregulated investment vehicles can also be structured as securitization vehicles (SVs), subject to the law of 22 March 2004 or the EU Regulation 2017/2402 of 12 December 2017.

Advantage of unregulated/ indirectly supervised investment vehicles

Compared to regulated fund vehicles, they are highly flexible and cost less to set up and operate since they do not require direct CSSF approval, reporting or supervision. In addition, they are not subject to registration duty, but subject to limited minimum taxation if set-up as SCS/SCSP or SV.

Loan origination, to the extent debt are granted to a limited numer of identified persons can be done without any CSSF authorization and supervision (i.e. provided the fund does not qualify as an AIF)[6]. This makes the Luxembourg market extremely attractive to the debt industry, as unregulated investment vehicles may be used in the framework of specific projects — for example, to acquire a single portfolio or several portfolios in the same industry.

Unregulated AIFs set up as SCSs, SCSp or SOPARFIs can also invest in any type of asset. If they are managed by an EU AIFM, they can market their partnership interests to EU-wide professional investors with a specific passport.

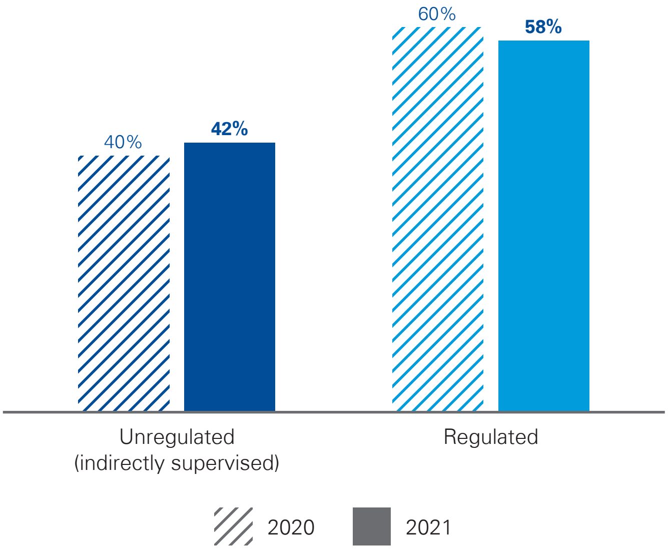
Data collection for the unregulated part of the debt fund market is a difficult exercise. These vehicles are neither authorized nor supervised by the CSSF, and no detailed information or listing currently exists on the market.

Similar to last year's survey, we extended the data collection within depositary banks to unregulated AIFs investing in debts. Thanks to the various depositary banks who collaborated with us on the 2021 debt fund survey, we managed to get a broader view on the unregulated part of the debt fund market.

Based on the data collected, the favored vehicle of debt fund managers in the unregulated market[7] is still the SCSp (88%), who tend to prefer it to the Sàrl (4%) and SCS (2%). SCSp are widely used mainly due to their accessibility and flexibility — and also because they are well-known to investors and promoters.

5. Article 3, §2 and §3 of the law of 12 July 2013 on Alternative Investment Fund Managers
6. Based on the definition of AIF: "any collective investment undertaking, including investment compartments thereof, 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 authorisation pursuant to the UCITS Directive."
7. The data for the unregulated debt funds market only refers to AIFs. No data has been collected for unregulated non-AIF vehicles.

Figure 5: Split between regulated / unregulated (indirectly supervised) debt funds



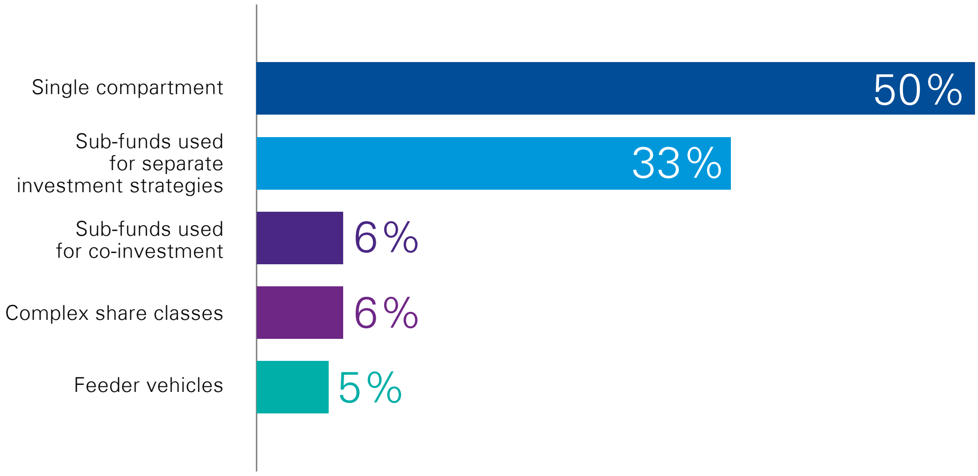
Source: KPMG/ALFI debt fund survey

Figure 5 shows that, similar to last year, most of the Luxembourg debt funds are regulated funds while 42% are unregulated (but indirectly supervised) investment vehicles. We however can notice a small decrease in regulated fund vehicles (-2%).

Regarding debt fund structuring, promoters can choose between single or multiple compartments. Figure 6 shows how these types are split as of 30 June 2021. Similar to last year, the percentage of single compartment funds is higher than sub-funds used for separate investment strategies.

Complex share classes mean that different management and performance fee structures can be managed for different investors. Usually, a single compartment is chosen to focus on one asset class and sub-funds are used to build up different strategies. Due to other accounting and consolidation considerations, investors tend to opt for the simplest solution.

Figure 6: Debt fund structures

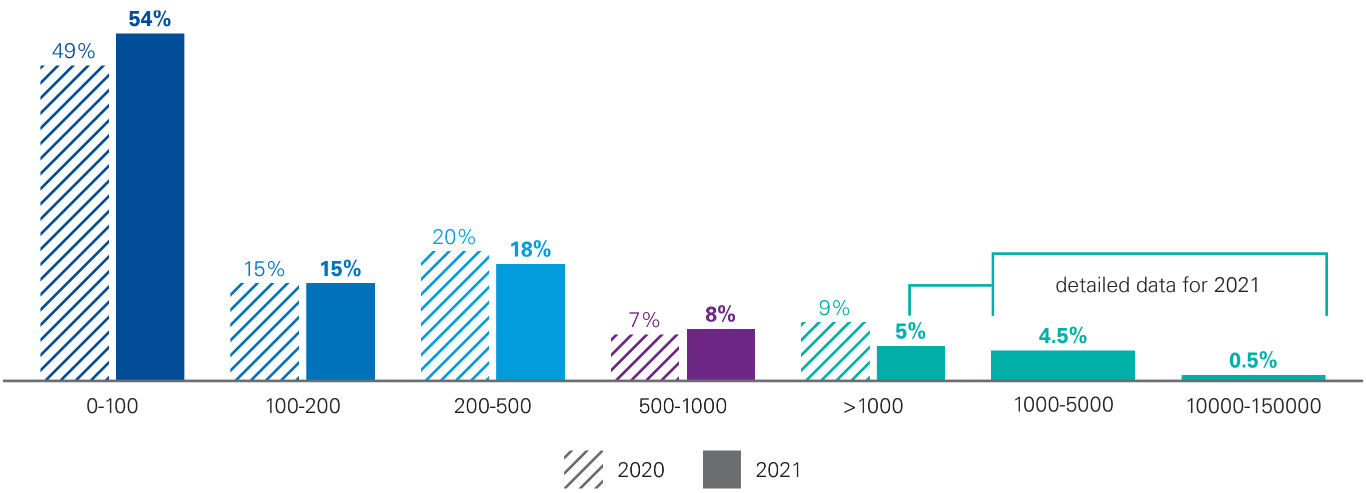


Source: KPMG/ALFI debt fund survey

Like last year, most funds range up to €100 million in size (Figure 7). Notably, mid-size funds — i.e. those with a net asset value of between €100 million and €500 million — represent 33% of the total number of debt funds. As of 31 July 2021, and based on CSSF data, the directly regulated market of debt funds (i.e. SIF, SICAR, Part II) represented around €67.6 billion AUM (compared to €58.9 billion of AUM in mid-2020). These numbers should however be taken carefully since these exclude AUM invested in RAIFs and other indirectly supervised and unregulated investment vehicles.

Based on the information received from the depositary banks, the total AUM as at 30 June 2021 for regulated funds and indirectly supervised investment vehicles is approximately €181.7 billion. Moreover, the depositary banks surveyed reflected an average growth in AUM of 40.6% compared to last year.[8]

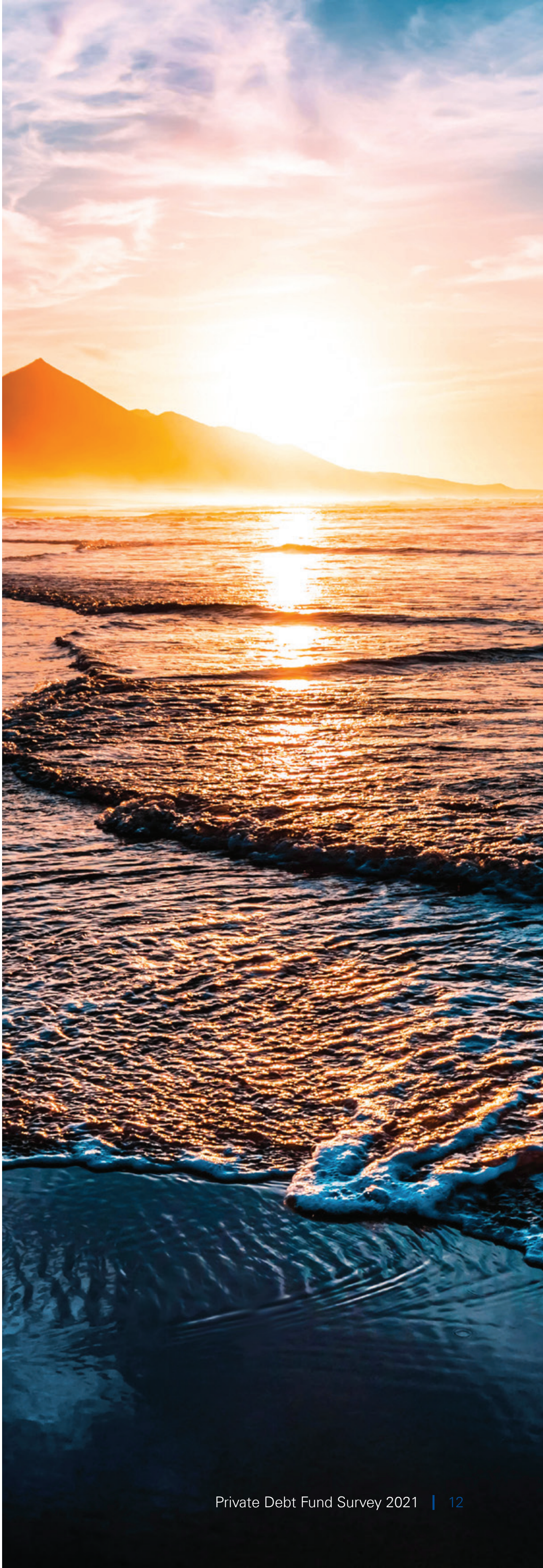
Figure 7:
Debt funds by fund size (in million EUR)



Source: KPMG/ALFI debt fund survey

8. Average growth between June 2020 and June 2021 based on data provided by depositaries surveyed.

The rise of ESG



Social and environmental issues, particularly climate change, have climbed the agendas of corporates, investors and governments, increasing the need for market players to integrate environmental, social and governance (ESG) elements into their risk, performance and impact management.

The fallout from the 2007–2009 financial crisis saw governments impose weighty measures to prevent future crises, imbuing a strong climate change mindset into European economies and financial markets. Key lessons learned were that financial markets lacked transparency, long-termism and sufficient sustainability metrics, as well as appropriate regulation. These insights, together with the final report of the High-Level Expert Group on Sustainable Finance, formed the bedrock of the EU Action Plan on Financing Sustainable Growth.

This EU Action Plan, which boasts a gamut of regulations and directives, kicked off on 10 March 2021 with Level 1 of the Sustainable Finance Disclosure Regulation (SFDR) entering into force. This represented a crucial first step to clarify which financial products can be classified as ESG products — as well as distinguishing between products that promote environmental and/or social characteristics (article 8) and those with an environmental or social impact (article 9).

Early 2022 will usher in more regulatory obligations on the transparency of information and investment strategies, focusing on identifying the potential contribution of the EU Taxonomy through investment. But why should the market pay attention to these regulatory updates?

The term "sustainable finance" doesn't just affect financial sector players; the EU's sustainable finance package has much wider implications. For example, corporates — especially listed companies in sectors playing a key role in climate change mitigation and adaptation — will need data on how their investors and financiers view and analyze their sustainability.

Those failing to demonstrate to investors that their business is sufficiently aligned with the EU Taxonomy Regulation's criteria could suffer higher capital costs.

The SFDR and the EU Taxonomy are complemented with further requirements. First, the Delegated Acts update existing directives by integrating ESG elements, namely

UCITS, AIFMD, MiFID II, IDD[1] and Solvency II. Second, the growing need for general standards has led to the EU ESG Benchmark, the EU Green Bonds Standard and the EU Ecolabel. Most of these standards will begin applying in 2022, including the SFDR Level 2, which aims to standardize performance and impact reporting.

The entire EU Action Plan delivers significant challenges for firms, especially given their current operating conditions. Even if its implementation is delayed, companies can no longer afford to ignore the writing on the wall. The European Supervisory Authorities (ESAs) recognize that firms will face several practical difficulties:

- A lack of data, especially on principal adverse impacts.
- The lack of finalized Level 2 rules under the EU Taxonomy Regulation, as they are still under discussion.
- A difficulty fitting additional disclosures into products that have pre-contractual information documents of a limited length.
- Portfolio managers with separately managed accounts may struggle to balance website disclosure requirements with client privacy and data protection rules.
- Smaller firms may struggle with compliance costs, due to a lack of economies of scale.

However, in the long run, market players must approach these challenges as opportunities to define new ways of managing investments. The paradigm shift within the new generation of investors is clear: our focus is broadening from financial performance and managing risk to measuring and considering impact.

Luxembourg has always been at the forefront of sustainable finance. In 2007, the country issued the first green bond by the European Investment Bank (EIB).

In 2020, Luxembourg was the leading sustainable domicile in Europe, with sustainable funds accounting for EUR371 billion by the end of 2020 and capturing 44 percent of total net flows made across all European domiciles in 2020 .

Since 2018, the share of sustainable assets in UCITS and regulated open-end AIFs has surged, accounting for 11 and 9 percent respectively.

The largest asset managers have already unveiled plans to escalate the number of sustainable funds classified under SFDR articles 8 and 9 in the coming months. We're seeing a boost in market demand for these products, with sustainable fund products attracting 52% of all net new flows in 2020[2].

Despite the challenges, which are mostly regarding data, asset managers are embracing ESG innovation and seizing the opportunity to generate long-term added value. Organizations that already measure and track wider financial data in lieu of traditional indicators can enjoy a range of benefits.

For example, collecting and monitoring ESG indicators enhances companies' risk management approaches, improves their valuation possibilities, and helps them demonstrate their environmental and social positive contributions.

ESG also plays a role in private debt investment products. While there's a lack of hard proof that considering ESG leads to better overall performance, we can assume that integrating ESG criteria will heighten companies' long-term returns by considering and integrating more external risk factors and assessing the corporate governance behind activities.

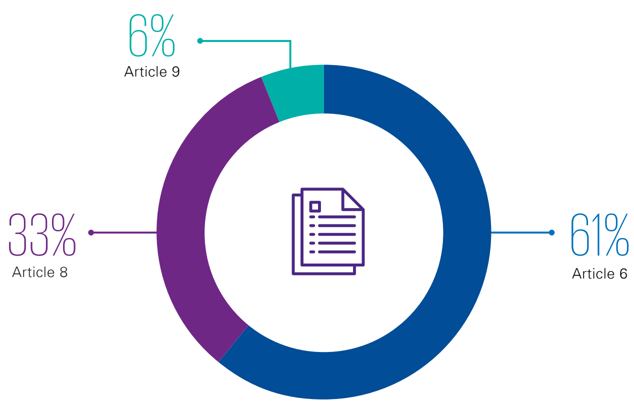
Further ESG integration may also create value by reducing fossil fuel dependency, increasing inclusion and diversity, and attracting top talent.

For every financial market player, 2020 will likely be a year of transition — where ESG graduates from a "nice to have" to a fully integrated element in the investment value chain and related operating models, opening new areas of investment opportunities that lead to a greener, more sustainable future.

ESG classification

In this year survey, we also included a specific question in relation to the ESG classification of the funds under the Sustainable Finance Disclosure Regulation (SFDR) (Figure 8). While the classification of the funds according to SFDR is still ongoing, for the funds for which we received the information, most of the funds are classified under article 6 (61%), followed by article 8 (33%) and article 9 (6%). Article 6 covers funds which do not integrate any kind of sustainability into the investment process. Article 8 are funds which promote environmental or social characteristics, or a combination of both, and article 9 are funds which must have a sustainable investment objective. We expect funds classified under article 8 and 9 to surge in the coming years.

Figure 8: Debt funds by ESG classification



Source: KPMG/ALFI debt fund survey

1. The Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive, the Alternative Investment Fund Management Directive (AIFMD), the Market in Financial Instruments Directive II (MiFID II) and the Insurance Distribution Directive (IDD).
2. European Sustainable Investment Funds study 2021 (performed by Morningstar, ZEB & ALFI).

Reshaping international taxation

Circular L.I.R n°168bis/1 on Interest deduction limitation

On 21 December 2018, to transpose the EU Anti-Tax Avoidance Directive 2016/1164 (ATAD 1) into Luxembourg law, the Luxembourg legislator introduced article 168bis in the Luxembourg income tax law (LITL). This sets out the legal framework of the interest limitation rules (ILR) in Luxembourg and entered into force as of 1 January 2019[1].

Given that the hottest investment strategies of Luxembourg debt funds are direct lending (72%), mezzanine (11%) and distressed debt (12%), and as investment vehicles are often themselves leveraged, market players were eager for the Luxembourg tax authorities to clarify some of the legislation's highly technical and complex concepts.

On 8 January 2021, the Luxembourg tax authorities issued Circular L.I.R n°168bis/1 (the "Circular") to guide taxpayers on the more challenging applications of the ILR. The Luxembourg tax authorities updated and expanded the Circular on 2 June 2021, adding other practical examples.

Private debt sector: who is affected?

The ILR apply to Luxembourg resident companies and permanent establishments of non-resident companies that are subject to Luxembourg corporate income tax. Therefore, the ILR are especially relevant to standard Luxembourg resident fully taxable companies (such as "SOPARFIs"), as regulated investment funds are generally exempt from corporate income tax.

For SOPARFIs (or securitization companies governed by the 22 March 2004 Luxembourg domestic law) that are involved in financing plain vanilla performing debts, the ILR shouldn't trigger adverse Luxembourg tax implications. This is because these companies usually achieve an arm's length margin and, de facto, don't need to report any "exceeding borrowing costs" — i.e. their interest income should be higher than their interest expenses.

1. The ILR should apply to taxpayers that have a financial year starting on or after 1 January 2019.

However, the situation grows more complex for SOPARFIs (or securitization companies governed by Luxembourg domestic law) that are financed with debt and generate income and gains on a portfolio of distressed debt or non-performing debts, which are purchased at a discount compared to their face value that may not be included in the interest income definition or equivalent.

How could the ILR affect private debt players?

These rules affect the exceeding borrowing costs incurred on all types of debt, whether it is interest expenses relating to Luxembourg debt or foreign debt, or whether it is interest due to third parties or related parties.

Article 168bis LITL, which applies as of the fiscal year 2019 for most Luxembourg taxpayers, limits the deductibility of net interest expenses — i.e. deductible interest expenses minus taxable interest income — of up to 30% of the taxpayer's adjusted EBITDA or EUR3 million, whichever is higher. This is computed annually.

The Circular's clarifications and examples

The Circular doesn't only clarify certain rules, definitions and concepts, but also provides welcomed examples to help taxpayers better understand article 168bis LITL and its impact on annual corporate tax returns.

Interest income and symmetry principle

Since the ILR entered into force in Luxembourg, the definition of the "interest income and other income economically equivalent" concept has been a hot topic. While it's key for taxpayers to determine and compute the exceeding borrowing costs, the Luxembourg legislator didn't define this concept in detail. In the Circular, the Luxembourg tax authorities address this absence, confirming this concept should follow a symmetrical approach.

In a nutshell, taxpayers must consistently and symmetrically interpret interest income (and other income economically equivalent) to the borrowing costs definition. If accrued expenses are considered as borrowing costs at the debtor level, they should be symmetrically considered as interest income (or other income economically equivalent) at the beneficiary level.

Ordering rule

The Circular also confirms that article 168bis LITL should apply after other LITL provisions that could deny the deduction of operating expenses. These include the transfer pricing provisions, anti-hybrid rules and the Luxembourg participation exemption regime.

Forex classification

Notably, the Circular sheds light on article 168bis LITL's non-exhaustive examples of borrowing costs and costs economically equivalent to interest. It clarifies which foreign exchange fluctuations should be considered as other economically equivalent income/expenses and, as a result, be taken into account when determining a company's exceeding borrowing costs amount.

Grandfathering clause

The so-called "grandfathering clause" of article 168bis LITL doesn't restrict the deduction of exceeding borrowing costs incurred on loans concluded before 17 June 2016, but such clause shall not extend to any subsequent modification of the loans' terms and conditions. The Circular provides several examples of "subsequent modifications" that would jeopardize the grandfathering rule's application.

Subsequent modifications include changes to the loan's maturity or principal amount, as well as to the interest rate or the methodology used to compute the interest rate. Changes to one or more parties to the loan also qualify, apart from a merger/demerger if the initial terms and conditions stay the same upon restructuring.

Borrowing costs clarification

Article 168bis LITL broadly defines borrowing costs as either (i) interest expenses on all forms of debt; (ii) other costs economically equivalent; or (iii) expenses incurred in connection with the raising of finance.

The Circular provides a non-exhaustive list of payment examples that should constitute borrowing costs, such as issuance and repayment premiums (primes d'émission et de remboursement) relating to bonds, exchangeable bonds, convertible bonds and zero-coupon bonds.

An important step towards clarity

The ILR are complex; each type of debt transaction must be analyzed on a case-by-case basis. While the Circular does not (yet) address all practical situations or issues that may arise, it represents a positive step towards clarity for Luxembourg taxpayers.

Currently, the Circular does not directly address the ILR's impact on distressed debts/non-performing loan investments, which are key investment targets of the private debt sector — therefore, these should be closely and carefully structured going forward. However, the Circular's recent update suggests that the Luxembourg tax authorities may add further practical examples and clarifications in future revisions.

Viewpoint: quotes from Depositaries

Elaine Furnari
Head of Loan Services
Citco Fund Services (USA) Inc

With the growing amount of capital being allocated into private debt markets and complexities with the underlying loans, investment managers have become increasingly focused on the product and industry expertise - as well as staying power - of their service providers. Administrators and asset servicers with a model that can be easily introduced to augment key operational functions at a manager, provide access to data, whilst operating under a robust controls framework - will be at a competitive advantage to firms who solely focus on the build out of technology

Shane Hurley
Executive Director, Head of J.P. Morgan Depositary Bank Services, J.P. Morgan Bank Luxembourg S.A.

Time to market, flexibility and reliability of fund structuring in Luxembourg continues to be very important factors to meet an increasingly sophisticated global investor base. International debt fund managers are choosing Luxembourg Alternative Investment Funds to support these new international opportunities. For depositaries, the continued growth and evolving complexity of private debt funds (bilateral and syndication) requires detailed understanding of the fund structures, investment strategies and the control environments for ensuring investor protection.

Claudia Mogg
Head of Business Development & Product Solutions, Alternative Investments,
DZ PRIVATBANK S.A.

The private debt asset class has developed into a fundamental investment component that has become an indispensable part of the portfolios of institutional investors. Therefore, it is all the more important to create stable and secure settlement platforms that bring capital seeking enterprises and investors together in an effectively and efficiently way. Regulated fund structures will offer the ideal platform for this purpose.

Catherine Gauthier
Associate,
Brown Brothers Harriman Luxembourg SCA

The alternatives market continues to thrive and investors are taking note. Credit as a broad strategy remains strong and we are seeing increased demand for specialist products. Direct lending, senior secured strategies continue to attract investor interest driven by the relatively high risk adjusted returns available, and those managers with previous exposure to the best credits are continuing to succeed as new vintages are launched. The largest investors are increasingly using SMAs to create bespoke exposure baskets.

Liquid credit is strong with managers creating pools of performing, multi-strategy exposure. Real estate lending, and financing for infrastructure projects, especially renewable energy facilities are continuing to find favour. The tenor of the loan and the security interest in the underlying physical assets make these strategies especially interesting for large institutional investors with long term investment liabilities.

Pension funds and insurance companies are the main buyers of the strategies but some managers are actively looking at ways to distribute to private individuals. Hybrid structures, like the ELTIF are complex to manage and administer but the pool of retail capital is significant and is driving new product development.

Brian McMahon
Global Head of Credit & Debt fund services, BNY Mellon

The appetite for debt investment continues to grow at an accelerated rate. While driven by a desire to have appropriate risk reward returns, our clients have been clear that "this is not a fad, this is a central to our strategy going forward", and in that Luxembourg continues to be the dominant jurisdiction, and attracting ever larger asset managers and platforms. It is a testament to the effectiveness of the regulatory and operational capabilities of the jurisdiction.

Greg Myers
Group Sector Head – Debt & Capital Markets at Alter Domus

Building a fund services ecosystem
As the markets begin to rebound from Covid into some version of a 'new normal', there is the associated challenge of building a fund services ecosystem to facilitate growth, product development, new sectors and new markets.
The technological demands of our clients continue to increase and the reporting and delivery methodologies for providing data to our clients is always front of mind, but getting the right resources, talent and systems in place is a challenge, not just from an accounting and loan operations perspective, but also from the lack of IT professionals.

Guillaume Castel
Head of Alternatives Luxembourg, State Street Bank International

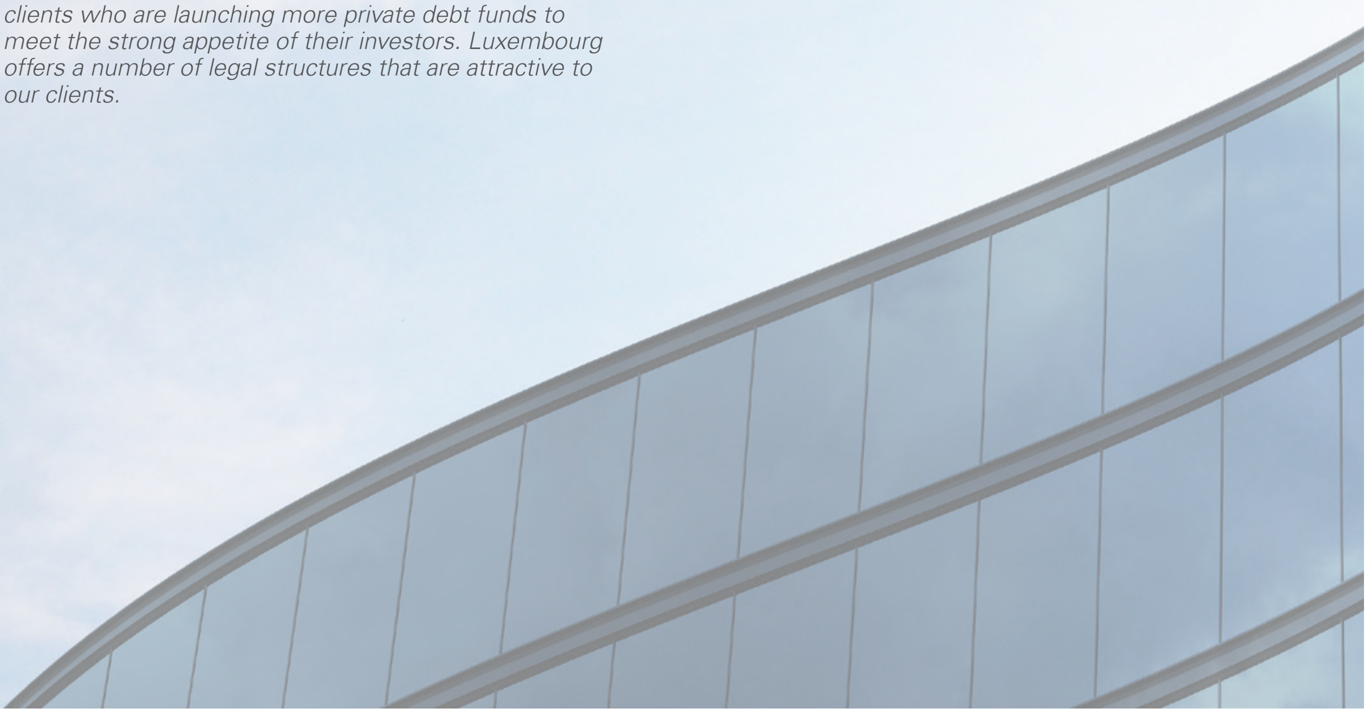
In their pursuit of higher yields, the private equity funds have stepped into the private debt space to offer a viable alternative to borrowing from banks facing increasingly heavy regulations. We see this trend continuing with our clients who are launching more private debt funds to meet the strong appetite of their investors. Luxembourg offers a number of legal structures that are attractive to our clients.

Alessia Lorenti
Head of Business Development, Edmond De Rothschild Asset Management (Luxembourg)

Following the Q2 2020 dip in private debt, this asset class has experienced a buoyant rebound in both capital raising and deployment, with direct lending emerging strongly. In the low interest rate environment private debt remains an allocation focus for investors seeking to generate stable returns.
Distressed debt and special situations have been slow moving, with central banks backing being rolled as the COVID crisis still continues. As this buffer will gradually subside, we are likely to see a progression in both distressed debt and special situations.

Robert Van Kerkhoff
Managing Director, BP2S Luxembourg

The Private Debt market has continued to massively grow in 2021, mainly driven by direct lending. We expect Luxembourg to continue to be the predominant domicile of choice in Europe for the years to come thanks to a dynamic ecosystem of international expertise, innovation and regulation.
Global performance of the asset class will be monitored closely in 2022, with monetary and fiscal policies likely to evolve in a challenging "post-covid" environment.
In this context, data transparency is key for both investors and asset managers to generate actionable insights, and adjust investment strategies where necessary. This can be achieved thanks to service partners able to heavily invest in technology, with local footprint and expertise, while being able to create scalability by leveraging a global operating model."



Regulatory outlook

The implications of CSSF Circular 18/698 on private debt funds

In August 2018, the Commission de Surveillance du Secteur Financier (CSSF) issued Circular 18/698 ("the Circular"). Also known as the "governance" or "substance" Circular, this replaced Circular 12/546 regarding the requirements for investment fund managers (IFMs) to obtain and maintain authorization under Luxembourg law.

It covers IFM management bodies, fund requirements, shareholder structure, administration and governance, and introduced provisions regarding the fight against money laundering and terrorist financing.

The Circular mirrors most of the market's current best practices. Amongst others, it introduced rules on how to organize the valuation function — it can either be performed internally by the alternative investment fund manager (AIFM) or delegated to an independent external valuer.

Article 527 states that *"The IFM must implement policies and procedures for the valuation of the AIF's assets in accordance with Article 17 (1) of the 2013 Law and Art. 67(1) of Reg. 231/2013"*. This implies that if a model is used to value an AIF's assets, it must be explained and justified in the valuation policies and procedures. The following points must be appropriately documented:

/ The reasons why the model was selected.

/ The model's underlying data.

/ The assumptions used in the model and the rationale for using them.

/ The limitations of the model-based valuation.

Before this model is used, the valuation policies and procedures must ensure it is validated by a sufficiently experienced person who was not involved in building the model. This validation process must also be appropriately documented (Article 530).

To avoid potential conflicts of interest in the valuation of assets, the Circular stresses that the valuation, risk management and portfolio management functions must be kept independent of each other. Article 533 states that *"the AIFM must, in particular, ensure the independence between the risk management and valuation activities."* In other words, the risk management function cannot perform any valuations and the AIFM must make sure no conflicts of interest arise.

Even if the AIFM delegates the valuation function, it is still responsible for its organization and governance. The AIFM must demonstrate that *"[…] the external valuer is subject to mandatory professional registration recognized by law or to legal or regulatory provisions or rules of professional conduct; the external valuer can provide sufficient professional guarantees to be able to perform effectively the relevant valuation function and the appointment of the external valuer complies with the requirements of Article 20(1) and (2) and the delegated acts adopted pursuant to Article 20(7)."* (Article 19 of Directive 2011/61/EU[1])

The AIFM and the delegated valuer must first create a process to provide all the necessary information to perform the valuation task and to exchange information with each other. Article 538 refers to Article 67 of the Delegated Regulation (EU) 231/2013, stating that *"The valuation policies and procedures shall ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services"*. This implies that the AIFM is still responsible for the valuation of assets.

Due to the nature of private debt the valuation is mainly done using mark-to-model methods. Therefore, the Circular's valuation rules affects the private debt fund industry, introducing and enhancing regulatory requirements to the applied valuation models, processes and procedures and their documentation.

The most popular accounting standards in the Luxembourg private debt fund market are IFRS and Lux GAAP. In both cases, the instruments can either be valued at fair value or at the impairment definition that applies (known as "cost less impairment" in Lux GAAP and "amortized cost" in IFRS). However, as the Circular doesn't specify which accounting standard should be used, both standards apply regardless of the model's complexity.

Practically speaking, three valuation techniques are used to estimate a fair value— income, cost, and market approach. For private debt, the income approach is the most commonly used. All approaches use a dedicated valuation model that must be independently validated following the Circular's requirements.

Recent market observations show that private debt market players tend to follow one of two opposite strategies. Some simplify the applied valuation models, while others build more sophisticated models based on the three primary techniques stated previously.

The first strategy reduces both the time spent valuing the portfolio and the cost of market research. However, it doesn't guarantee that the model considers all relevant risks and adequately assesses more complicated portfolios leading to the fact that the result may not be deemed to be a fair value. This means factors that are not covered in the mathematical model must be monitored and evaluated during valuation, which is still not always market practice. Therefore, the model validation must assess both the mathematical model and the entire valuation process, including qualitative components.

The second strategy benefits from market insights and a rigorous approach while calibrating the model. However, increasing model complexity leads to increasing time required to apply the model and to train the staff maintaining it. This might lead to higher operational risk as the model need to be used in the appropriate and foreseen manner.

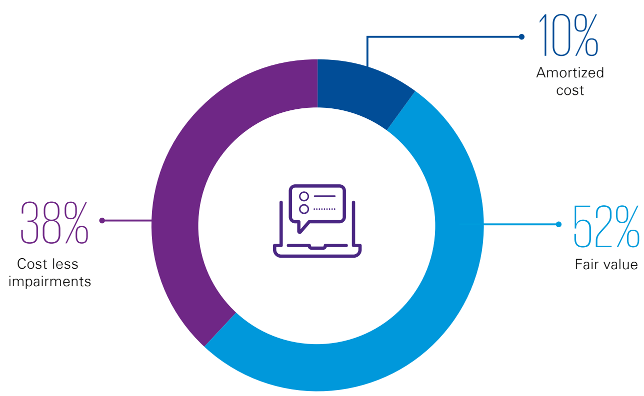
In both cases, rigorous model validation is essential to ensure it complies with the Circular's requirements.

Despite the Circular being in force since 2018, market participants have not yet solved all its challenges and obligations. Therefore, AIFMs must revise these regulatory requirements today to be ready to tackle any challenges ahead.

Valuation methodology

The most popular valuation method used is fair value (52%), followed by cost less impairments (38%) and amortized cost (10%) (Figure 9).

Figure 9: Debt funds by valuation method



Source: KPMG/ALFI debt fund survey

1. Also known as the AIFMD.

US GAAP: an acceptable accounting principle in Luxembourg

With the rise in US-based asset managers choosing Luxembourg for their next alternative investment funds (AIFs), there's an increasing desire to stick to the accounting principles they currently use for their structures: the United States Generally Accepted Accounting Principles, or US GAAP.

This need for similar reporting frameworks for investors is also driven by many of these managers running funds alongside their larger US and Cayman Island master funds. But is US GAAP accepted in Luxembourg?

On 21 July 2021, the AIFM law of 12 July 2013 was amended regarding the acceptable accounting principles for an AIF in the form of a Special Limited Partnership (SCSp).

These principles must comply with Luxembourg's law of 19 December 2002, and be considered equivalent as per the European Commission's modified decision of 12 December 2008 on the use of third countries' national accounting standards in the EU.

In other words — SCSps can now prepare their financial statements according to US GAAP and comply with the AIFM law.

US GAAP versus Lux GAAP

But what about net asset value (NAV) calculations as per Lux GAAP and US GAAP? To the surprise of many asset managers, there's little difference — apart from formation expenses, which can be amortized over 5 years under Lux GAAP but is expensed when incurred under US GAAP, and the cut-off timing for transaction recording.

Of course, it's a different story regarding disclosures in the financial statements. US GAAP requires a weightier burden of information, including:

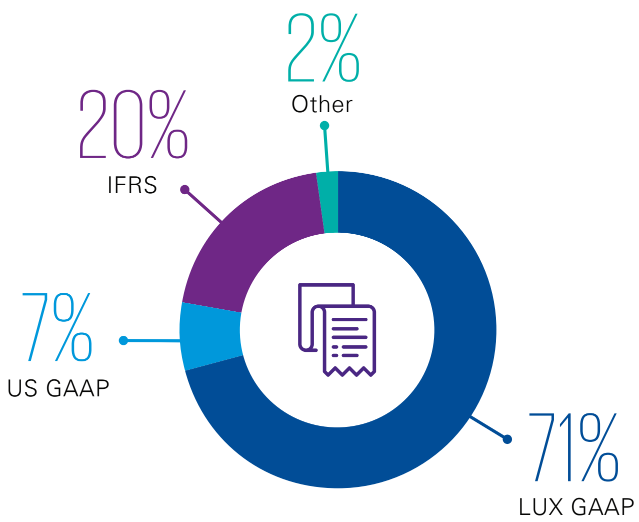
1 Statement of cash flows

2 Financial highlights information

3 Leveling of valuation

4 Different presentation requirements in the statement of operations for master-feeder structures.

Figure 10: Debt funds by accounting standard



Source: KPMG/ALFI debt fund survey

Amendment of the Luxembourg Securitization vehicle regime

Luxembourg is a prime location for securitization vehicles due to its attractive and flexible regime, which has been in place since 2004. On 21 May 2021, to inject even more flexibility into the current legal framework, the Luxembourg government submitted draft law No. 7825 (the "Draft Law") to parliament, which clarifies and relaxes some of the rules applying to securitization vehicles.

The Draft Law proposes the following changes:

/ Replacing the currently used, undefined term of "securities" with the broader term "financial instruments".

/ Clarifying the CSSF's supervisory role: if a securitization vehicle performs three issues per year to the public, it should be able to issue continuously. An offering or issuance would qualify as public if it meets the following three criteria:

(i) The issuance is not targeted to professional clients;

(ii) The financial instruments have a denomination of less than EUR100,000; and

(iii) The financial instruments are not distributed in a private placement.

/ Opening the refinancing of transactions to any financial instrument and not just securities.

/ Allowing active management (by the vehicle or a third party) for Luxembourg securitization vehicles for risks linked to bonds, loans or other debt instruments, unless the financing instruments are issued to the public. As a result, Luxembourg could attract more collateralized debt obligation (CDO) and collateralized loan obligation (CLO) structures.

/ Increasing the corporate forms available for securitization vehicles, including the unlimited company (société en nom collectif), common limited partnership (société en commandite simple), special limited partnership (société en commandite spéciale), and simplified limited company (société par actions simplifiée).

/ Requiring that securitization funds be registered with the Luxembourg trade and companies register (Registre de Commerce et des Sociétés, or RCS), which is currently not required.

Supervisory focus on non-performing loans (NPLs) in the wake of COVID-19

While legacy NPL stocks, a hangover from the previous global financial crisis, have been significantly curtailed in the EU banking sector, these loans remain substantial in some jurisdictions and banks.

A deluge of NPLs triggered by the COVID-19 crisis could affect banks' profitability and ability to lend, preventing liquidity-constrained borrowers from accessing capital and aggravating the NPL problem.

A spate of measures was implemented to cushion COVID-19's blow, such as payment moratoria and state guarantees, which helped mitigate the impact on banks' asset quality — albeit temporarily. However, as the benefits of these measures begin to erode, EU regulators fear a delayed effect, which may cause a glut of NPLs in late 2021 and 2022.

Among others, the European Central Bank (ECB) is hyper-focused on banks identifying and measuring credit risk regarding the COVID-19 pandemic. In its "Dear CEO" letter of 4 December 2020, the ECB laid out its supervisory expectations for banks — they must have sound credit risk management that is reflected in their internal risk measurement and management processes, financial statements, and regulatory reporting.

On 16 December 2020, the European Commission published an action plan to fend off the accumulation of new NPLs in the EU banking system. This plan mainly focuses on further developing the secondary NPL markets, supporting the cooperation of national asset management companies, reforming the EU's corporate-insolvency and debt-recovery legislation, and implementing precautionary public-support measures where needed.

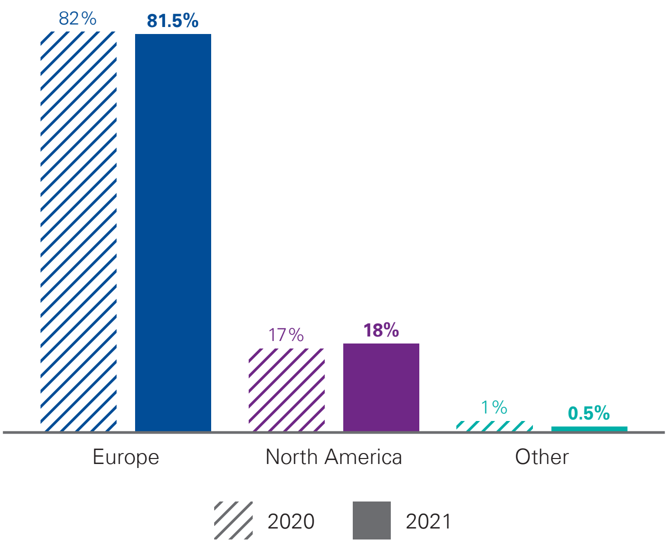
We expect this regulatory focus to accelerate the deleveraging of banks in the NPL sector. The effects on the private debt market remain to be seen. However, like the additional regulation imposed on banks after the 2008 financial crisis, the shrinking of available credit for players outside banks' typical risk appetites should trigger more opportunities for the private debt sector.

Overview of key data

Initiator origin

Similar to last year, the vast majority of debt fund initiators (promoters) in Luxembourg are from the EU, distantly followed by those from North America (Figure 11). Most of the initiators come from the UK (43%), followed by Germany (20%) and USA (18%) with only 1% coming from Luxembourg.

Figure 11: Initiators - origin by region



Source: KPMG/ALFI debt fund survey

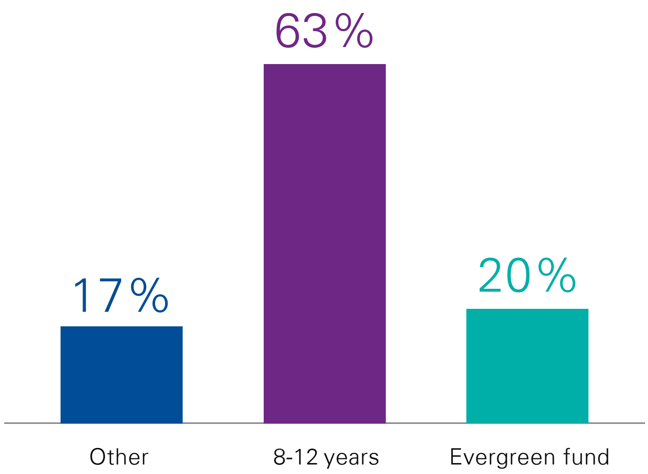
Investments per fund and holding period

The number of investments per debt fund is highly variable and depends on several factors, including the size of the fund and its investment strategy.

Based on the information gathered, the average number of investments per fund is 32.

Regarding maturity, 63% of the funds have maturities between 8 and 12 years and 20% of the funds are evergreen (Figure 12). Compared to last year, this reflects an extension of maturity (in 2020, 11% of the funds had a maturity below 8 years). Regarding the maturity strategy, most of the investments are held to maturity (99%) with only a small percentage held for trading (1%).

Figure 12: Debt funds by maturity

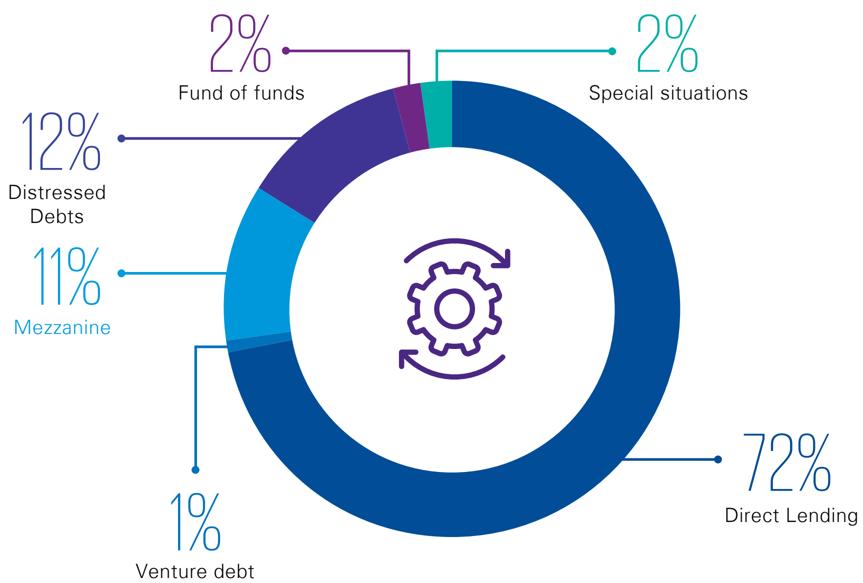


Source: KPMG/ALFI debt fund survey

Investment strategy

The investment strategy of Luxembourg debt funds is mainly focused on three debt strategies (Figure 13): direct lending (72%), distressed debt (12%), and mezzanine (11%). Compared to last year, this reflects an increase in direct lending (+34%), distressed debt (+6%) and mezzanine (+2%). This can be explained by the fact that direct lending may include other sub-strategies not reflected in the below figure 13.

Figure 13: Debt funds by investment strategy

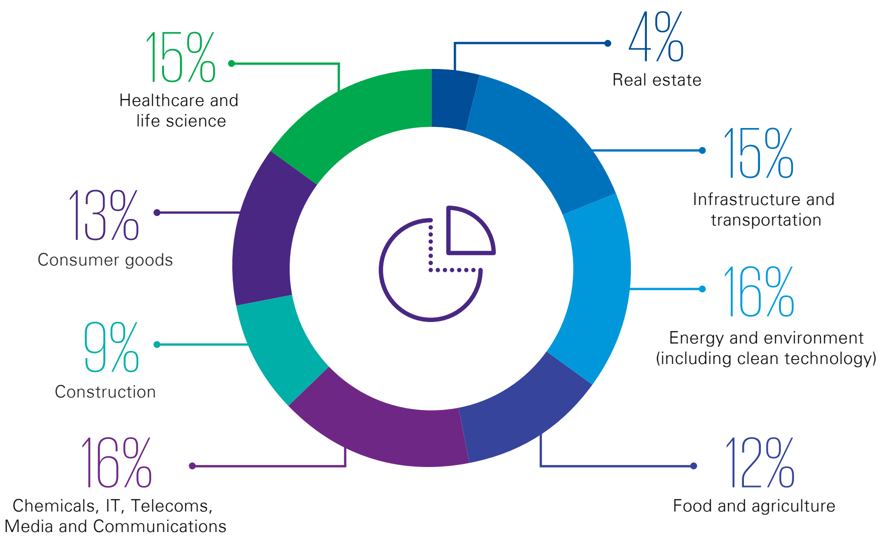


Source: KPMG/ALFI debt fund survey

Sector financed

In this year survey, we included a specific question in relation to the sector financed (Figure 14). As reflected in figure 14, there an equilibrium between Infrastructure and transportation (15%), Energy and environment (16%), Chemicals, IT, Telecoms, Media and communications (16%) and healthcare and life science (15%).

Figure 14: Debt funds by sector financed

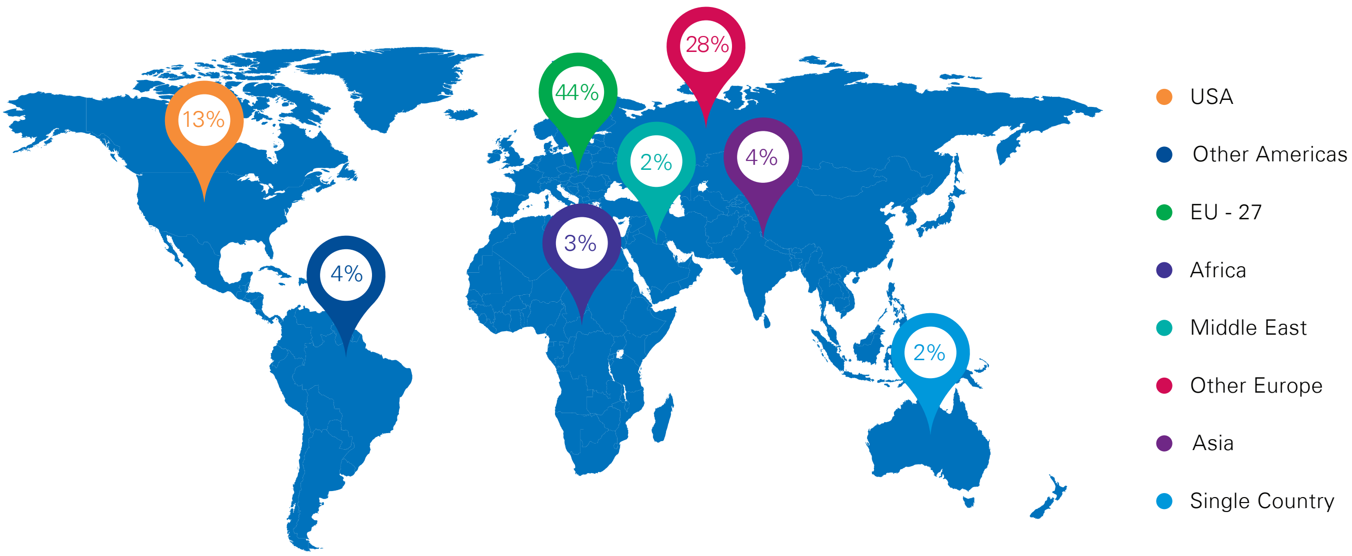


Source: KPMG/ALFI debt fund survey

Geographical investment target

Most debt funds (98%) have a multi-country investment approach. Similar to last year, the preferred investment targets (Figure 13) are in the EU (44%), other European countries (totaling 28%) and North America for 13%.

Figure 15: Debt funds by geographical investment targets



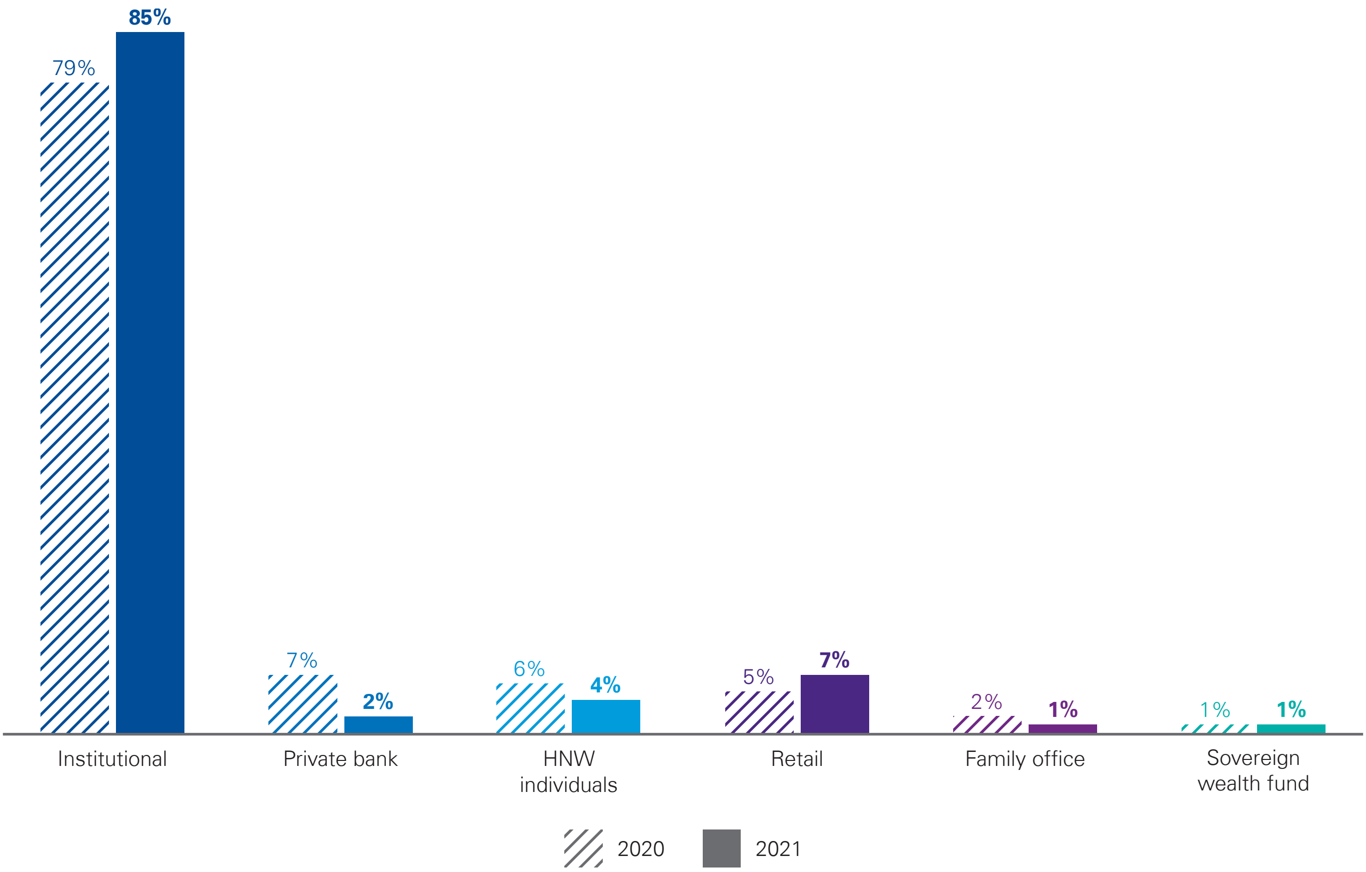
Source: KPMG/ALFI debt fund survey

Investor type and origin

Similar to last year, the main type of investors are institutional investors (85%), followed by retail investors (7%) and high-net-worth individuals (HNWIs) (4%) (Figure 16). Compared to last year, the percentage of institutional investors increased (+6%), retail investors increased as well (+2%), private banks decreased (-5%), as well as for HNWI (-2%). Most of the institutional investors are pension funds or insurance companies (53%).

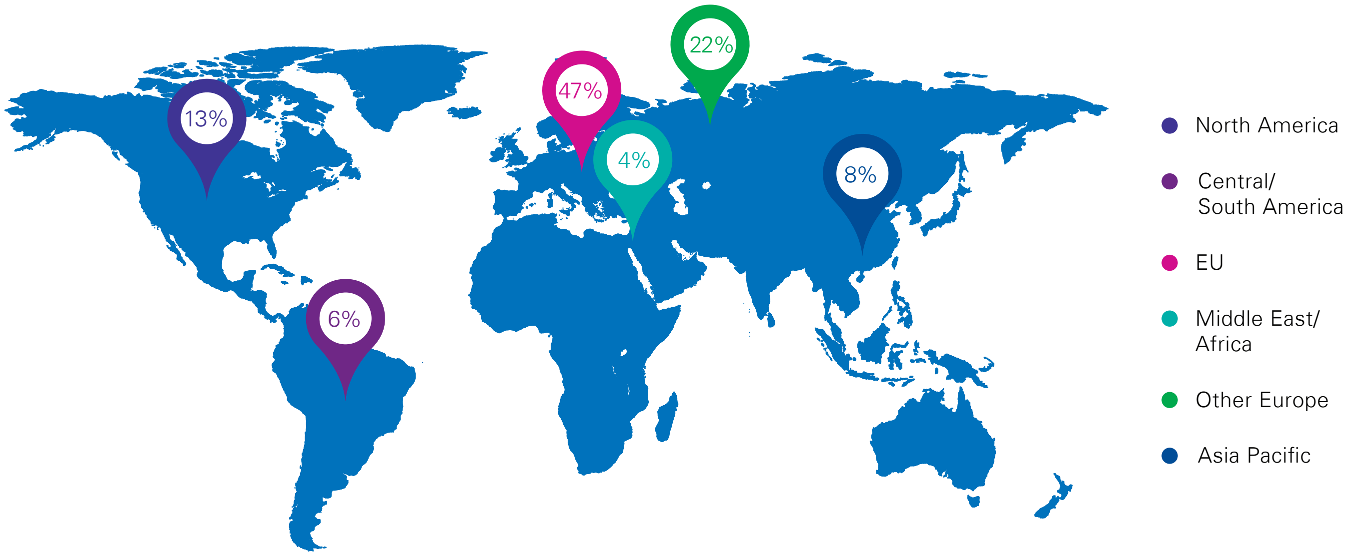
Similar to last year, these investors are mainly from EU countries (Figure 17). 74% of funds have between 1 and 25 investors per fund (Figure 18).

Figure 16: Debt funds by investor type



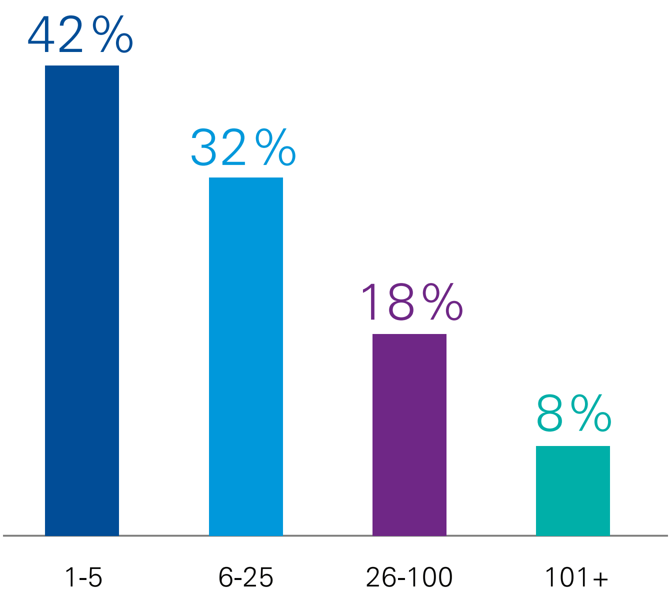
Source: KPMG/ALFI debt fund survey

Figure 17: Debt funds by investor origin



Source: KPMG/ALFI debt fund survey

Figure 18: Debt funds by number of investors

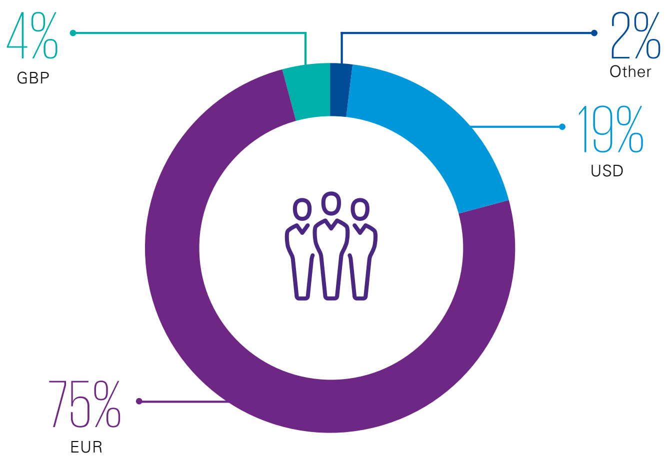


Source: KPMG/ALFI debt fund survey

Financial statements

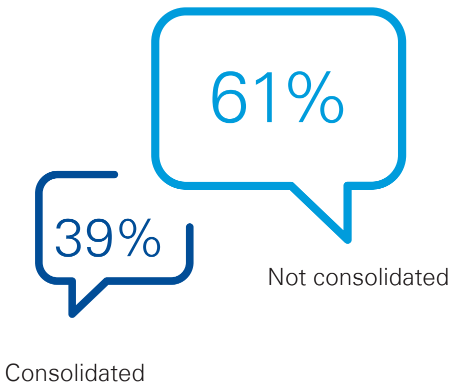
Like last year, the financial statements of Luxembourg debt funds are mostly prepared in euros (75%), closely followed by US dollars (19%) (Figure 19). The majority of funds (61%) do not consolidate their assets (Figure 20).

Figure 19: Debt funds by currency



Source: KPMG/ALFI debt fund survey

Figure 20: Debt funds consolidation

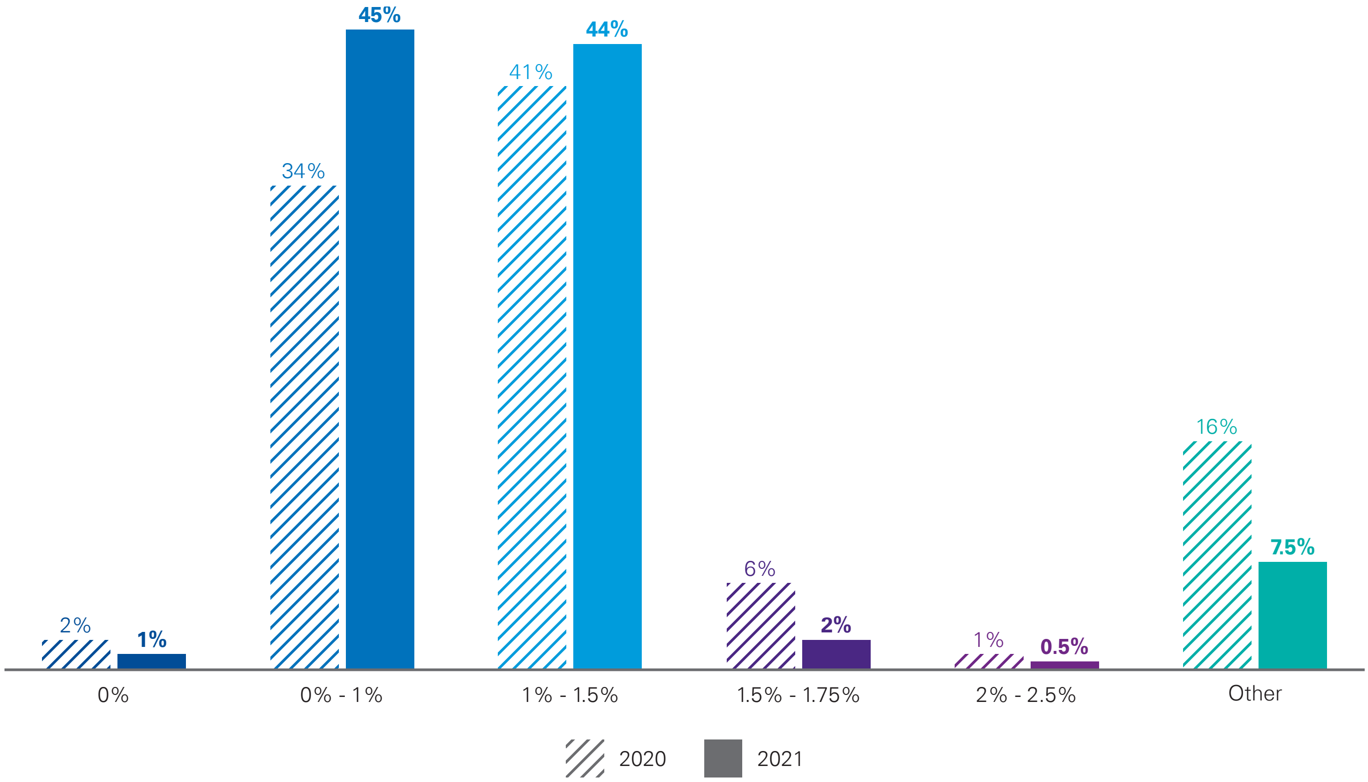


Source: KPMG/ALFI debt fund survey

Management fees

Like last year, management fees typically lie between 0% and 1.5%, with a small proportion above 1.5% (Figure 21).

Figure 21: Debt funds by management fee charged

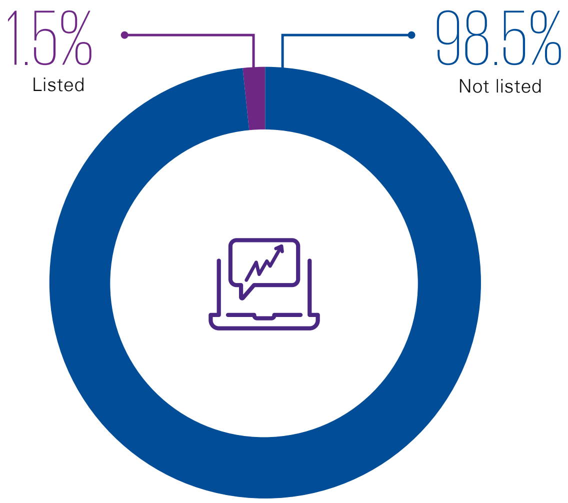


Source: KPMG/ALFI debt fund survey

Other information

Only a small percentage of funds (1.5%) are listed on a stock exchange (Figure 22). Furthermore, 82% of the funds do not use Separately Managed Accounts (SMA).

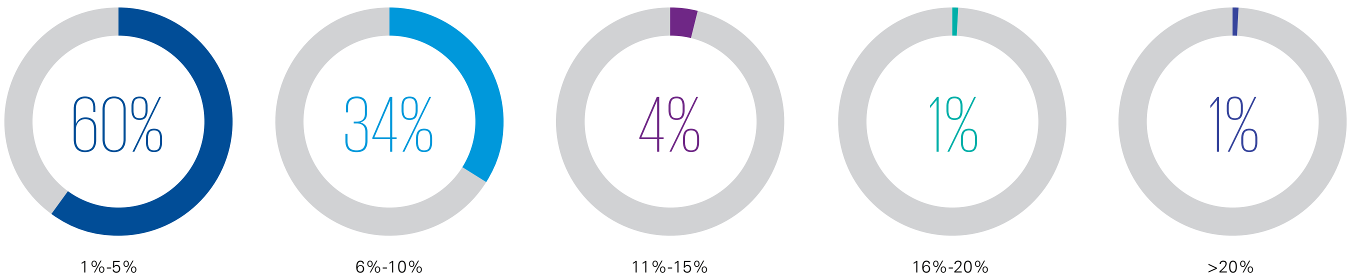
Figure 22: Proportion of debt funds listed on a stock exchange



Source: KPMG/ALFI debt fund survey

Most of the funds have an expected return between 1%-5% (for 60%), followed by return between 6%-10% (for 34%) (Figure 23).

Figure 23: Expected return



Source: KPMG/ALFI debt fund survey

About this research

Objectives

This study has two main objectives :

/ Interpret current behaviors and structuring trends in private debt funds in Luxembourg and predict where they are headed.

/ Provide qualitative insights based on numerical data.

Methodology

We received data from eight depositaries acting on the market and representing 661 funds (or sub-funds) investing in private debt. We sent a pre- defined questionnaire to each depositary surveyed in order to gather data on the various debt funds they are in charge of :

A questionnaire of 32 closed-ended questions covering various topics such as: the fund category, their regulatory regimes, legal forms, sizes, geographical investments targets, investors origins or even data regarding the financial statements.

Content

The key findings of the survey are disclosed in this report on a no-name basis.

Research for this survey was carried out since August 2021 by KPMG Luxembourg, in collaboration with ALFI.

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