

# Loan fund survey

**Shedding light on a fast  
growing asset class**







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# Luxembourg loan funds more popular than ever



**Camille Thommes**  
Director General of ALFI

One building block in the European Commission's Capital Markets Union initiative for unlocking funding for Europe's growth is to encourage 'greater diversity in funding', or 'market-based financing'.

Regulators and policymakers in Europe are becoming aware of the benefits of non-bank intermediation and especially loan funds, which provide an alternative to the banking industry as a source of financing for the real economy. Loan funds play an important role in addressing the imbalance in liquidity supply and demand, in helping businesses raise capital, and in stimulating economic growth.

Luxembourg has long-standing experience in both loan origination and secondary market trading. All fund types, except UCITS, can be structured as loan funds (UCI part II funds, SICARs, SIFs, and RAIFs).

Our survey shows that Luxembourg loan funds are more popular than ever.

# Luxembourg: an impressive toolbox of loan fund structures



**David Capocci**

Head of Alternative Investments

Since the 2007-2008 financial crisis, bank lending in Europe has been significantly reduced due to the tightening of banking regulations and the higher capital ratios imposed on banks. Government bonds and fixed-income bonds yields have fallen dramatically, critically impacting the investors' return and the guaranteed payments that pension funds will have to make. Pension funds and other institutional investors need to look for alternative investments with higher yields.

The European Securities and Markets Authority (ESMA) published its opinion on 'Key principles for a European framework on loan origination by funds' at the European Commission's request in order to give their views on this market development from a regulatory perspective. Following this opinion, the Commission de Surveillance du Secteur Financier (CSSF) published an update of its AIFM Law FAQ in June 2016 which officially confirmed that Luxembourg-based AIFs may engage in loan origination, loan acquisition, or loan participation activities, subject to specific organisational and operational requirements. European and Luxembourg regulators are clearly willing to support non-banking intermediation to finance the real economy.

In recent years, the reality of non-banking credit intermediation has led loan funds to expand significantly in the Grand Duchy. A trend that is expected to continue. This survey's goal is to show the main characteristics of the Luxembourg market regarding loan funds. It is the first survey of this kind that ALFI and KPMG Luxembourg have carried out. We hope that you will enjoy it and find it useful for your business.

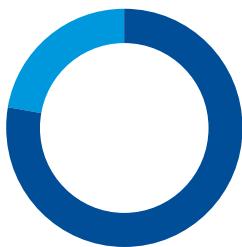


# Snapshot



EUR 40bn

aggregate capital invested in regulated loan funds mid-2017



78%

of loan funds are SIFs



55%

of the investors are European



160%

increase of number of funds in 2017 compared to 2016 and 280% increase compared to 2015



60%

of the top ten players are using or plan to use RAIIFs



70%

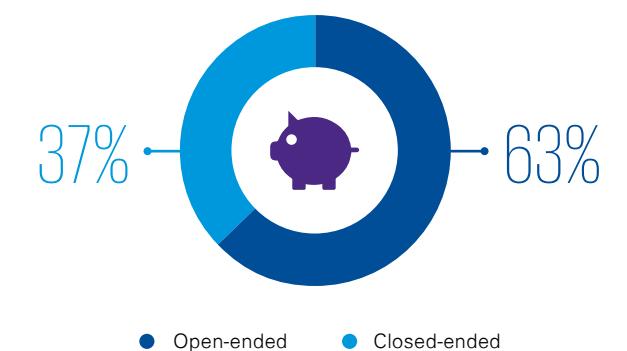
of major assets managers use Luxembourg vehicles for their loan funds investment

# Fund structures



Loan funds may be open-ended or closed-ended. The choice between the two depends on the type of investor as well as the underlying asset type. Closed-ended funds are generally, for example, more suitable for private equity actors. The majority of Luxembourg loan funds are open-ended.

**Figure 1: Proportion of open- and closed-ended loan funds**

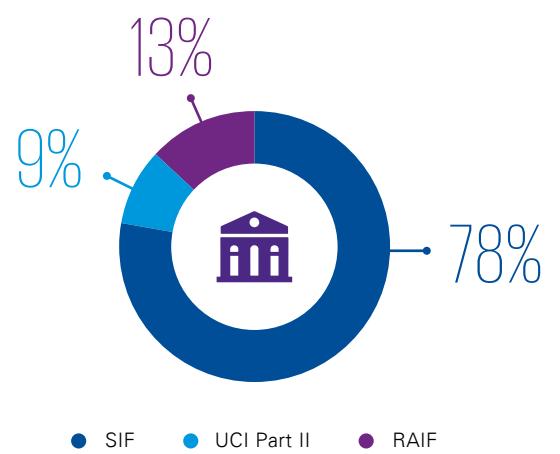


A distinction can be drawn between two types of loan funds<sup>1</sup>:

- A loan originating fund is any type of fund that is, according to its investment strategy, allowed to grant and restructure loans (i.e. subsequent amendment of loan conditions such as prolongation or deferral).
- A loan participating fund is a fund that is allowed to partially or entirely acquire and restructure existing loans originated by banks and other institutions, either directly from the lender or in secondary markets, where such loans are traded. According to their investment strategy they are not allowed to grant loans.

As can be seen below, the biggest part of the loan fund market in Luxembourg is driven by SIFs (78%), followed by RAIF and UCI Part II (13% and 9%). The use of SICARs is marginal.

**Figure 2: Loan funds by legal regime**



1. The International Organization of Securities Commissions, findings of the survey on loan funds, February 2017, pp.2



The fact that SIFs are the first choice of loan fund managers (excluding UCITS) can be easily explained by their flexibility with regard to investment policy, as well as by the SIF regulatory regime. Furthermore, this vehicle is well-known by loan fund managers given that it is now a decade old.

Last year, Luxembourg upgraded its funds toolbox with a new fund vehicle, the Reserved Alternative Investment Fund (RAIF), which better aligns with the shift in regulatory focus towards the managers of alternative funds. Many AIFMs and their sophisticated investors had been calling for the removal of the dual regulatory approach whereby both manager and fund are regulated and supervised. Luxembourg responded to this call by creating the RAIF structure which contains many of the same features as the popular SIF and SICAR structures. The novelty with the RAIF lies in the removal of this double layer of regulation of both the fund manager and the fund, which also promises a quicker time-to-market.

Only authorised external AIFMs are allowed to manage RAIFs and it is expected that the RAIF will have considerable appeal to many categories of sophisticated investors that seek to invest quickly in products with solid investor protection.

Based on Figure 2, we can see that SICARs are marginally used by loan fund promoters. This can be explained by the investment policy that a SICAR must follow (i.e. investment in risk-bearing securities), which is typically not in line with loan investments (with some exceptions). Going forward, SIFs will continue to be used by loan fund managers, but RAIFs will constitute a very strong alternative.

In terms of structuring loan funds, promoters have a choice between single compartments or multiple compartments. As of 30 June 2017, the split between both types of fund structures may be summarised, as in the following Figure 3.

Figure 3: Loan funds structure

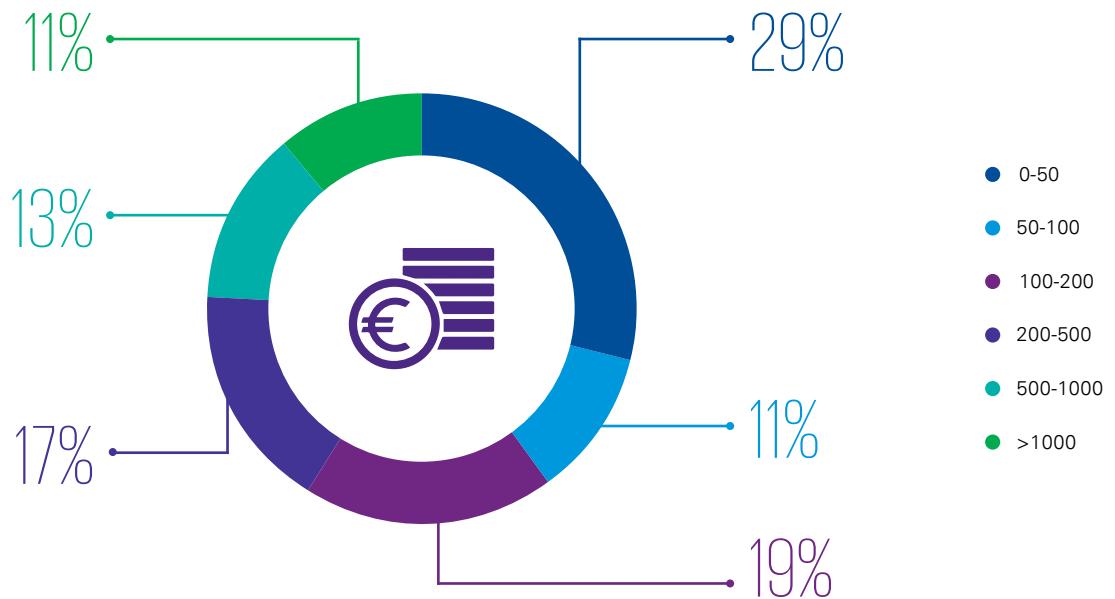


Source: KPMG/ALFI loan fund survey

We note that the percentage of sub-funds used for separate investment strategies is roughly equal to single compartment funds. Complex share classes means that different management and performance fee structures can be managed for different investors.

Most of the funds have a size ranging between €0-50 million. Notably, large funds (i.e. funds having a total commitment exceeding €1 billion) represent 11% of the total number of loan funds. As at 31 August 2017, the regulated market of loan funds represents approx. EUR 40b.

**Figure 4: Loan funds by fund size (in million EUR)**



Source: KPMG/ALFI loan fund survey

The above information is purely related to regulated funds (for the RAIF, the regulation takes place at the level of the AIFM). However, a big part of the market is not regulated, and is, as a result, difficult to catch.

Indeed, non-regulated investment vehicles can be set up as limited partnerships (*société en commandite simple* or SCS), special limited partnerships (*société en commandite spéciale* or SCSp), non-regulated securitisation vehicles (SV), or holding and financing companies (SOPARFI).

These vehicles are set up either by Luxembourg or foreign funds to acquire portfolios of loans or even to originate loans. Indeed, granting loans to a limited number of identified persons (and therefore not on a large scale) may be done without the CSSF's authorisation. This is a great advantage of the Luxembourg market, as unregulated vehicles may be used in the framework of specific projects to do such activities. This ability strengthens the attractiveness of Luxembourg for the loan fund industry.

As a result, many loan fund actors have used Luxembourg unregulated structures to originate or acquire loan portfolios. This means that the figures presented in this survey, which only provides statistics in relation to regulated funds, only capture a portion of the total size of the loan fund structures carried out from Luxembourg entities.

In compiling this survey we spoke to the top ten loan fund managers in the world, as well as other major actors in the debt-investment sector. All of them have a presence in Luxembourg and assets under management totalling more than EUR 45b. From these interviews we have collected data on the unregulated part of the market.

The main trend is that most of the actors use unregulated vehicles. The first vehicle of choice is the SOPARFI, which is preferred over the unregulated SV. Indeed, SOPARFIs are widely used amongst investors due notably to their accessibility, flexibility, and how well-known they are by investors and promoters alike.

Furthermore, several actors have confirmed that they have started (or are in the process of starting) to use a RAIF structure for future investments. These fund managers have been drawn to the RAIF's quick time-to-market as well as its flexibility on legal forms and rules.

In terms of investment regions, the European and the North American markets are still, unsurprisingly, seen as providing good opportunities of investment in the short to medium-term. More interestingly, we see an appetite for more investments in Asia and South America. As for the evolution of the market in the coming years, overall returns are expected to remain stable but good opportunities might become more difficult to find.





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# Impact of other EU regulations on loan funds

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## ELTIF

The European Long-Term Investment Fund (ELTIF) framework became effective on 9 December 2015 and introduced a new long-term fund product that may be sold to professional and retail investors. ELTIFs must be managed by an authorised AIFM and respect specific investment and diversification rules.

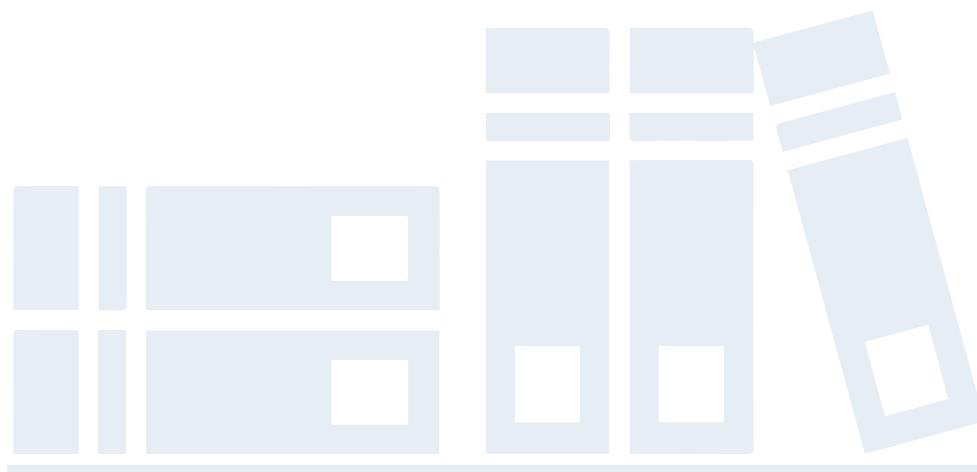
The aim of ELTIFs is to increase the pool of capital available for long-term investment in the EU economy, and they must invest at least 70% of their capital in long-term assets such as infrastructure, private equity, and certain types of real estate, as well as listed SMEs and other types of funds.

In this respect, eligible assets include loans granted to qualifying portfolio undertakings with a maturity no longer than the ELTIF lifetime.

## EuVECA/EuSEF

The European Venture Capital Funds (EuVECA) regulation intends to support venture capital by facilitating cross-border fundraising activities and increasing the number of funds available for venture capital in the EU. The aim of the European Social Entrepreneurship Funds (EuSEF) regulation is to support the provision of finance to social businesses in the EU by facilitating their fundraising activities. Qualifying investments include secured or unsecured loans to qualifying SMEs. These labels give qualifying managers the right to market to qualified investors throughout the EU using a passport without having to seek an AIFM license.

The EuVECA and EuSEF came into force on 22 July 2013 and were revised recently to make the framework more attractive. Appetite for these regimes has however been extremely limited at this stage.



# Looking forward

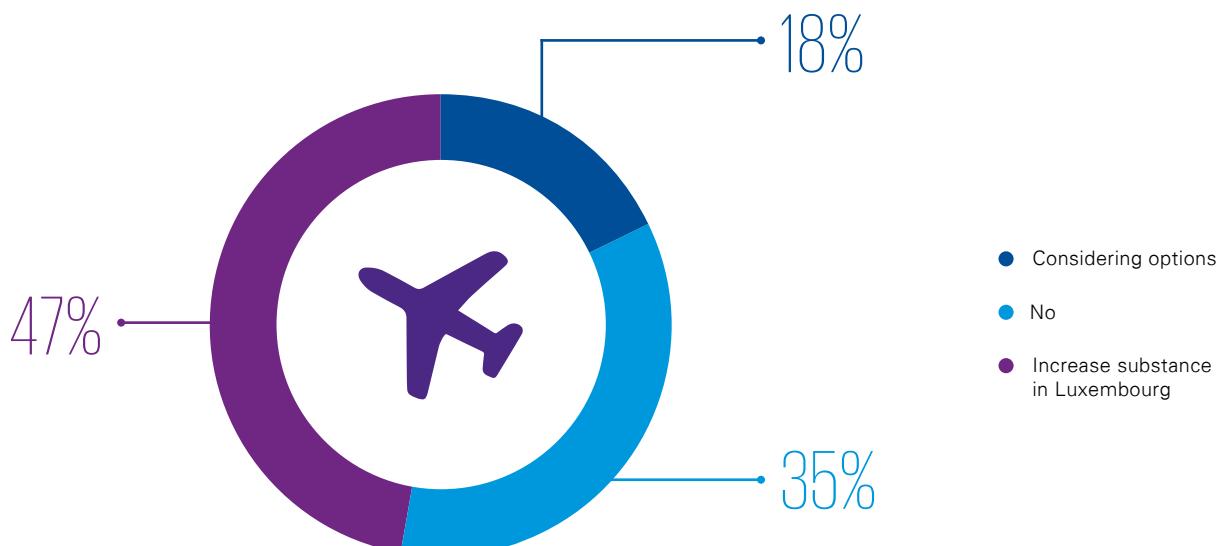
Luxembourg is a very popular location for structuring international investments. The reasons are many, among which are the flexibility of Luxembourg's legal, tax, and regulatory environment, and the availability of diversified investment vehicles. Over 70% of the top 30 loan fund managers worldwide are present in Luxembourg<sup>2</sup>, and the Grand Duchy offers a large portfolio of investment fund vehicles, either regulated or unregulated, as mentioned earlier.

Furthermore, international tax law is evolving rapidly under the OECD Base Erosion and Profit Shifting project (BEPS), triggering new tax complexities and opportunities. In particular, the concept of substance has reached another level with the principal purpose test (PPT) introduced in Action 6 of the BEPS reports. The PPT is an anti-treaty abuse clause that 'allow[s] contracting states to deny the application of treaty provisions when transactions or arrangements (such as the setting

up of a Special Purposes Vehicle in Luxembourg) (SPV) are entered into in order to obtain the benefits of these provisions in inappropriate circumstances'.

We have therefore asked some of the main alternative investments actors for their opinions on the changes in the international tax environment. As a whole, although managers are concerned, they do not intend to leave Luxembourg but would rather stay and reinforce their presence (see Figure 5 below).

Figure 5: Do loan fund managers contemplate to leave Luxembourg?



One of the reasons why promoters and investors continue to use Luxembourg vehicles is Luxembourg's stability. Luxembourg's fund management industry is also seen as a draw and a valid reason to establish a loan fund structure in Luxembourg, even if deal people remain in other countries.

Finally, all types of debt strategies are accommodated in, and have been successfully operating out of, Luxembourg

for a number of years. This includes origination, secondaries, mezzanine, distressed, various debt instruments, and others.

In conclusion, Luxembourg's loan fund industry has the tools and skills, as well as the appropriate legal, regulatory, and tax environments, to continue its development.



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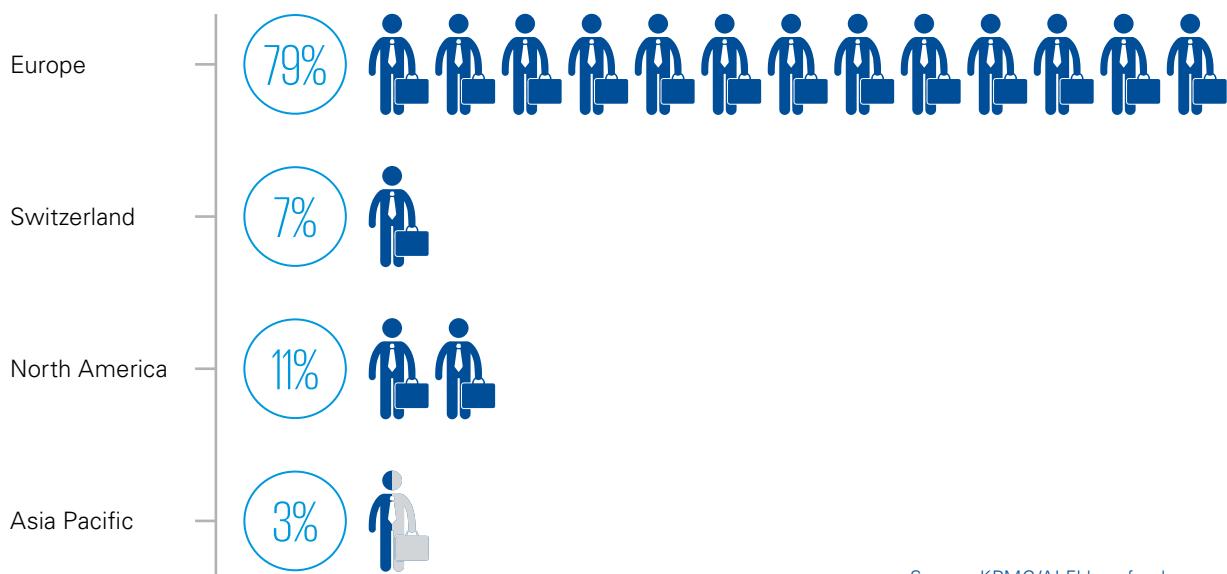
# Outlook on key data

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## Initiator origin

The vast majority of initiators (promoters) come from the EU, followed distantly by those from North America.

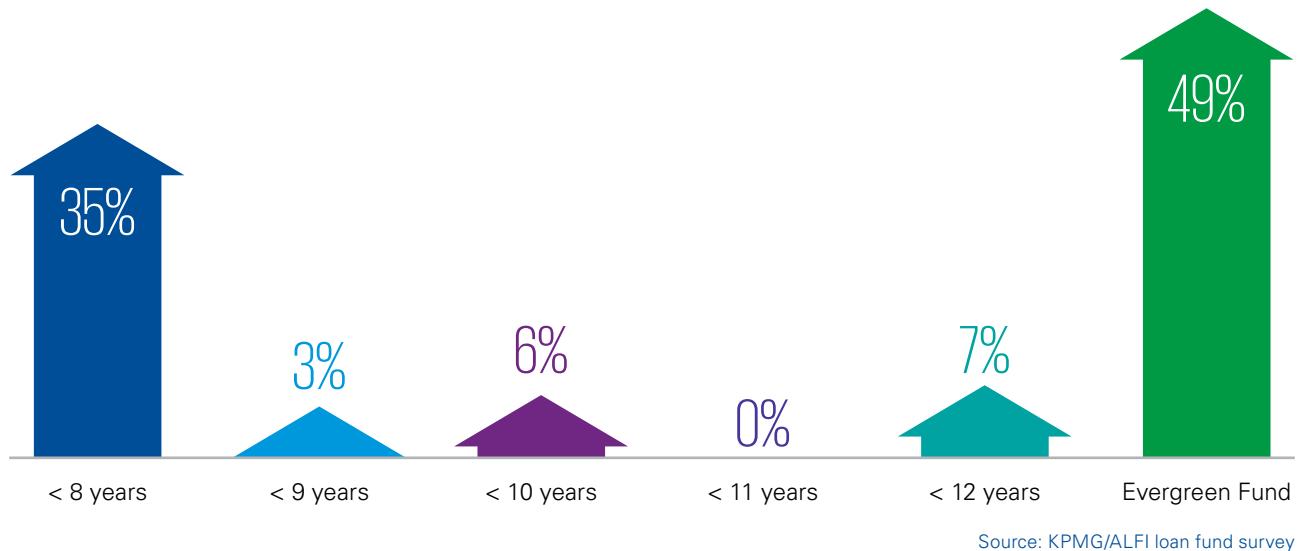
Figure 6: Initiators' origin by location



## Investment and holding period

The number of investments per fund is highly volatile and depends on several factors, for instance the size of the fund and its investment strategy. Based on the information gathered, the average number of investments per fund is 63. With respect to maturity, 35% of the funds have maturity below eight years. A small percentage have slightly more maturity (between 10 years and 12 years). Approximately half of the funds are evergreen funds.

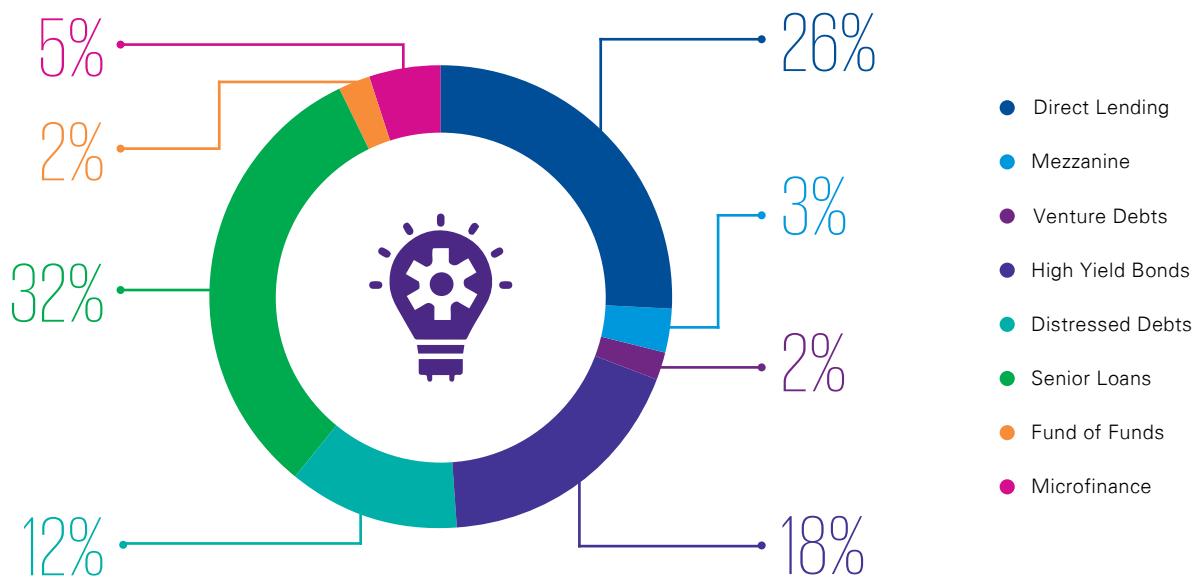
Figure 7: Loan funds by maturity



## Investment strategy

The strategy of the Luxembourg loan funds is mainly threefold: senior loans for 32% of them, direct lending and high yield bonds for 26% and 18%.

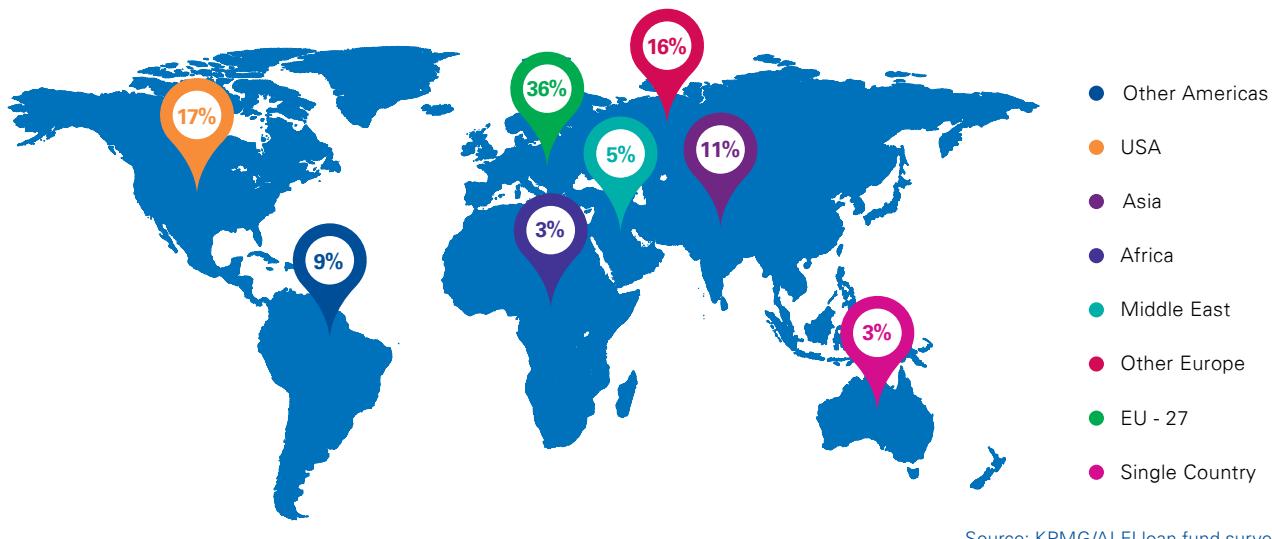
Figure 8: Loan funds by investment strategy



## Geographical investment target

Most of the loan funds (97%) have a multi country investment approach. The preferred investment targets are in the EU and the Americas.

Figure 9: Loan funds by geographical investment targets



## Investor type and origins

Unsurprisingly, the main tranche of investor type is institutional investors (74%) followed by HNW Individuals (13%) and private banks (7%). These investors mainly come from EU countries (Figure 11). There are typically between 6 and 25 investors per fund (Figure 12).

Figure 10: Loan funds by investor type

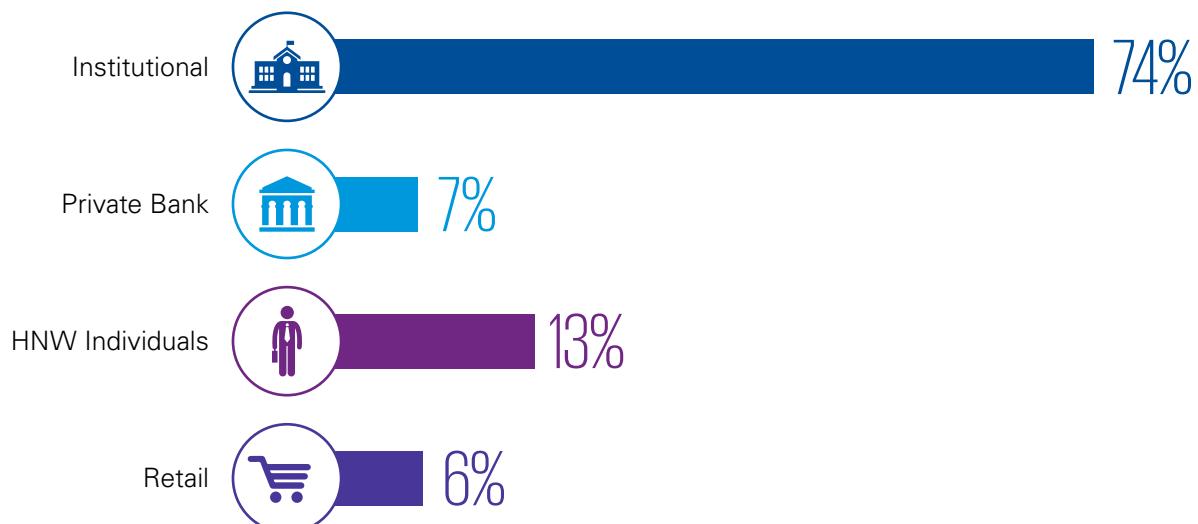
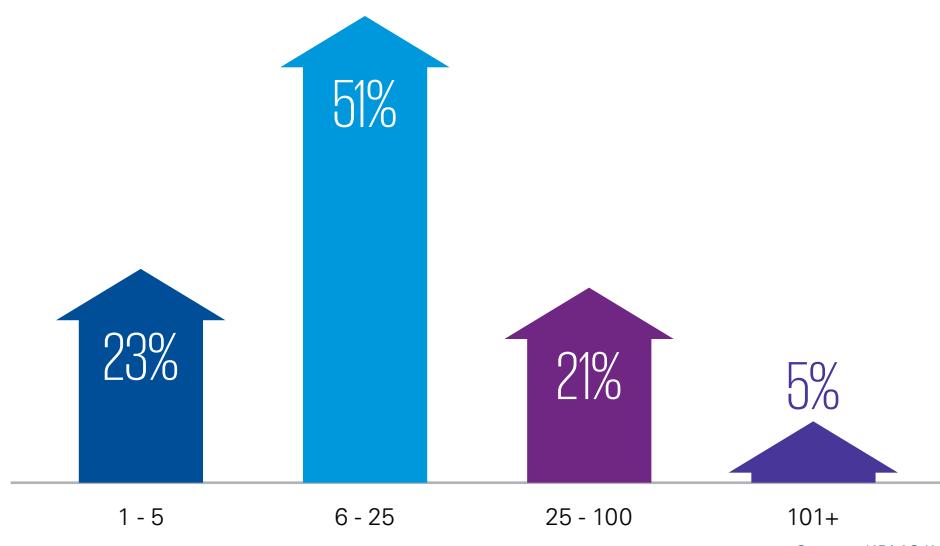


Figure 11: Loan funds by investor origin



Figure 12: Loan funds by number of investors



## Financial statements

The financial statements of the Luxembourg loan funds are mostly prepared under LuxGAAP. These accounts are prepared in EUR by a small majority (57%) followed shortly by USD (41%).

Figure 13: Loan funds by currency

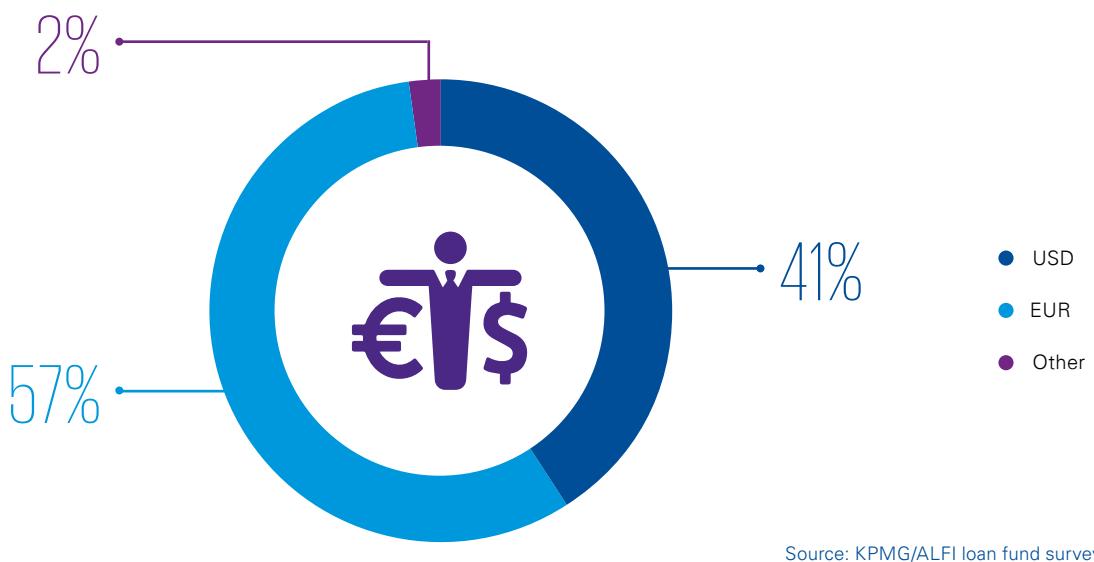


Figure 14: Loan funds GAAP

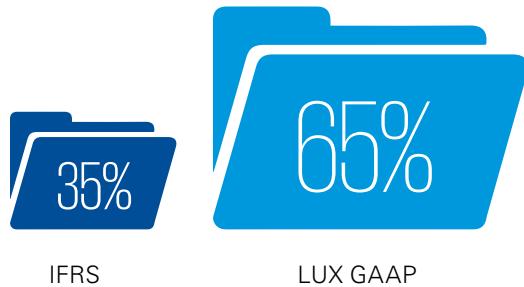
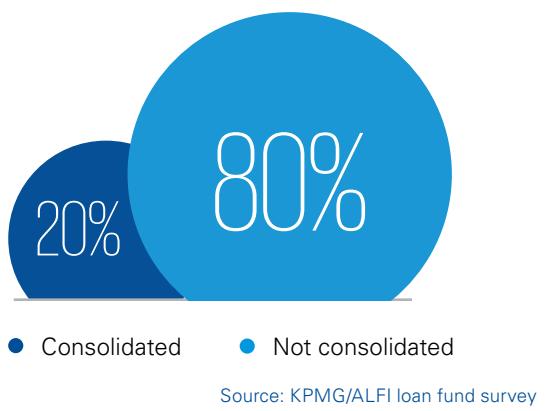


Figure 15: Loan funds consolidation



## Investor reporting

The reporting methodology used is mainly fair value (38%), followed by IFRS (35%) and cost less impairments (25%).

Figure 16: Loan funds by investor reporting

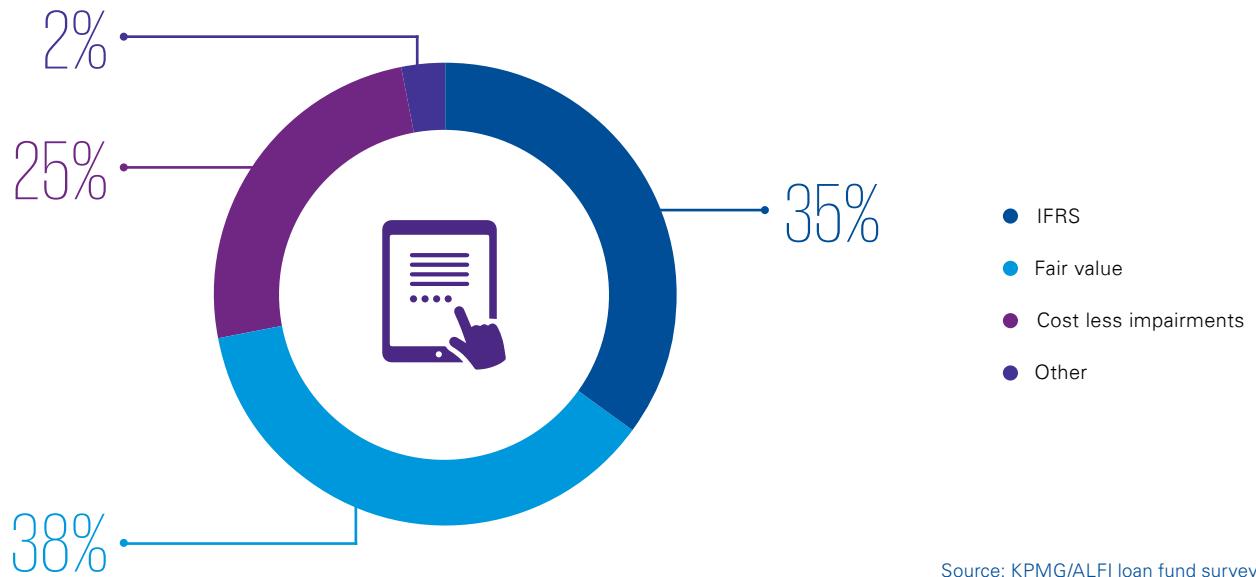
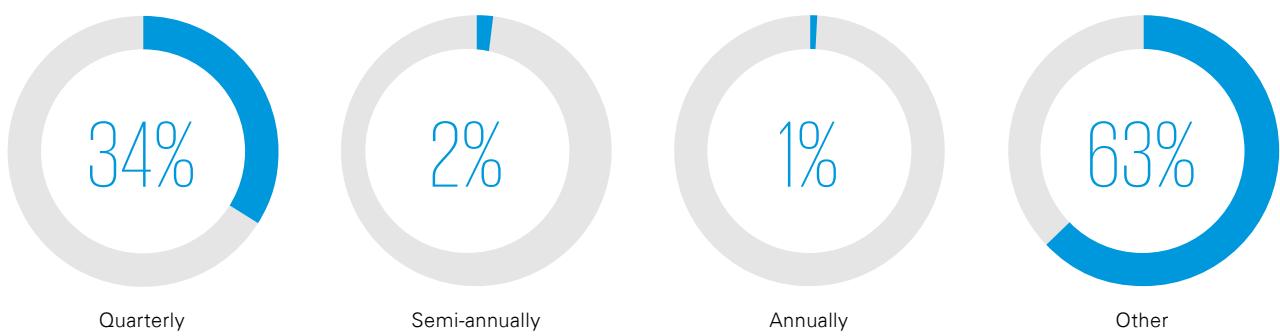


Figure 17: Loan funds by frequency of NAV computation



## Management and performance fee

Management fees are typically lower than 1.5% and usually computed on the NAV of the fund rather than the committed or invested capital. When a performance fee is payable, it usually ranges between 0% and 4% and is accrued and payable during the lifetime of the fund.

Figure 18: Loan funds by performance fees structure

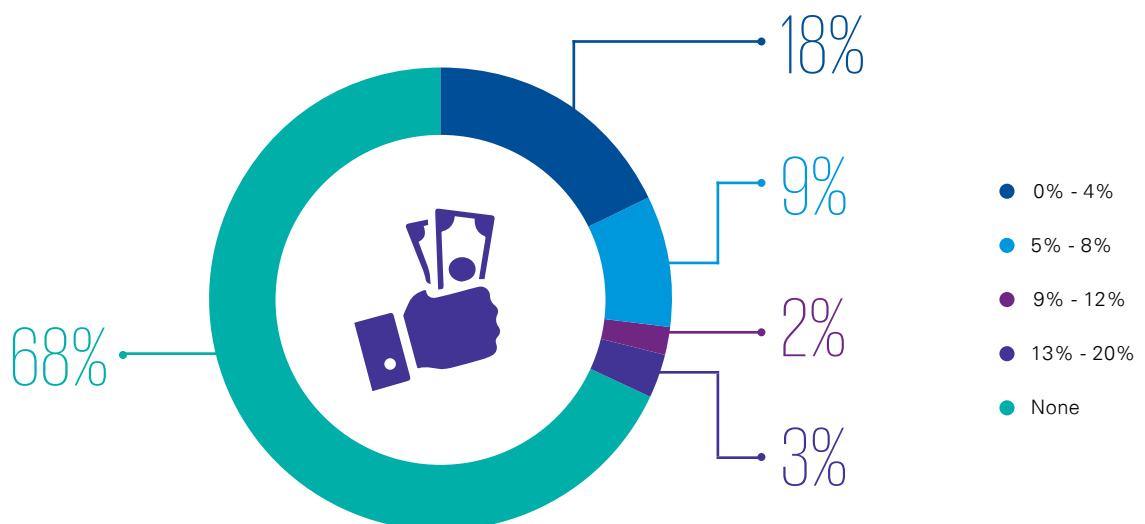


Figure 19: Loan funds by performance fee charged

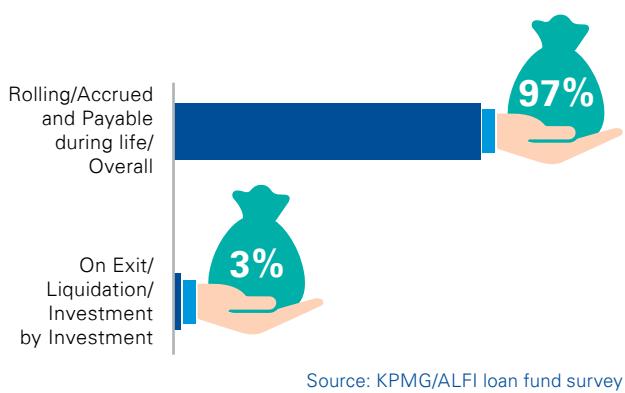
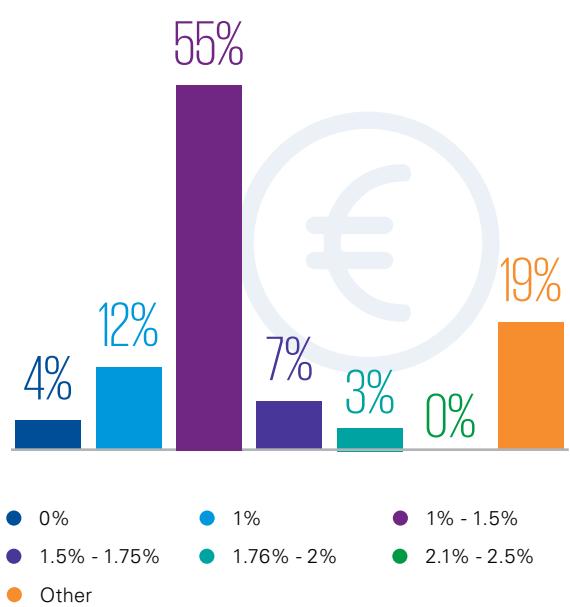


Figure 20: Loan funds by management fees charged



## Other information

Only a small percentage of the funds are listed (2%). Since the credit crunch of 2008, we can notice steady increase of the number of loan funds launched.

Figure 21: Launch year of the loan funds

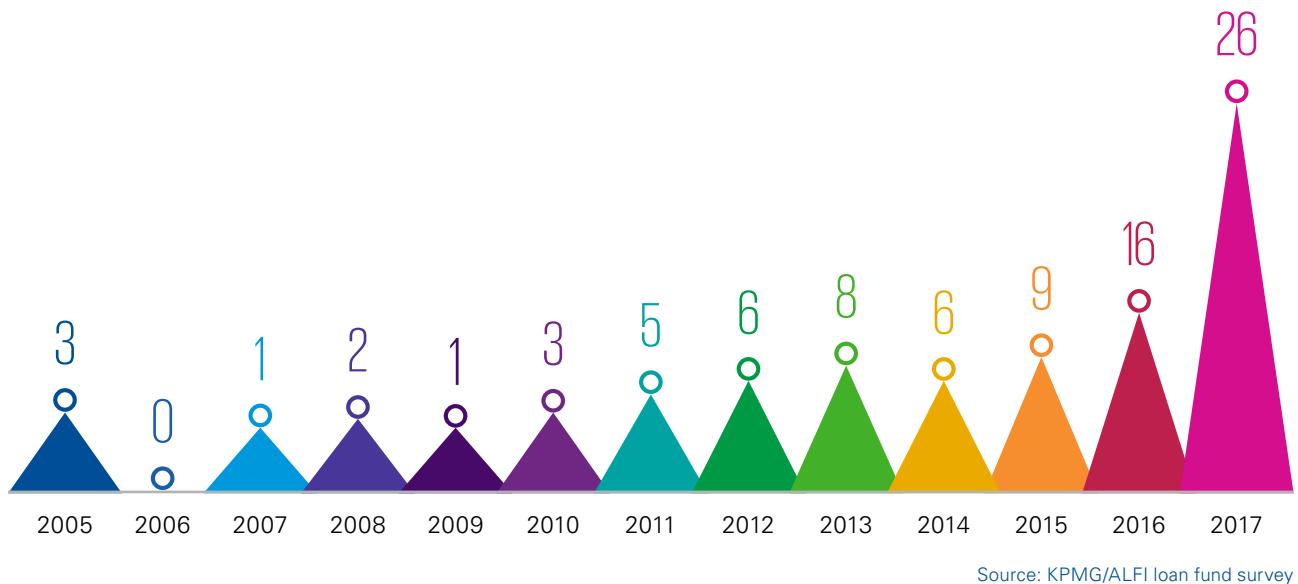


Figure 22: Proportion of loan funds having a registered/authorised AIFM

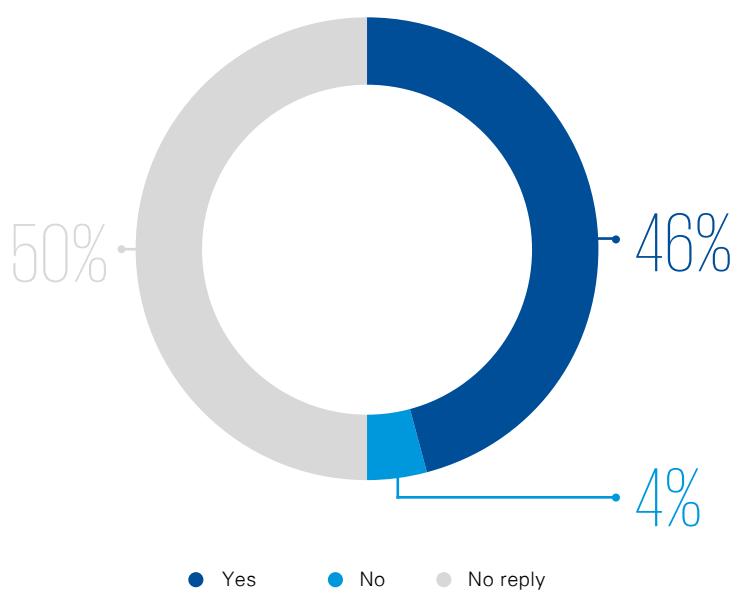
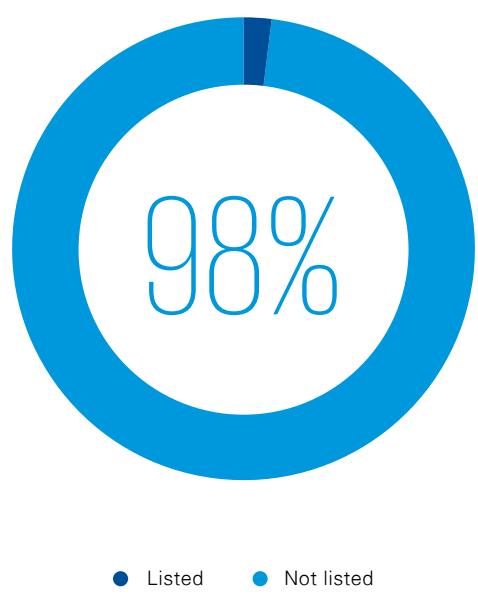


Figure 23: Proportion of loan funds listed on a stock exchange



# Contact us



**David Capocci**

**Head of Alternative Investments**

**T:** +352 22 51 51 5110

**E:** [david.capocci@kpmg.lu](mailto:david.capocci@kpmg.lu)

## **KPMG Luxembourg, Société coopérative**

39, Avenue John F. Kennedy  
L-1855 Luxembourg

**T:** +352 22 51 51 1

[kpmg.com/lu](http://kpmg.com/lu)



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