



Private debt fund survey 2019

The unstoppable rise of an asset class

kpmg.lu







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Introduction



Camille Thommes
Director General
of ALFI

“Designed to unlock funding for Europe’s growth, the European Commission’s Capital Markets Union project aims at increasing the diversity in funding and the facilitation of market-based financing.

Non-bank intermediation, such as financing through private debt funds, is gaining further momentum. Private debt funds are a growth stimulator and important source of financing for the real economy. Alongside the banking industry, they can help businesses raise capital and address the imbalance of liquidity supply and demand.

The Grand Duchy has long-standing experience and recognized knowledge in both loan origination and secondary market trading, and our survey shows that Luxembourg private debt funds are more sought-after than ever.”



David Capocci
*Head of Alternative
Investments*

The private debt fund market has steadily grown over the last few years and 2019 is no exception. AuMs have increased by 40% in two years — from EUR€40 billion in 2017 to EUR€56 billion as of June 2019. These numbers reflect the debt fund market's success, which we expect to continue in the coming years.

One interesting revelation from this year's survey is that the percentage of loan funds set up as reserved alternative investment funds (RAIFs) has rocketed. While specialized investment funds (SIFs) still dominate the market at 71%, 20% of funds were set up as RAIFs as of June 2019 compared to 13% in 2018. Meaning that the number of RAIFs in the private debt fund market has almost doubled in only a year!

The regulatory reform agenda has continued its steady advance. Today's landscape reflects current policy priorities: financial stability and systemic risk, maintaining an open and well-functioning EU financial market and promoting sustainable finance. Debt fund managers should keep a close eye on regulatory developments as they will likely impact the industry.



€56 bn

20%

69%

of aggregate capital
invested in regulated loan
funds as of mid-2019

of loan funds (excluding
UCITS) are RAIFs

of investors are European

The investment strategy is mainly



14.5%

increase in AuMs
compared to 2018



32%

direct lending



25%

senior loans

| Source: KPMG/ALFI loan fund survey

Fund structures

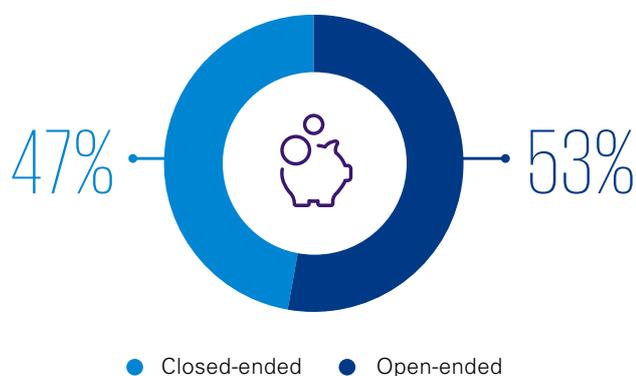
Loan fund categories

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

- / A loan-originating fund is, according to its investment strategy, allowed to grant and restructure loans. In other words, it can amend loan conditions such as prolongation or deferral.
- / A loan-participating fund is allowed to partially or fully acquire and restructure existing loans from banks and other institutions, either directly from the lender or in secondary markets where these loans are traded. According to its investment strategy, a loan-participating fund is not allowed to grant loans.

Loan funds can be open- or closed-ended, depending on the type of investor and the underlying asset type. A slim majority (53%) of Luxembourg loan funds are open-ended (Figure 1).

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



| Source: KPMG/ALFI loan fund survey

Regulatory framework (regulated investment vehicles)

Loan funds can be structured as regulated or unregulated. Regulated funds are authorized and supervised by Luxembourg's supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF).

Ordered from least regulated to most, regulated loan funds can be structured as:

- / Reserved alternative investment funds (RAIFs): funds subject to the law of 23 July 2016.
- / 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.
- / UCITS funds: funds subject to part one of the law of 17 December 2010, as amended.

UCITS are available to retail investors, while 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 EUR€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.



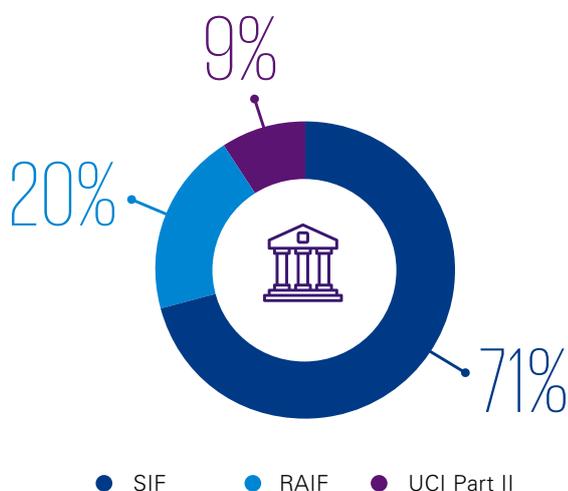
Regarding assets, UCITS can only invest in transferable securities and other liquid assets, as stated in article 41 of the law of 17 December 2010. Eligible assets for Part II funds, SIFs or RAIFs are unrestricted, although Part II funds must receive prior CSSF approval of their investment objectives and strategy.

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

UCITS, 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 the CSSF. In comparison, UCITS, Part II funds, SIFs and SICARs are all subject to direct CSSF supervision.

Figure 2: Loan funds¹ by legal regime



Source: KPMG/ALFI loan fund survey

Alternative investment funds set up as Luxembourg limited partnerships (SCS/SCSp) 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.

As seen in Figure 2², SIFs dominate Luxembourg's loan fund market at 71% — followed by RAIFs (20%) and Part II funds (9%).

SIFs' popularity with loan fund managers (excluding UCITS) is due to their flexible investment policy and their regulatory regime. In addition, this vehicle is well known, having been available for a decade.

Compared to last year, the percentage of loan funds set up using RAIFs has surged from 13% to 20%.

We expect RAIFs to continue this 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 direct CSSF supervision and reporting requirements, removing the double regulation layer and allowing a quicker time to market.

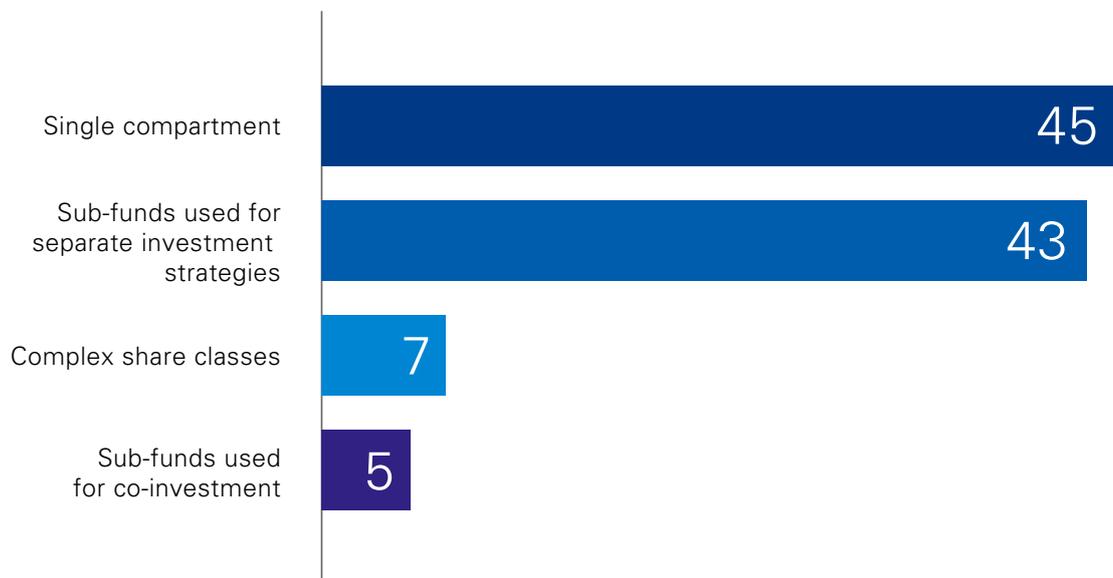
Loan fund promoters rarely use SICARs, due to their restricted investment policy — they can only be used to invest in risk-bearing securities.

Loan funds can be set up under the UCITS framework by using tailored indices and derivatives, but this is unpopular — mainly due to its strict liquidity requirements regarding assets. However, we still list the option here for the sake of completeness.

1. Excluding UCITS
2. Ibidem

Regarding loan fund structuring, promoters can choose between single or multiple compartments. Figure 3 shows how these types are split as of 30 June 2019 — 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.

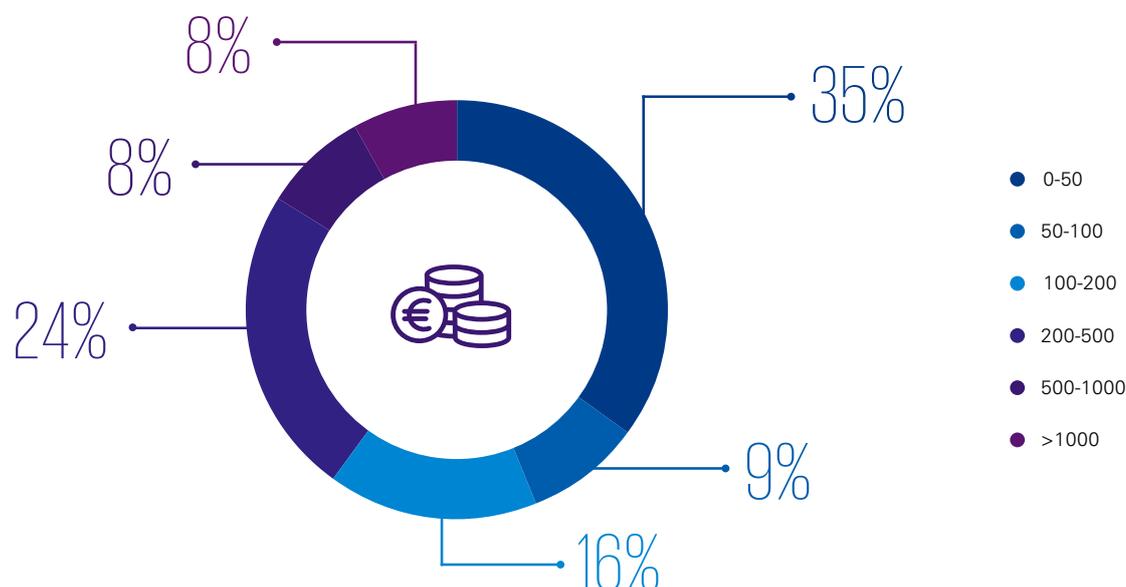
Figure 3: Loan fund structures



| Source: KPMG/ALFI loan fund survey

Like last year, most funds range up to EUR€50 million in size (Figure 4). Notably, mid-size funds — i.e. those with a net asset value of between EUR€200 million and EUR€500 million — represent 24% of the total number of loan funds (versus 20% in 2018). As of 31 July 2019, the regulated market of loan funds represented around EUR€56 billion (compared to EUR€49 billion as of mid-2018).

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



| Source: KPMG/ALFI loan fund survey



Unregulated investment vehicles

Another important element of the loan fund market is unregulated investment vehicles. These vehicles can be set up as limited partnerships (sociétés en commandite simple or SCSs), special limited partnerships (sociétés en commandite spéciale or SCSps), unregulated securitization vehicles (SVs) or holding and financing companies (sociétés de participations financières or SOPARFIs).

Compared to regulated vehicles, they are highly flexible and cost less to set up and operate since they do not require CSSF approval, reporting or supervision.

In fact, granting loans to a limited number of identified persons — i.e. on a small scale — can be done without CSSF authorization. This makes the Luxembourg market extremely attractive to the loan fund industry, as unregulated vehicles may be used in the framework of specific projects — for example, to acquire a single portfolio or several portfolios in the same industry.

The favored vehicle of loan fund managers in the unregulated market is the SOPARFI, who tend to prefer it to the unregulated SV. SOPARFIs are widely used mainly due to their accessibility and flexibility — and also because they are well-known to investors and promoters.

Reshaping international taxation

The Anti-Tax Avoidance directives

2019 delivered substantial changes to Luxembourg and international taxation.

The transposition of the EU Anti-Tax Avoidance Directive (ATAD 1) into Luxembourg tax law and the bill of August 2019 transposing the EU Anti-Tax Avoidance Directive 2 (ATAD 2) has significantly and permanently moved the goalposts for loan fund actors and alternative investment players.

ATAD's aim is to provide a baseline level of protection for the internal market and to strengthen the average level of protection against aggressive tax planning.

Effective in Luxembourg since 1 January 2019, the ATAD 1 transposition law introduced provisions covering five main topics:

- / interest limitation
- / exit taxation
- / a general anti-abuse rule (GAAR)
- / controlled foreign companies (CFCs)
- / intra-EU hybrid mismatches.

The limitation of interest deduction and the anti-hybrid provisions are particularly relevant for SOPARFIs in the loan fund market, since regulated investment funds are generally exempt from corporate income tax and net wealth tax. Therefore, SOPARFIs would require debt financing of their loan receivables to offset otherwise taxable interest income.

Luxembourg's ATAD law limits the deductibility of net interest expenses — i.e. taxable interest income minus deductible interest expenses — of up to 30% of the taxpayer's adjusted EBITDA or EUR€3,000,000, whichever is higher (calculated annually).

For SOPARFIs involved in the back-to-back intragroup financing of plain vanilla loans, this rule should not trigger adverse Luxembourg tax implications because the company would achieve an arm's length margin. And, if a gain on distressed debt/non-performing loans is included in the definition of interest income or equivalent, this new limit should not negatively affect SOPARFIs. There is currently no clear guidance on the definition of "*interest income*" or "*other economically equivalent income*", however clarification is expected in the coming months.



Implementation of anti-hybrid provisions

In August, the ATAD 1 rules regarding anti-hybrid mismatches between EU countries were expanded by the ATAD 2 transposition bill to cover hybrid mismatches with third countries.

The bill confirms the scope of the anti-hybrid mismatches as foreseen by ATAD 2, such as the non-deductibility of interest charges under a debt instrument regarding (i) payments made to associated enterprises or (ii) payments related to structured arrangements that trigger either a “*deduction without inclusion*” or “*double deduction*” outcome due to hybrid mismatches involving:

- / hybrid instruments
- / hybrid entities
- / permanent establishments
- / imported mismatches
- / hybrid transfers
- / residency mismatches.

The Luxembourg bill provides much-needed clarification for investment funds. In short, investment funds, held by several unrelated investors while managed by the same person, could potentially benefit from the presumption that their investors do not qualify as “*associated enterprises*” under ATAD 2.

This is because the anti-hybrid rules focus on payments made to “*associated enterprises*” that require participation of at least 25% for hybrid financial instruments — i.e. voting rights, capital or profit entitlement — and 50% for hybrid entities. In principle, these thresholds should, de facto, exclude investment funds held by several investors.

However, the bill also introduces the concept of “*acting together*” which aggregates the holding percentage of investors “*deemed*” to be acting together regarding an entity’s voting rights or capital ownership — e.g. an investment fund.

The bill provides a “*de minimis*” exception for applying the acting together principle. An individual or enterprise that holds either directly or indirectly less than 10% in the capital of an investment fund — and is entitled to receive less than 10% of the profit — is exempt from acting together and should, therefore, fall out of the anti-hybrid provision’s scope.

Further clarifications and guidance on the concrete application of the anti-hybrid provisions are expected in the coming months. The provisions will become effective from 1 January 2020, apart from the reverse hybrid provisions that apply as from 1 January 2022 and must follow the legislative process.



EU SUSTAINABLE FINANCE

Green loans

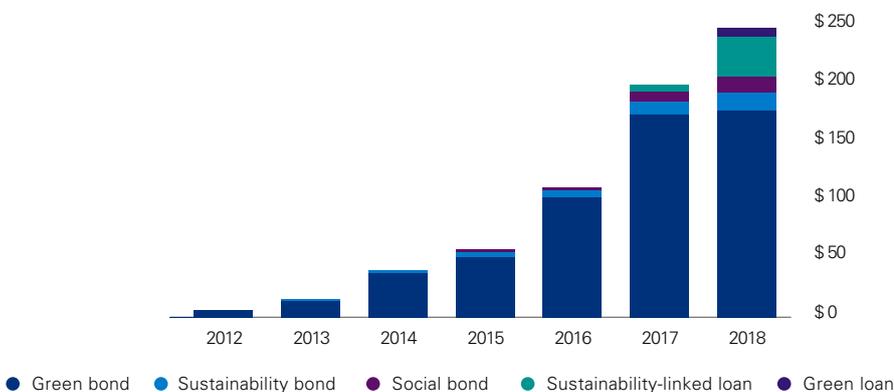
What are green loans and why are they taking off?

Green loans are a hot topic in the loan market. Even though they are relatively new, their volume has shot up over the past few years. Green loan issuance globally amounted to USD\$60 billion in 2018, up by more than 30% from 2017. The largest issuers are in the US, the UK, Spain and India and the majority of proceeds are used for renewable energy projects¹.

Green loans are any type of loan instrument that exclusively finances or refinances — in whole or in part — new and/or existing eligible green projects. Any issuer can use these financial instruments regardless of ESG status — because it’s how the proceeds are used that is important.

A New Green Market

Sustainability debt issued by instrument type



1 Source: BloombergNEF

What standards ensure a loan's greenness?

The Green Loan Principles (GLP) of the International Capital Market Association (ICMA) defines a consistent methodology to assess green loans and promote their integrity on the market.

Similar to the Green Bond Principles, which were developed in March 2018, the GLP defines four key components that make a loan green²:

- / **Use of proceeds:** the fundamental element of a green loan is the use of its proceeds for green projects, including related and supporting expenditures such as research and development. This should be appropriately stated in the finance documents and, if applicable, the marketing materials. The GLP provides a non-exhaustive list of environmental issues that apply, such as climate change, natural resources depletion, loss of biodiversity and air, water and soil pollution.
- / **Process of evaluating and selecting projects:** the borrower of a green loan should clearly communicate to its lenders the loan's environmental sustainability objectives, and how its projects fall under the eligible green categories including related eligibility criteria.
- / **Management of proceeds:** the proceeds of a green loan should be credited to a dedicated account or otherwise tracked by the borrower appropriately, to maintain transparency and promote the integrity of the product.
- / **Reporting:** borrowers should provide and keep readily-available and up-to-date information on how the proceeds are being used. This includes a list of green projects, qualitative performance indicators and, where feasible, quantitative performance measures.

Also, a borrower can certify its green loan or associated green loan framework against an external green assessment standard. The green loan is tested against the criteria of the assessment standard by qualified third parties/certifiers, such as auditors.



EU sustainable finance — taxonomy

The EU Technical Expert Group on Sustainable Finance (EU TEG) is currently finalizing its work on selected points of the EU Action Plan on Sustainable Finance. One of these elements is the taxonomy. The EU Parliament has already developed its position on the legislative proposal regarding taxonomy and the next step is to reach an agreement with the Commission and the Council. The resulting Directive will be implemented in future national-level regulations.

An EU taxonomy plays an essential role in making EU climate targets implementable in practice. It is a classification system that allows the categorization of economic activities/sectors that play key roles in climate change mitigation and adaptation. For an economic activity to be included in the proposed EU taxonomy, it must substantially contribute to at least one environmental objective — while doing “no significant harm” to the other five environmental objectives set out in the legislative proposal.

The classification’s technical screening criteria, methodology and guidance are set out in the EU report on taxonomy. The EU TEG is designing the taxonomy together with extensive stakeholder consultations involving many experts from sectors covered by the taxonomy.

The Regulation on disclosures relating to sustainable investments and sustainability risks — adopted by the European Parliament and Council in April 2019 — states that financial market actors must disclose sustainability risks and impacts. Given that these actors provide financing for and invest across various sectors, the sustainability risks and impacts of these investments must be analyzed to deliver the regulation’s disclosure requirements.

It’s expected that financial market actors will investigate more closely the activities they finance and invest in. Before this new regulation, it was easier to hide unfavorable investments from a climate point of view. As this is no longer an option — and, for example, massive stranded assets and carbon-heavy indicators will require disclosure — this will make non-sustainable investments less tempting.

All of this will likely mean that financial sector actors will make use of the taxonomy to closely analyze the sectors in which they are investing.

Implications

Financial sector actors will likely want to develop the analysis of their investment and financing targets, combine these targets to define their organization’s risks and impacts, and develop them further in a report. The key takeaway questions for financial market actors include:

- / To what extent do our financing/investment objects mitigate climate change and/or promote its adaptation? How do our indices and funds compare to other similar products and to what degree do they exceed reference benchmarks? Are there any emerging business risks resulting from these and what are they? How should we define and analyze these risks?
- / What are the effects of our financing/investments? What can we disclose about these impacts and underlying risks? Do we have a common understanding of what we mean by “impact”? What types of indicators should we use?
- / Have we prepared targets and a methodology for risk and impact assessment, measurement and monitoring? Are we clear on what processes we are following?
- / In many cases, the taxonomy thresholds are based on sector-specific best practices. Therefore, it will be worthwhile for companies to investigate what these sector-specific best practices are, as it is likely that financiers and investors will seek related benchmarks. For companies, key takeaway questions include:
 - / Does our business support climate mitigation or adaptation and to what extent?
 - / Are we aware of the sustainability criteria, with a specific focus on climate, that is used by our financiers and investors? How does our business compare to our peers?
 - / Is the required information easily available to financiers and investors? Do we report this information in a way that is relevant to them?

The goal of ensuring good “*financiability*” and “*investability*” at a reasonable cost will only be met if companies devote enough time and effort to attaining it.



Regulatory outlook

Performance fees

ESMA consultation on performance fees

In July 2019, the European Securities and Markets Authority (ESMA) launched a public consultation on performance fee draft guidelines under the UCITS Directive. ESMA stated: *“draft guidelines aim to harmonize how performance fees can be charged to the UCITS and its investors while ensuring common standards of disclosure, as current practices vary among EU Member States.”* (ESMA News)

These guidelines aim to achieve supervisory convergence in the following areas:

- / General principles on performance fee calculation methods.
- / Consistency between the performance fee model and the fund's investment objectives, strategy and policy, for example regarding benchmarks.
- / Frequency of performance fee crystallization and payment — with the minimum crystallization period consistent with the investors' holding period and one-year minimum.
- / Circumstances where a performance fee should be payable.
- / Disclosures of performance fee models.
For example, new disclosures could be ex-ante, providing concrete examples of how the performance fee will be calculated in the prospectus; or ex-post, how performance fees are charged per share class (currently at sub-fund level).

The respondents will give feedback on the proposals, including their opinion on whether the scope of the guidelines' principles should be extended to AIFs distributed to retail investors. ESMA will analyze the consultation results in Q4 2019 and plans to finalize the guidelines for publication afterward.

Performance-based fee models replacing fixed-fee models

The main goal of the new fee models is to align asset managers and investor interests by significantly decreasing the fixed based Assets Under Management (AUM) fees and increasing the performance-fee model remuneration. In a nutshell, asset managers are only remunerated if they can deliver Alpha, a performance over a certain benchmark. This should help the industry regain investor trust.

Creation of local performance fee requirements in Germany, Ireland and the UK

Additional local restrictions on performance fees were recently implemented in Germany, Ireland and the UK, piling more pressure on asset managers. They'll need to urgently adapt their fee models if they wish to keep distributing their products in these countries.

However, the Luxembourg Fund Industry Association (ALFI) stated: *“it should not be possible to block Luxembourg-domiciled funds from distribution in Germany when changes to the regulation take effect in December.”* They called for the industry to urgently adapt their products and prevent new barriers of entry to local markets.

According to ALFI's legal and tax director Marc-André Bechet, *“acceptance by other EU regulators of the extraterritorial effect of national rules would be in violation of the ‘passport principle’ and would be disruptive to the UCITS framework in general.”* (Funds Europe.) ALFI believes that best practice is to follow the International Organization of Securities Commissions' (IOSCO) principles until ESMA provides further guidelines on that topic.

The regulatory reform agenda has continued its steady advance across the EU and worldwide. Today's landscape reflects current policy priorities: financial stability and systemic risk, maintaining an open and well-functioning EU financial market and promoting sustainable private finance. We have summarized the main initiatives of interest to loan fund managers below.



Liquidity stress testing

ESMA guidelines on liquidity stress testing

Following consultations that began in April 2019, ESMA published the final guidelines on liquidity stress testing (LST) for UCITS and AIFs on 2 September 2019.

The newly-released guidelines will take effect on 30 September 2020.

ESMA released an economic report — *“Stress simulation for investment funds 2019”* (STRESI) — documenting a comprehensive study on liquidity resilience of bond funds to liquidity shocks. The report also describes the methodologies and tools applied during the stress exercise which could potentially help asset managers implement their internal LST framework.

Why is LST so important?

Liquidity risk has recently hit the headlines. The announced suspension of the Woodford Equity Income fund — followed by H2O Asset Management's heavy outflows due to concerns about the liquidity of certain bonds — has resulted in increased regulatory scrutiny and market attention.

ESMA's STRESI also highlights the need for additional consideration regarding liquidity management. Overall the report showed that, in the event of a weekly redemption shock of 5% to 10%, most funds would be able to meet investors' redemptions. However, up to 40% of high-yield bond funds could experience a liquidity shortfall — likely resulting in a material impact on the market, even if these funds were able to sell securities.

What does this mean for asset managers?

Asset managers are faced with a challenging 12-month implementation timeline to comply with the new requirements.

LST will need to be carried out on an annual basis at least. However, ESMA recommends quarterly testing, as there are specific situations that will increase or decrease the frequency required like high-dealing frequency.

To decide on the appropriate frequency and the LST features, proportionality will be the founding principle underpinning all relevant decisions.

Asset managers are also required to document the LST policy framework in the risk management process (RMP). This represents a substantial and favorable development compared to the consultation paper which required asset managers to document the LST twice — namely in a stand-alone LST policy and the RMP itself.

Following consultations, ESMA also clarified that reverse stress testing (RST) — albeit especially useful for funds exposed to high-impact, low-probability events — will not be mandatory for all funds due to the implementation's complexity and low-added value for the majority of funds.

As a result, the LST should consider both historical and hypothetical scenarios and, if necessary, RST.

To ensure the overall framework's soundness, an initial validation of the LST models and assumptions will need to be carried out by an independent — but not necessarily external — entity.

Last but certainly not least, the guidelines will require the asset management industry to demonstrate or build up an acceptable level of substance regarding liquidity risk management and measurement knowledge.

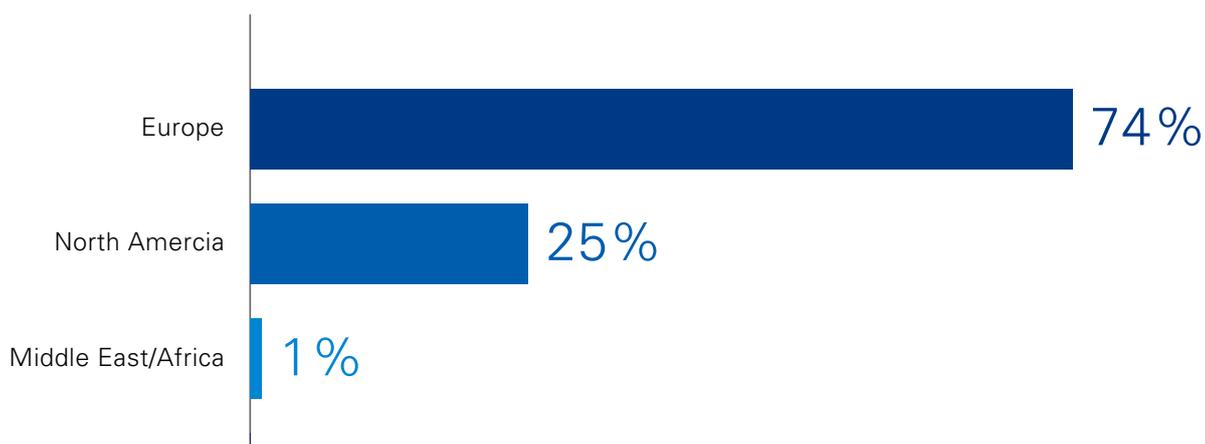


Overview of key data

Initiator origin

The vast majority of loan fund initiators (promoters) in Luxembourg are from the EU, distantly followed by those from North America (Figure 5).

Figure 5: Initiators' origin by region



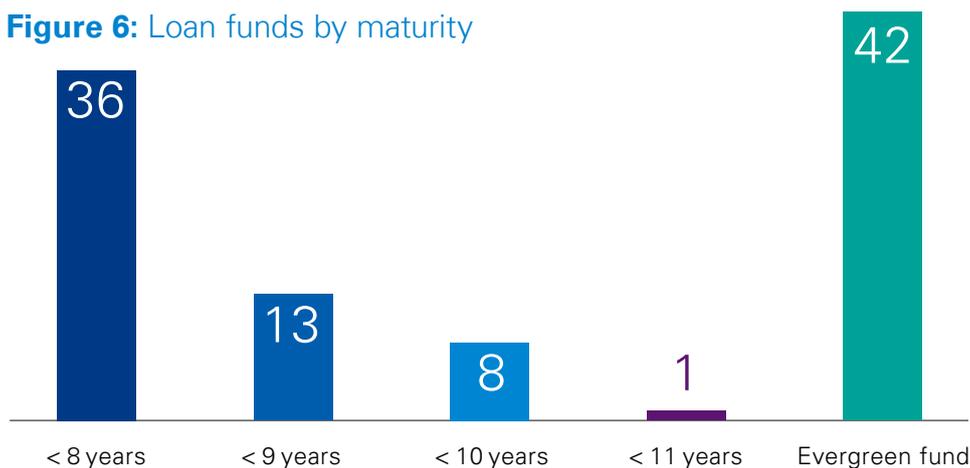
| Source: KPMG/ALFI loan fund survey

Investments per fund and holding period

The number of investments per loan 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 126.

Regarding maturity, 42% of the funds are evergreen, 36% have maturities of up to eight years and a small percentage have maturities between 9 and 11 years (Figure 6).

Figure 6: Loan funds by maturity

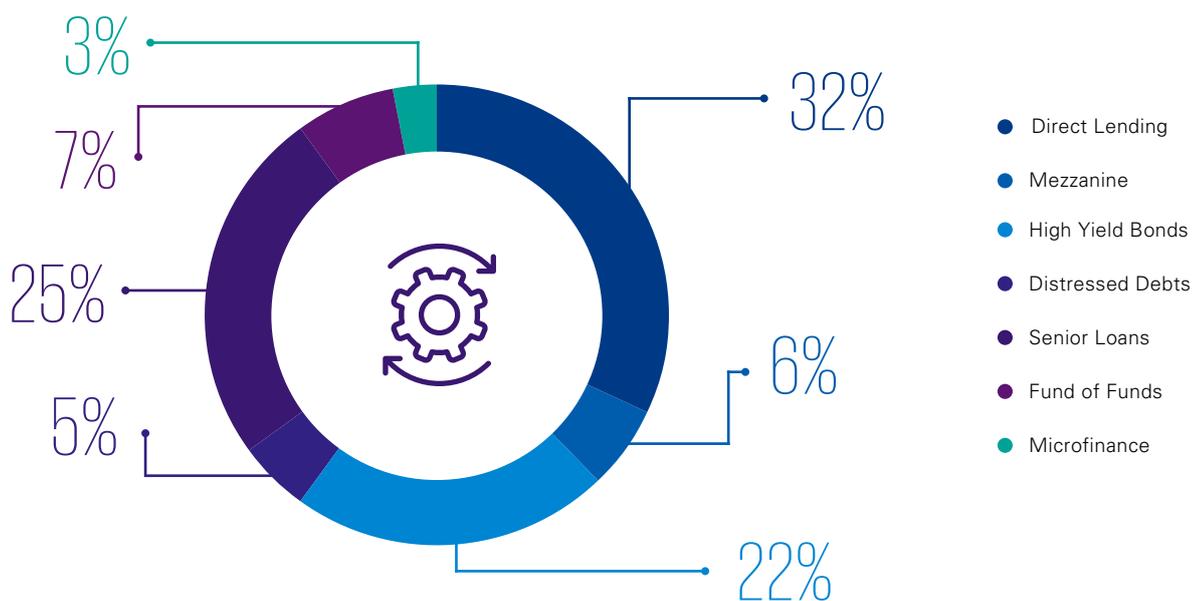


| Source: KPMG/ALFI loan fund survey

Investment strategy

The investment strategy of Luxembourg loan funds is mainly focused on three loan strategies (Figure 7): direct lending (32%), senior loans (25%) and high yield bonds (22%).

Figure 7: Loan funds by investment strategy

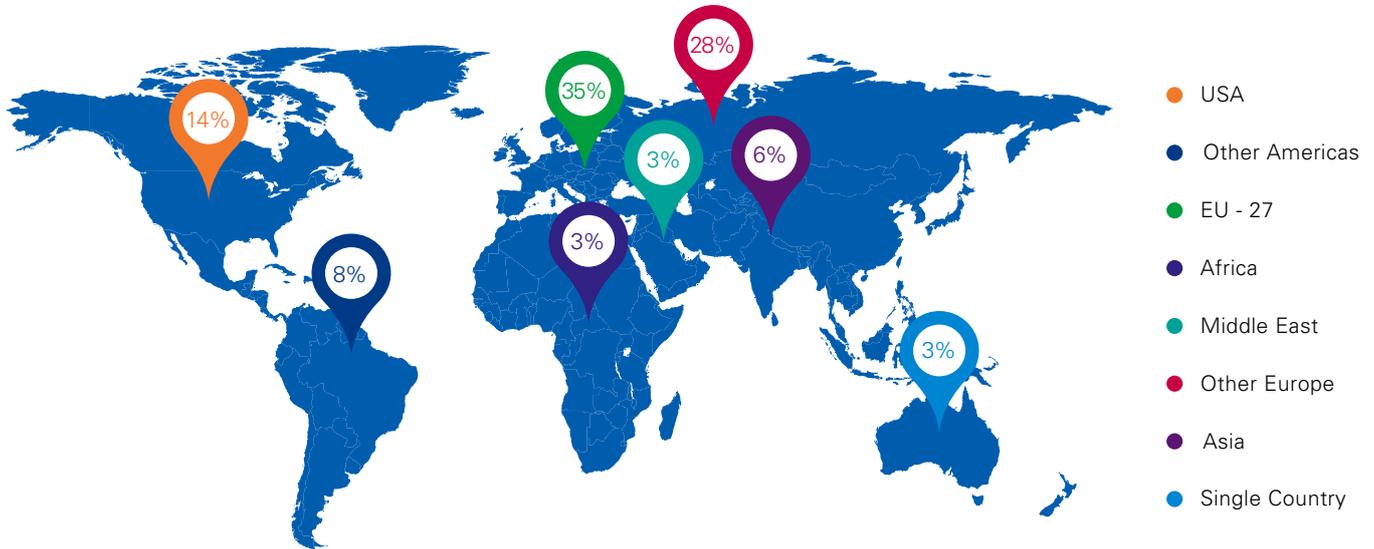


| Source: KPMG/ALFI loan fund survey

Geographical investment target

Most loan funds (97%) have a multi-country investment approach. The preferred investment targets (Figure 8) are in the EU (35%) and the other European countries (totaling 28%).

Figure 8: Loan funds by geographical investment targets

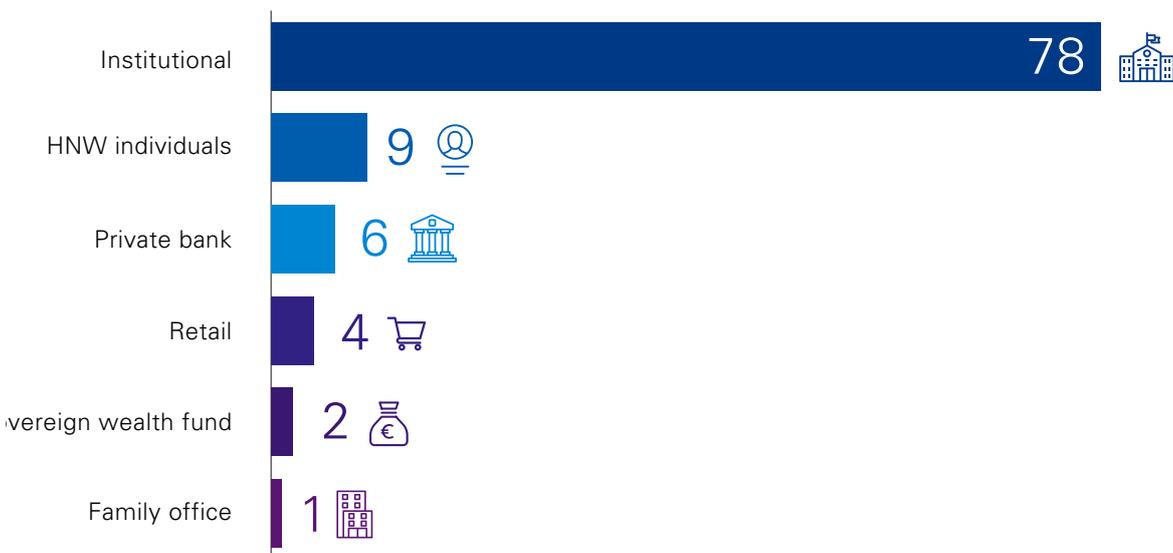


| Source: KPMG/ALFI loan fund survey

Investor type and origin

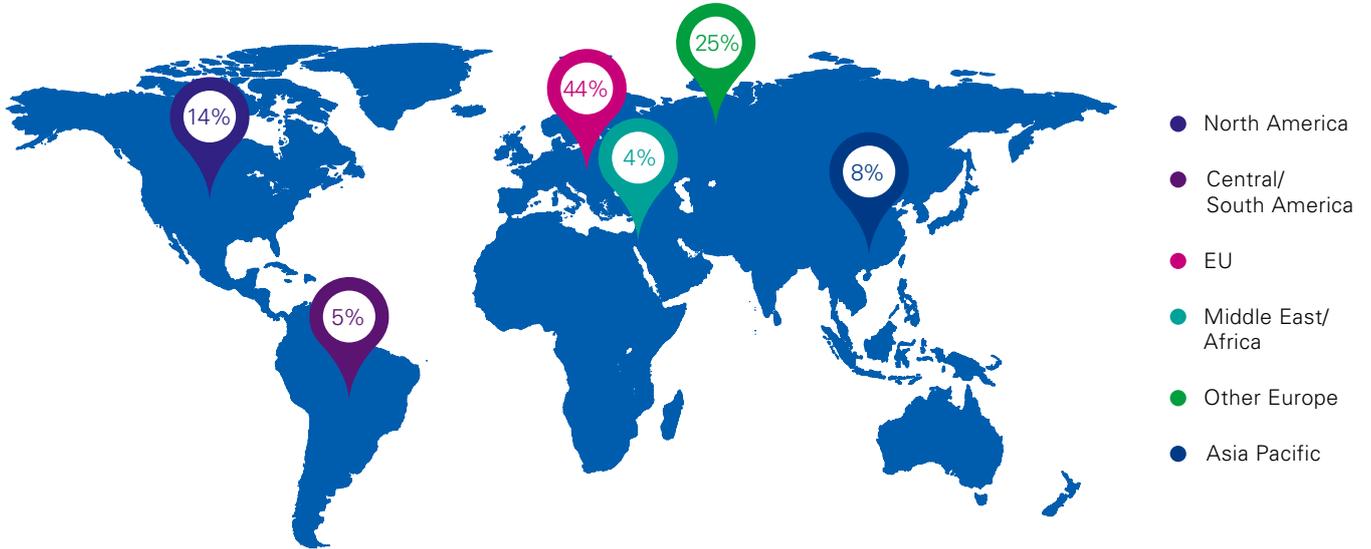
Unsurprisingly, the main type of investors are institutional (78%), followed by high net worth (HNW) individuals (9%) and private banks (6%) (Figure 9). These investors are mainly from EU countries (Figure 10). Two-thirds of funds have between one and 25 investors per fund (Figure 11).

Figure 9: Loan funds by investor type



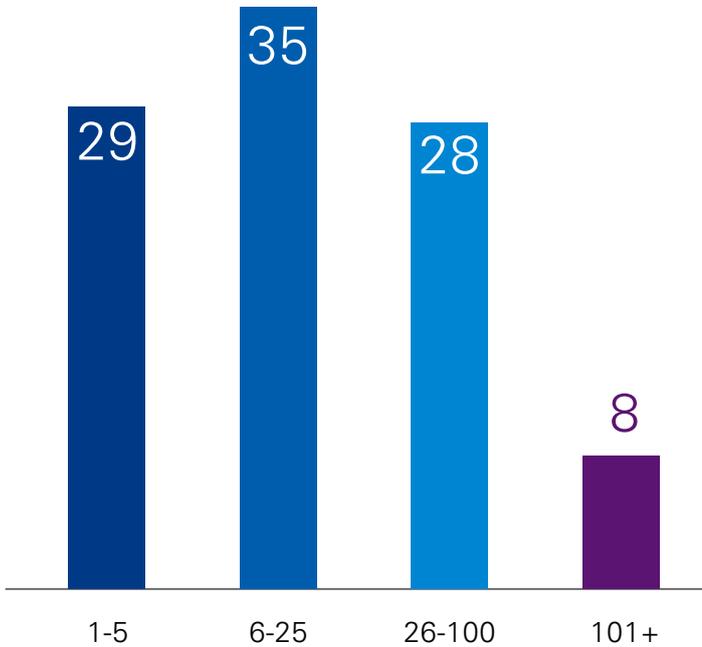
| Source: KPMG/ALFI loan fund survey

Figure 10: Loan funds by investor origin



| Source: KPMG/ALFI loan fund survey

Figure 11: Loan funds by number of investors

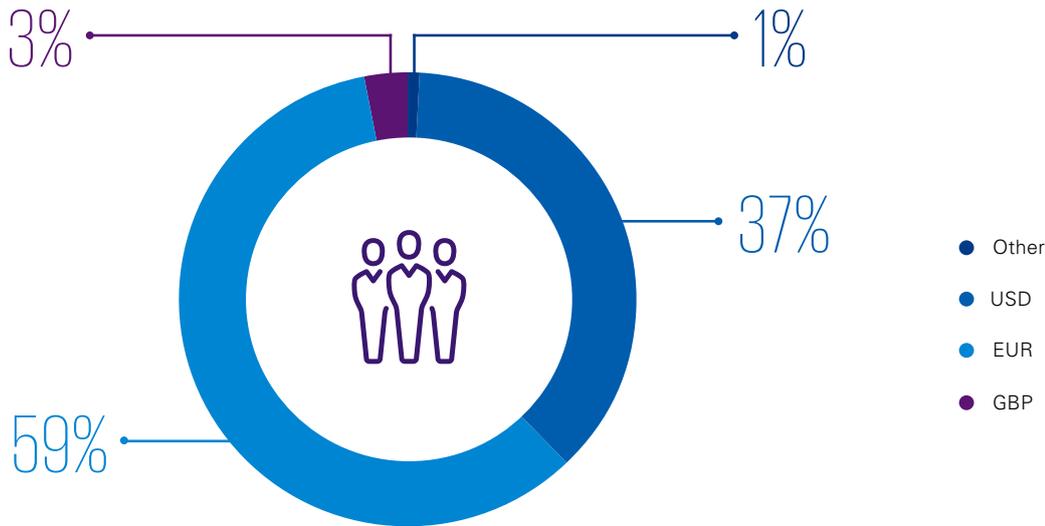


| Source: KPMG/ALFI loan fund survey

Financial statements

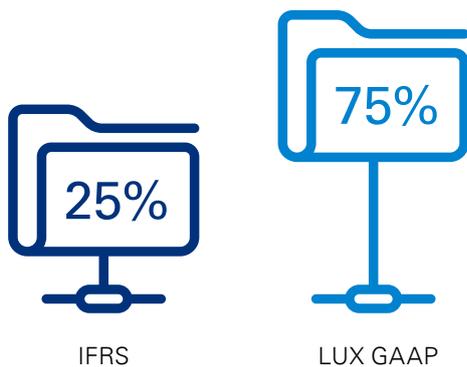
The financial statements of Luxembourg loan funds are mostly prepared under the Luxembourg GAAP accounting standard (Figure 12). These accounts are mostly prepared in Euros (59%), closely followed by US dollars (37%) (Figure 13). The majority of funds (65%) do not consolidate their assets (Figure 14).

Figure 13: Loan funds by currency



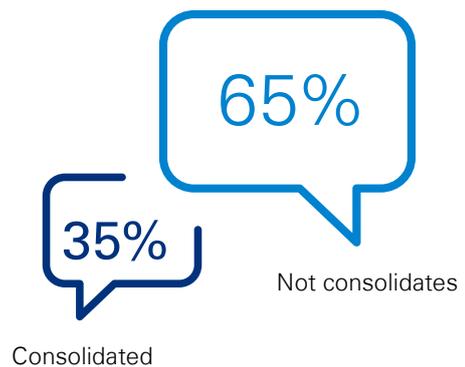
| Source: KPMG/ALFI loan fund survey

Figure 12: Loan funds by accounting standard



| Source: KPMG/ALFI loan fund survey

Figure 14: Loan funds consolidation

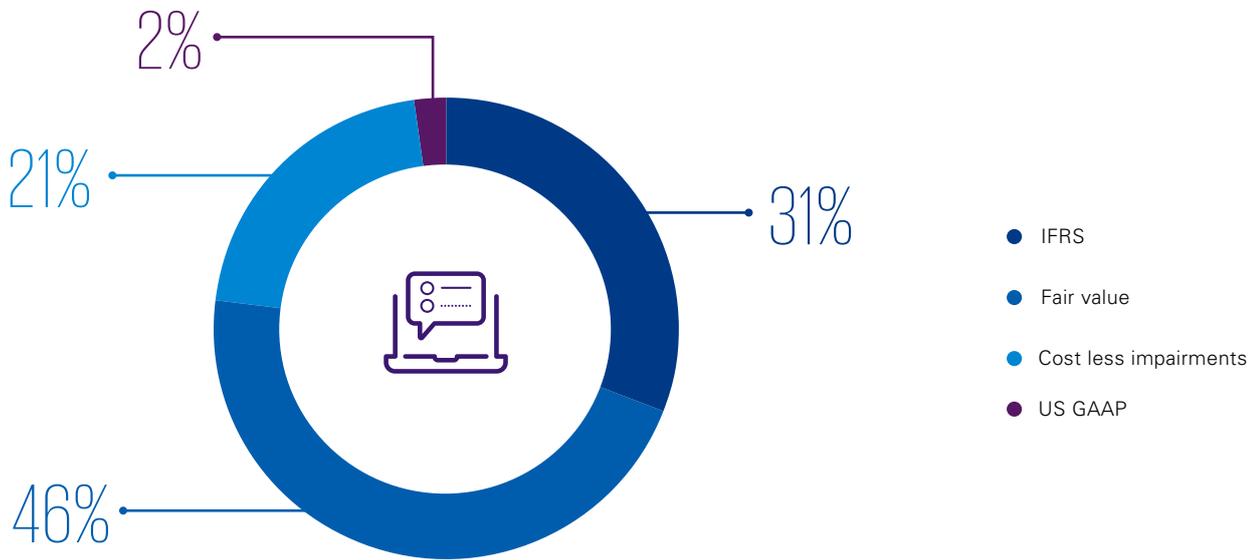


| Source: KPMG/ALFI loan fund survey

Investor reporting

The most popular reporting methodology used is fair value (46%), followed by IFRS (31%) and cost less impairments (21%) (Figure 15).

Figure 15: Loan funds by investor reporting methodology



| Source: KPMG/ALFI loan fund survey

Figure 16: Loan funds by frequency of NAV computation

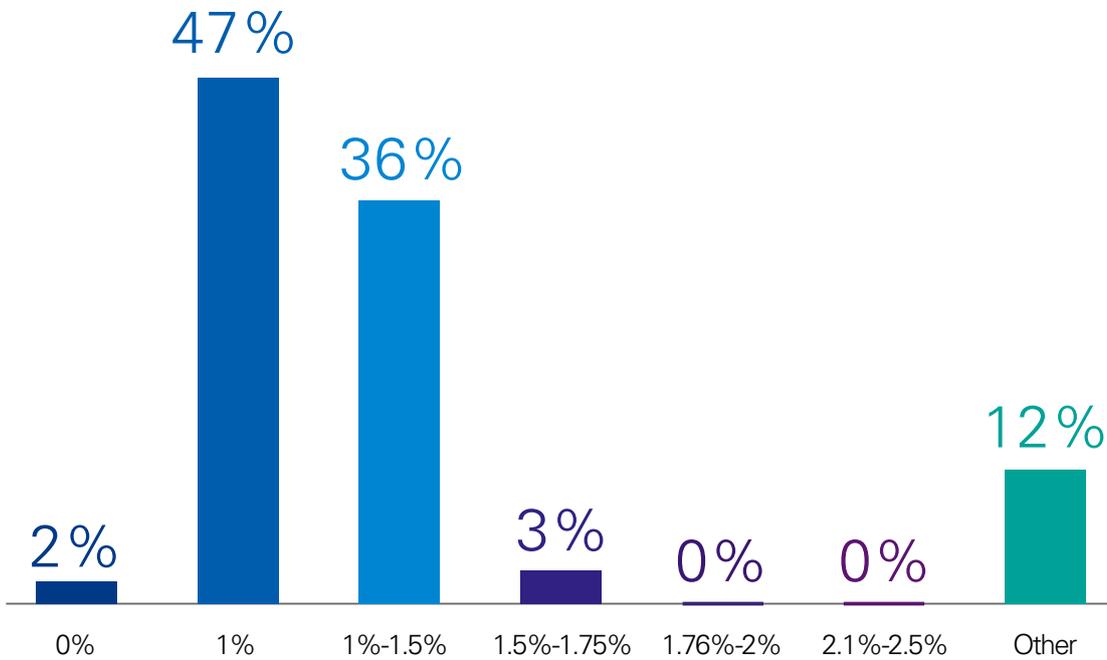


| Source: KPMG/ALFI loan fund survey

Management fees

Management fees typically lie between 1% and 1.5%, with a small proportion at 1% or less (Figure 17).

Figure 17: Loan funds by management fee charged

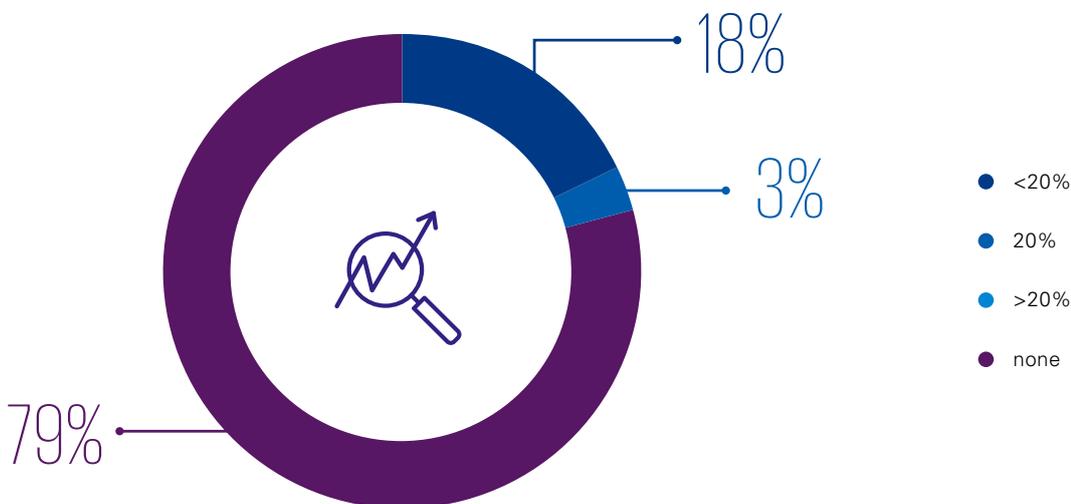


Source: KPMG/ALFI loan fund survey

Performance fees

Based on the data gathered, most funds do not charge performance fees (79%). Of those who do, the performance fees are mostly below 20% (Figure 18).

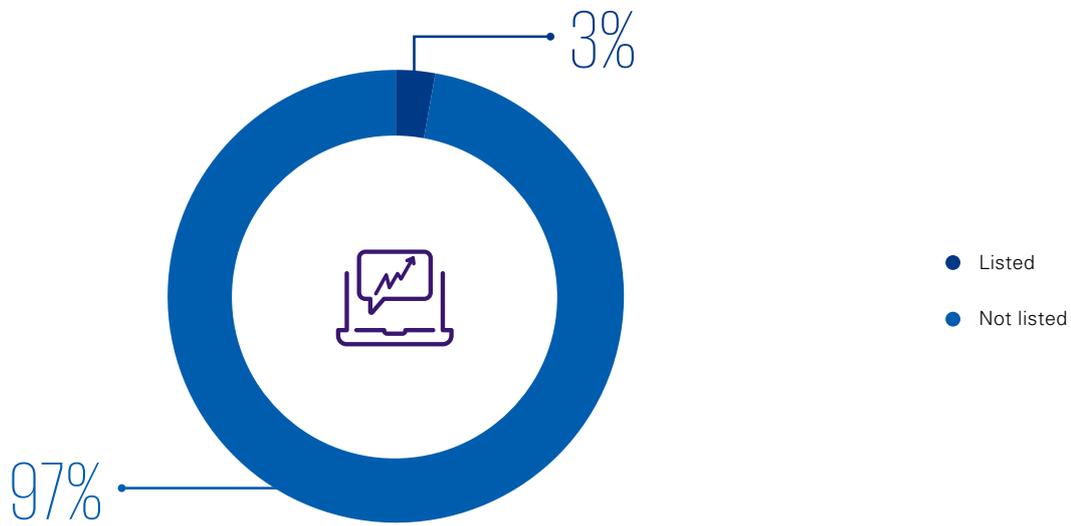
Figure 18: Percentage of performance fees charged by funds



Other information

Only a small percentage of funds — 3% — are listed on a stock exchange (Figure 19).

Figure 19: Proportion of loan funds listed on a stock exchange



| Source: KPMG/ALFI loan fund survey



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