KPMG

alfi association of the luxembourg fund industry

An asset class exceeding expectations

Private debt fund survey 2020

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Introduction

Camille Thommes
Director General of ALFI

This third edition of the KPMG and ALFI Private Debt Fund Survey showcases the strong growth momentum of private debt funds. With an average growth of 36.2% in assets under management (AUM) in Luxembourg compared to last year, private debt is one of the fastest growing segments in the alternative space. At a global level, Preqin[1] forecasts a CAGR of 11.4% for the period 2020 to 2025, with AUM amounting to USD$1,456 billion by 2025.

Institutional investors are expected to increase their allocation to private debt. Issuers are likewise increasingly turning to private markets for their funding, thereby confirming a fundamental shift with capital markets playing a bigger role as a source of financing for the real economy.

Luxembourg is uniquely positioned to benefit from this growth. As the survey indicates, asset managers view Luxembourg as an attractive hub for private debt vehicles. Its toolbox, the wealth of expertise across the ecosystem and the role of the regulator are all factors that contribute to Luxembourg's success in this segment.

This will certainly prove beneficial in the upcoming discussions on the review of the AIFMD, the management of liquidity risks and loan origination with European and international policymakers. As part of its mission, ALFI will provide industry feedback through the consultation on the review of the AIFMD and it will continue to engage in a constructive dialogue with policymakers.

1. Preqin is The Home of Alternatives™, the foremost provider of data, analytics, and insights to the alternative, https://www.preqin.com

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

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

The Private Debt Market has seen success over the past few years, steadily growing into a strong asset class. And today, amidst the chaos of a global pandemic, it has not only remained resilient, but it continues to exceed expectations. The average growth in assets under management is +36.2%*, with the market now reaching €108.4 billion**. In line with last year's results, loan funds set up as reserved alternative investment funds (RAIFs) are forging ahead at a steady rate, with an +8% increase this year. And the EU remains the geographical investment target of choice with 39% of respondents surveyed favoring it.

Change really is the only constant when discussing the Luxembourg international tax landscape, and 2020 proved no different. This year we saw the introduction of the EU Anti Tax Avoidance Directives 1 and 2 (ATAD 1 and ATAD 2) into Luxembourg domestic law. This introduction has made waves for loan fund actors and alternative investment players and the impact has been felt within many layers of the alternative investment industry. These impacts include, but are not limited to:

- The application of the interest deduction limitation rule for unregulated investment vehicles investing in distressed debt or non performing loans.
- The new anti hybrid provisions, in particular, for unregulated investment vehicles.
- The letter of formal notice sent by the European Commission regarding the interest limitation rule exemption applied to securitization vehicles governed by the European Union Regulation of 2017.
- The Multilateral Instrument (MLI) has also been ratified by many jurisdictions and has amended many double tax treaties (DTT).

We will continue to monitor these developments as they may have important consequences for cross border private debt investments.

Before we sign off, we would like to take a moment to thank all those who took part in the 2020 Private Debt Fund Survey, especially to the depositories and the interviewees.

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

*Average growth based on data provided by depositaries surveyed.

*Total assets under management based on data provided by depositaries surveyed. This only includes regulated and indirectly supervised debt funds.

108.4 billion*

Total AuM

*Based on data provided by depositaries surveyed. This does not cover all the market and only includes regulated and indirectly supervised debt funds.

36.2%

Average growth of AuM compared to last year

*Average growth based on data provided by depositaries surveyed.

84% SCSp

Vehicle of choice for unregulated AIF debt funds

28% RAIF

+8% compared to last year

Investment target

39%

Region EU

Investment strategy

38%

Direct lending

27%

Senior loans

| Source: KPMG/ALFI debt fund survey

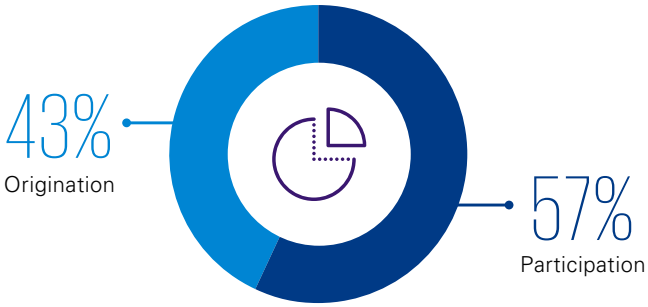
Fund structures

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 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 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.

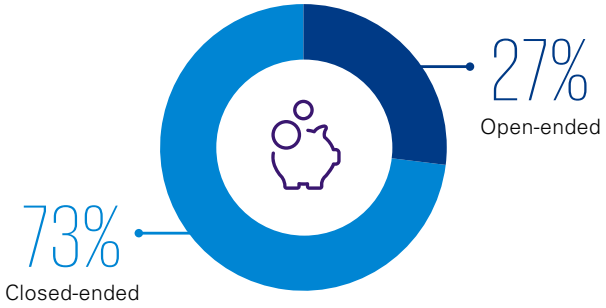
Figure 1: Debt originating and debt participating funds



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. The vast majority (73%) 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 investment vehicles[1])

Regulated funds 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 CSSF supervision and reporting requirements. Unregulated 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.

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

Ordered from least regulated to most, regulated debt funds (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.
- 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 €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.

On 7 August 2020, the CSSF published an FAQ clarifying that loans are not considered as qualifying assets for UCITS given that they neither qualify as a money market instrument, nor as a transferable security. Consequently, UCITS that would invest in loans have to disinvest from those positions by 31 December 2020.

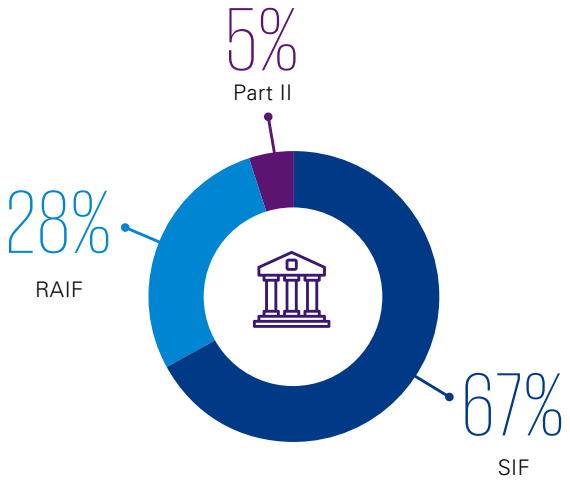
Eligible assets for Part II funds, SIFs or RAIFs are unrestricted, although Part II funds must receive prior CSSF approval of their investment objectives and strategy.

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 3: Regulated debt funds[3] by legal regime



Source: KPMG/ALFI debt fund survey

As seen in Figure 3[4], SIFs dominate Luxembourg's debt fund market at 67%, followed by RAIFs (28%) and Part II (5%).

The popularity of SIFs with debt fund managers (excluding UCITS) 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.

Compared to last year, the percentage of debt funds set up using RAIFs has surged from 20% to 28%.

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 direct CSSF supervision and reporting requirements, 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.

Up until the new CSSF FAQ, debt funds could be set up under the UCITS framework by using tailored indices and derivatives, but this was unpopular mainly due to its strict liquidity requirements regarding assets. However, we still list the option here for the sake of completeness.

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

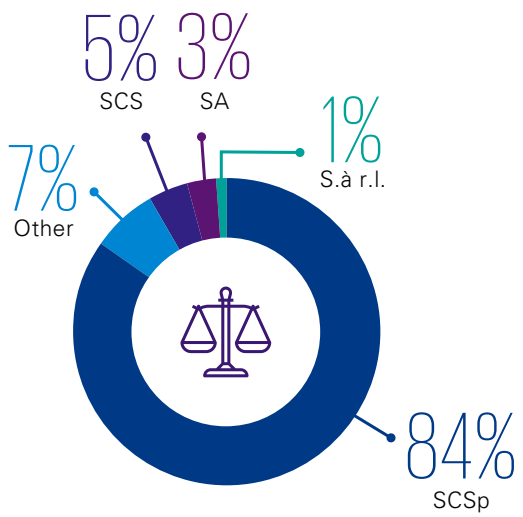
Contrary to regulated investment vehicles, unregulated debt funds are neither subject to any specific legal regime (e.g. UCITS, Part II, SIF, SICAR), nor subject to any CSSF prior authorization, reporting or direct supervision.

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

Nonetheless, unregulated Luxembourg debt funds 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

5. Article 3, §2 and §3 of the law of 12 July 2013 on Alternative Investment Fund Managers

Legal forms

Unregulated debt funds 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 debt funds 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 vehicles

Compared to regulated 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 fact, granting debts to a limited number of identified persons (i.e. on a small scale) 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 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.

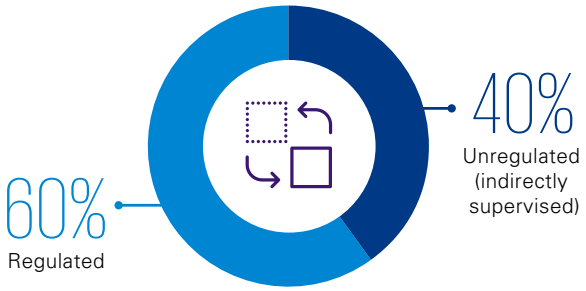
Data collection for the unregulated part of the debt fund market is a difficult exercise. These vehicles are neither authorized nor supervised by the CSSF, and no detailed information or listing currently exists on the market.

Nonetheless, in this 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 2020 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 the SCSp (84%), who tend to prefer it to the SCS (5%) or S.A. (3%). SCSp are widely used mainly due to their accessibility and flexibility — and also because they are well-known to investors and promoters.

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

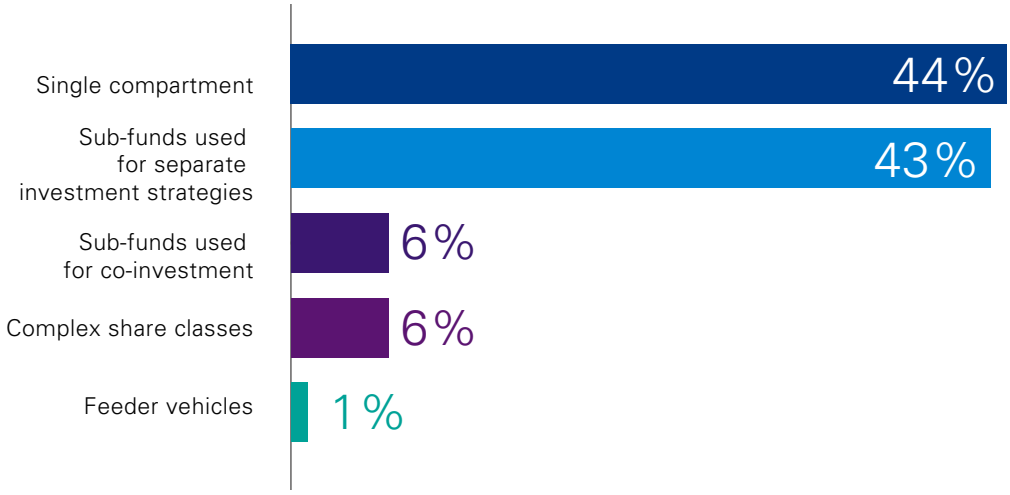


Source: KPMG/ALFI debt fund survey

Figure 5 shows that most of the Luxembourg debt funds are regulated vehicles while 40% are unregulated (but indirectly supervised) vehicles.

Regarding debt fund structuring, promoters can choose between single or multiple compartments. Figure 6 shows how these types are split as of 30 June 2020. 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

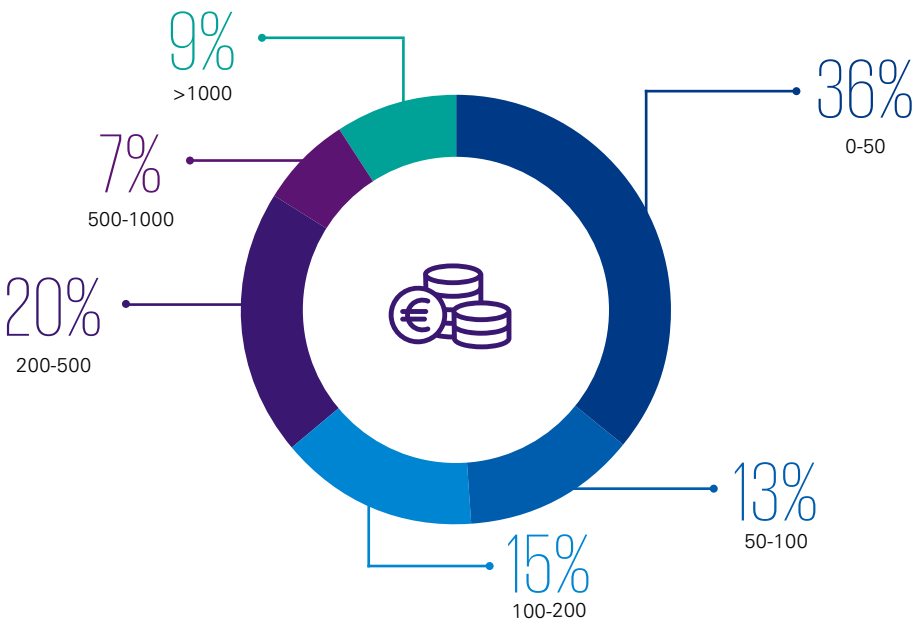


Source: KPMG/ALFI debt fund survey

Like last year, most funds range up to €50 million in size (Figure 7). Notably, mid-size funds — i.e. those with a net asset value of between €200 million and €500 million — represent 20% of the total number of debt funds. As of 31 July 2020, and based on CSSF data, the directly regulated market of debt funds (i.e. SIF, SICAR, Part II) represented around €58.9 billion AUM (compared to €56 billion of AUM in mid-2019). These numbers should however be taken carefully since these exclude AUM invested in RAIFs and other indirectly supervised and unregulated debt funds.

Based on the information received from the depositary banks, the total AUM as at 30 June 2020 for regulated and indirectly supervised debt funds is approximately €108.4 billion. Moreover, the depositary banks surveyed reflected an average growth in AUM of 36% compared to last year.

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



Source: KPMG/ALFI debt fund survey

Reshaping international taxation

The Anti-Tax Avoidance directives

The year 2020 was no exception to previous ones in terms of substantial changes brought to the Luxembourg and international tax landscape.

It has now been four years since the Organisation for Economic Co-operation and Development (OECD) published several recommendations including domestic and international instruments to tackle Base Erosion and Profit Shifting (BEPS) strategies. As a result, in 2016 and 2017, the European Union successively adopted the EU Anti-Tax Avoidance Directive (ATAD 1), transposed into Luxembourg tax law since 1 January 2019, and the EU Anti-Tax Avoidance Directive 2 (ATAD 2) transposed since 1 January 2020. Both directives have significantly and permanently changed the goalposts for debt 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 debt 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 debt 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 €3,000,000, whichever is higher (calculated annually).

For SOPARFIs (or a Securitization Vehicle governed by Luxembourg domestic law) involved in the back-to-back intragroup financing of plain vanilla debts, this rule should not trigger adverse Luxembourg tax implications because the company would achieve an arm's length margin.

The situation becomes more complex for a SOPARFI (or a Securitization Vehicle governed by Luxembourg domestic law) financed with debt and generating income under distressed debt/non-performing debts which would not be included in the definition of interest income or equivalent (although there is currently no clear guidance on the definition of "*interest income*" or "*other economically equivalent income*").

Under these circumstances, the interest deduction would be caught by the ATAD law deduction limitation thresholds with potential adverse tax consequences.

Securitization Vehicles governed by EU Regulation

Another hot topic is the exemption for "*financial undertakings*" in the ATAD law. Based on the ATAD law, "*financial undertakings*" are exempt from the interest deduction limitation provision, and the law states that securitization vehicles that are subject to EU Regulation 2017/2402 qualify as financial undertakings.

On 14 May 2020, the European Commission (EC) sent a letter of formal notice to Luxembourg in relation to the exemption of interest deduction limitation rules for these securitization vehicles.

The EC considers that Luxembourg domestic legislation goes beyond the allowed exemptions by providing unlimited deductibility of interest for corporate income and municipal business tax purposes to securitization entities governed by the EU Regulation, which in the EC's view do not qualify as "*financial undertakings*" under the ATAD.

It is worth mentioning that the definition of "financial undertaking" in the ATAD does not include those securitization entities governed by article 2 point 2 of Regulation (EU) 2017/2402, such EU Regulation being dated 2017 after the publication of the ATAD in 2016.

This letter of formal notice is the first step in the EU infringement procedure, which gives power to the EU to take legal action against member states that do not respect their obligation to comply with EU law. Should Luxembourg not take proper action within the next four months, the Commission may, as a second step in the infringement procedure, send a reasoned opinion (i.e. a formal request to comply with EU law).

Implementation of anti-hybrid provisions

On 19 December 2019, the Luxembourg Parliament passed the bill on the transposition of ATAD 2 into Luxembourg domestic tax law. The law introduced articles 168ter and 168quarter to the Luxembourg Income Tax Law (LITL), extending the scope of existing anti-hybrid rules to additional categories of mismatches and to mismatches with third countries. The law is applicable since 1 January 2020 except for reverse hybrid provisions that will apply as from tax year 2022.

Luxembourg law 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 as a result of hybrid mismatches involving:

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

The Luxembourg law 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 law 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 law provides for a "*de minimis*" principle for applying the acting together concept. 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 deemed (i.e. unless otherwise proven) not to act together with another investor regarding an entity's voting rights or capital ownership and should, therefore, fall out of the anti-hybrid provision's scope.

The new anti-hybrid provisions should have a limited impact on regulated investment vehicles since such vehicles should be exempt from corporate income taxes (i.e. full exemption for SIF and RAIF with a SIF regime, and exemption on income derived from transferable securities for SICAR and RAIF with a SICAR regime).

Moreover, regulated investment vehicles should, in principle, also fall out of the scope of the reverse hybrid mismatches provisions introduced by article 168quarter LITL and applicable as from 2022.

The situation becomes more complex for fully taxable unregulated investment vehicles and a case-by-case review should be performed to assess the potential impact of the new anti-hybrid provisions.

Withholding tax reclaims

Beware of foreign withholding taxes on interest and capital gains!

In times of low margins and missing liquidity, losing part of their return on foreign withholding taxes is difficult to accept for investors and managers. In recent years, stakeholders have become far more aware of international taxation rules while being very sensitive when it comes to avoidable tax leakage.

In fact, interest payments and capital gains relating to bonds and similar instruments are very often not taxed at source. There are, however, some countries that do impose a withholding tax on interest and capital gains which makes it very tricky for investment managers to identify the right opportunities.

A must-do: reclaims and relief based on double tax treaties

Double tax treaties have existed for years, and their reach is steadily extending. Most treaties foresee a maximum withholding tax of 10% on interest and very often a tax exemption at source on capital gains. If the domestic tax rate is higher, however, this leads to reimbursement possibilities in the source country.

Withholding tax reclaims based on double tax treaties function just like standardized reimbursements and happen within 6 to 12 months. Reclaiming 26% of Italian tax on interest, 19% in Poland and 26% on German hybrid bonds will considerably increase performance. It goes without saying that reclaiming these taxes is an absolute must.

In addition to double tax treaty reclaims, reimbursements can often also be requested based on local law, allowing for a reduced rate under certain conditions.

Besides reclaiming tax (ex-post), most countries allow the possibility of reducing the withholding tax at source (relief) leaving investors without a cash disadvantage. This option is even more preferable than the tax reclaim itself. In markets like Italy, where reclaim reimbursements may take up to 10 years, companies should not pass up relief at source.

Why it's important to act today and what to do

While some countries do not levy withholding tax on interest or on capital gains, some other source states do. As investors will no longer accept any avoidable tax leakage (most reimbursements are nearly guaranteed), it is crucial for investment managers and other stakeholders to have these positions analyzed on a yearly basis.

In addition, it is important to have the investment analyzed before even starting the project and ensure that avoidable tax leakage is prevented.

The voice of Private Debt Managers

Robin Doumar,
Founder and Managing Partner of Park Square Capital

1. What is the outlook for Private Debt in light of the COVID crisis?

As we emerge from the COVID crisis, we believe the outlook for private debt is extremely strong as the industry comes of age. Increasingly, private debt funds have become the relationship lenders of choice for the private equity industry while the market share of banks further declines. Banks continue to reduce their lending activity under pressure from ongoing regulatory capital issues and substantial loan loss provisions related to COVID. Private debt funds which have demonstrated strong performance throughout the crisis are likely to attract more capital, while those that were less disciplined in the pre-crisis period are likely to suffer.

Park Square expects private debt issuance volumes to remain robust, driven by an active M&A and refinancing environment, underpinned by record levels of private equity dry powder.

Lessons from the crisis, together with supply/demand factors, have produced more lender-friendly terms, pricing, and structures, further increasing the attractiveness of the asset class.

2. How do you see your investment strategy evolving, and is ESG an integral part of it?

Park Square has a defensive approach towards portfolio construction, seeking to build highly diversified investment portfolios in stable and predictable businesses. We have a well-developed investment style which has produced strong returns for our investors throughout several market cycles in our 16-year history. All of our investment committee members have been working together at the firm for more than 10 years. We have substantial experience in workouts and restructurings, and our annualized loss rate has been 0.1% since inception.

ESG forms a critical part of our investment process and each asset undergoes a formal ESG screening process by the investment committee. We believe that successful, well-run businesses that manage their ESG issues appropriately make better, lower risk investments.

3. How do you feel about the possible additional regulation of the private debt industry?

Generally speaking, we think sensible regulation is a good thing. Recent events have shown the value of good regulation in banks which are in a much better position to deal with market stress today than they were during the financial crisis. We believe the private debt industry today is better capitalized than the banking industry with typically lowly levered, long-term fund structures. As the private debt industry continues to play an increasingly important role in society, we would expect it to attract further regulatory scrutiny and a movement towards increased transparency. For high quality, established and increasingly institutionalized investment firms, this should be a positive as they are well-positioned to deal with regulatory change and reporting. We would ask regulators, however, to make sure any new regulation is appropriate for the fund structures and underlying investor groups.

4. What is your view on Luxembourg as an attractive hub for debt funds?

For Park Square, it was an obvious choice to establish our European funds hub in Luxembourg given our long-standing presence since 2005 and the high-quality team we have in place. The AIFMD regime is now well-established and communication with the regulator is direct and clear. The concentration of specialist talent across the ecosystem is also appealing as we continue to grow and work with local lawyers, accountants and advisors.

As a traditional asset manager what is your motivation for turning towards this asset class now?

"Our institutional clients are confronted with a long lasting low-return environment in the traditional asset classes. Therefore their focus is shifting towards alternative investments with higher return profiles, such as private equity and private debt. Union Investment offers private equity solutions since 2005 and is going to launch private debt solutions with a special focus on German real estate debt next year. Furthermore private real estate debt is a perfect supplement to our existing open and close-ended real estate equity funds."

Maria Löwenbrück
Member of the Executive Board, Union Investment

Douglass Welch,
Portfolio Conducting Officer at Pemberton

1. How do you see your investment strategy evolving and is ESG an integral part of it?

The evolution of Pemberton's investment strategy and our team's collective experience has allowed us to effectively navigate the COVID-19 crisis and the impact it has had on our borrowers. The social impact of supporting our borrowers, who in turn supported their employees through lockdown, was a conscious decision. For example, we facilitated structurally senior solutions using short-term government liquidity, while remaining an engaged social stakeholder.

Our investors are increasingly conscious of the E, S and G factors when assessing the attractiveness of an asset. Our investment strategy continues to benefit from the fact that we are weighting such factors appropriately when assessing the credit quality of a new loan in the post-pandemic economy.

2. How do you feel about possible additional regulation of the private debt industry?

We remain a committed and responsible actor within the European private debt industry. With the industry's overall healthy growth in AUM, we would expect more regulatory interaction but not necessarily targeted sub-sector regulation. A good example is the EU Taxonomy which will soon be a regulatory touchpoint for the entire financial industry. These regulations support Pemberton's deep understanding of the economic drivers of our borrower's credit quality.

3. What is your view regarding Luxembourg as an attractive place for debt funds?

Luxembourg remains an attractive European center for the domiciliation of management companies for private debt funds. The success of the RAIF has been a competitive master stroke for maintaining Luxembourg's competitive advantage for alternative investment funds. However, the success may have stretched the resources and responsiveness of the Commission de Surveillance du Secteur Financier (CSSF) a bit too tightly. Notwithstanding these challenges, Luxembourg remains a top choice for private debt funds. Our international Investors are very comfortable with the choice of domicile for our management company and the funds in Luxembourg, which is helpful when raising new capital. The response by the Grand Duchy to BREXIT has also been transparent and easy to navigate for both our staff and corporate contingency planning.

Viewpoint: quotes from Depositaries

"Looking across our client landscape, we have seen an average 40% increase in transaction volumes over the last year, further emphasizing that the credit markets remain very active and will continue to be influenced by COVID-19 and other global macro factors. As we look forward to 2021, we see the most significant challenge facing our clients to be the demise of LIBOR and its far-reaching impact on both investment management and operational execution."

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

"Private credit continues to be the fastest growing asset class in the private markets space, opening up new channels of financing that the real economy needs. The close ties between private credit lenders and borrowers have enabled faster, more tailored adjustments to react to market dynamics.

Disclaimer: The views and opinions expressed are for informational purposes only and may be subject to change."

Catherine Gauthier, Associate,
Brown Brothers Harriman Luxembourg SCA

"With Luxembourg being a prominent domicile of choice, there is a growing number of asset managers looking to access the broader opportunities under the AIFMD marketing passport. This is resulting in continuous growth in the alternatives segment which includes notable focus on private credit and debt funds."

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

"Valuations remain an important focus point for our clients, giving them the ability to perform due diligence on investments and to attract new investors.

Although we have seen uncertainty in the markets this year, we feel that on the overall market there is an increased appetite for loan funds leading to greater competition amongst fund managers."

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

"Investor allocations in loans as an asset class steadily increased in 2020, resulting in an enhanced diversification of loan investment strategies by both investors and product manufacturers. Market players with a consolidated track record have stepped into new markets with a perspective of strategic development, opportunistically identifying emerging domains for capital deployment.

We are also witnessing the emergence of ELTIFs (European long-term investment funds) in parallel to institutional loan funds, granting access to a new investor base in demand of long-term investment solutions which have an impact on the real economy.

The COVID-19 crisis has placed pressure on certain loan investment strategies, which in some cases has resulted in renegotiated loan terms in the most affected industry segments. This is likely to be an industry challenge in the months to come and lead to extensions of fund terms for existing vintages of private debt funds."

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

"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 effective and efficient way. Regulated fund structures will offer the ideal platform for this purpose."

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

"The pandemic has given rise to a lot of questions. The vast majority of our clients are wondering what their borrowers are going to do or how they're going to perform. The government stimulus that has or is in the process of being issued is eventually going to run out. How is that going to impact their customers and where is that going to put them in a post-Covid world? Are they going to need to extend more credit? How is it going to impact the performance of their funds and their ability to make distributions to their clients or their investors? It's still early stages to gauge the full impact of the pandemic, which will likely be felt through the end of 2021. "

"Dealing with data also remains crucial to our work, with an increasing need from our clients for data transparency consumption into their warehouse solutions. Going forward, we'll continue to leverage and build upon our in-house tech talent and capabilities to provide them with specific data pool solutions and other bespoke service offerings."

"Another thing that we're seeing on the Debt Capital Markets (DCM) side is a lot of consolidation of assets, especially of business development corporations (BDCs). As BDCs mainly lend to small and medium enterprises—a segment vastly impacted by the pandemic—many haven't performed well and are trading at hefty discounts creating opportunities for consolidation."

Greg Myers, Global Segment Head of Debt Capital Markets,
Alter Domus

Regulatory outlook

Liquidity Stress Testing / COVID-19

2020 has been an eventful year for liquidity risk management and stress testing. The European Securities and Markets Authority's (ESMA) final guidelines on liquidity stress testing (LST) for UCITS and AIFs came into force on 30 September 2020. The day before, the CSSF published Circular 20/752 which confirmed the application of the above-mentioned ESMA guidelines.

Such dynamism on the regulatory side along with the COVID-19 crisis has brought the market (and in particular the fund industry) face to face with unprecedented challenges. In this context, open investment funds needed and still need to implement effective liquidity risk measurement and management processes to ensure viability and survival. LST likely represents the best and most effective way for risk managers to simulate market turmoil and liquidity shortages in order to get a sense of the potential liquidity risk.

What does it mean for liquidity risk measurement and management?

The COVID-19 crisis fueled a rapid increase in transaction costs across different asset classes.

To simulate severe liquidity and market pressure, stress testing should be conducted on the asset side to account for both historical (Lehman's crisis, for example) and hypothetical (say, rising interest rates) scenarios and, if relevant, reverse stress testing.

In the context of private debt, which normally encompasses "less liquid" assets, it is of paramount importance for asset managers to consider low probability scenarios that could have a high impact on a fund's liquidity. For example, a scenario where it is difficult to obtain reliable pricing of less liquid assets during periods of market stress should be considered, clearly blurring the lines between liquidity and valuation risk.

The guidelines include an innovative concept from a regulatory perspective: while assessing the time and cost of asset liquidation, the manager will need to ensure compliance with investment objectives and restrictions. Being able to liquidate assets to meet redemption requests might no longer be enough to maintain investor confidence, especially from those remaining in the fund. Consequently, the simulation of asset liquidation would likely result in a sort of "slicing" of the fund as opposed to a "waterfall" approach, which can potentially translate into portfolios that are not compliant with existing investment restrictions and policies.

Considerable attention must be paid to stress testing liabilities – something traditionally put on the back burner.

When speaking of liabilities in combination with assets characterized by limited liquidity, the above becomes even more relevant. In the context of redemptions, different investor types should be considered as each specific type might behave differently in response to stress scenarios and different estimations should be carried out accordingly. That said, the so-called flow-return relationship might come in handy when it comes to foreseeing the redemptions a fund should expect given a certain negative return of the fund.

Redemptions, however, are not enough. In terms of derivatives, potential liabilities other than redemptions are to be considered, such as those related to derivatives trading. Market volatility could indeed lead to larger-than-anticipated margin calls that need to be covered by the fund's available liquidity.

In conclusion, recent regulatory developments have highlighted the need for a comprehensive and systematic approach to liquidity risk measurement and management even where less liquid assets are concerned. Asset managers are required to take control and build a deep understanding of the liquidity risk embedded in their funds.

Loan origination under AIFMD

On 18 August 2020, ESMA issued a letter to the European Commission concerning the upcoming review of the AIFM Directive.

The letter outlines areas of AIFMD where ESMA believes that improvements could be made, and one of the sections of the letter relates to loan origination under AIFMD.

ESMA advocates for a specific framework for loan origination within the AIFMD and referred to its opinion on loan origination issued in 2016.

ESMA's 2016 opinion contains recommendations on authorization for loan originating funds, types of funds (i.e. closed-end vehicles), admitted investors, as well as organizational and prudential requirements for loan originating funds (e.g. leverage, liquidity, stress testing, reporting, diversifications etc..).

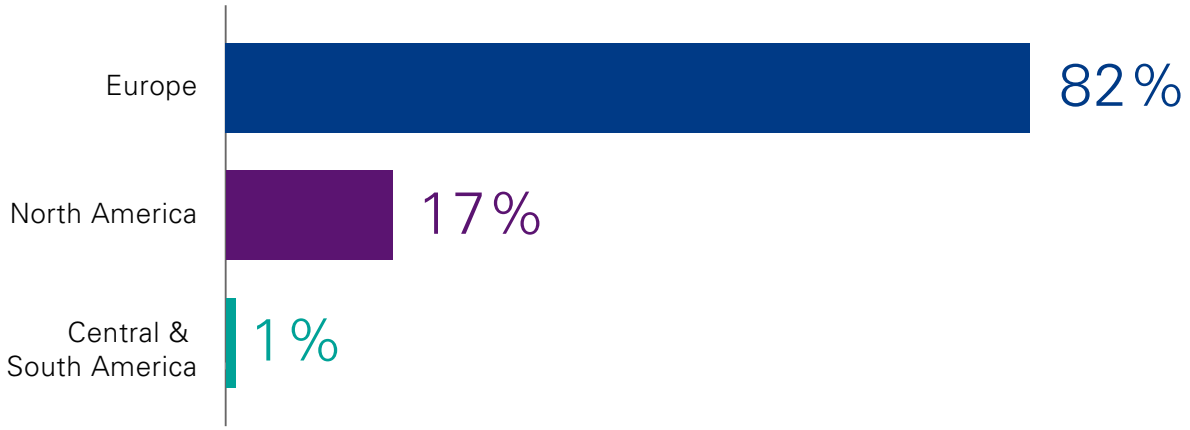
Finally, ESMA referred to the potential role debt funds might play in a post-COVID situation and the need for a specific framework which takes this into account.

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 8). Most of the initiators come from the UK (43%), followed by Germany (21%) and France (10%) with only 1% coming from Luxembourg.

Figure 8: Initiators - origin by region



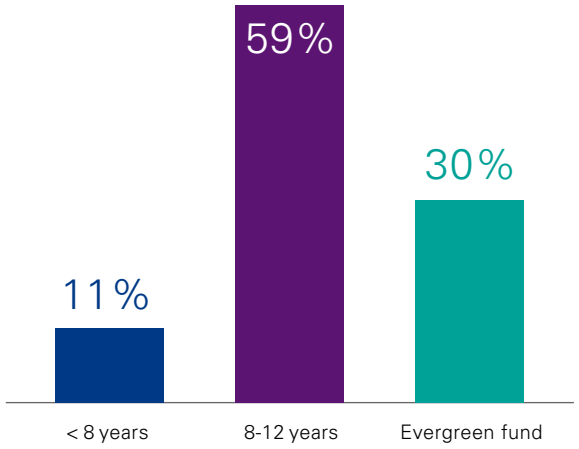
| Source: KPMG/ALFI debt fund survey

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 51.

Regarding maturity, 59% of the funds have maturities between 8 and 12 years, 30% of the funds are evergreen and 11% have maturities below 8 years (Figure 9). Compared to last year, this reflects an extension of maturity (in 2019, 36% of the funds had a maturity below 8 years)

Figure 9: Debt funds by maturity

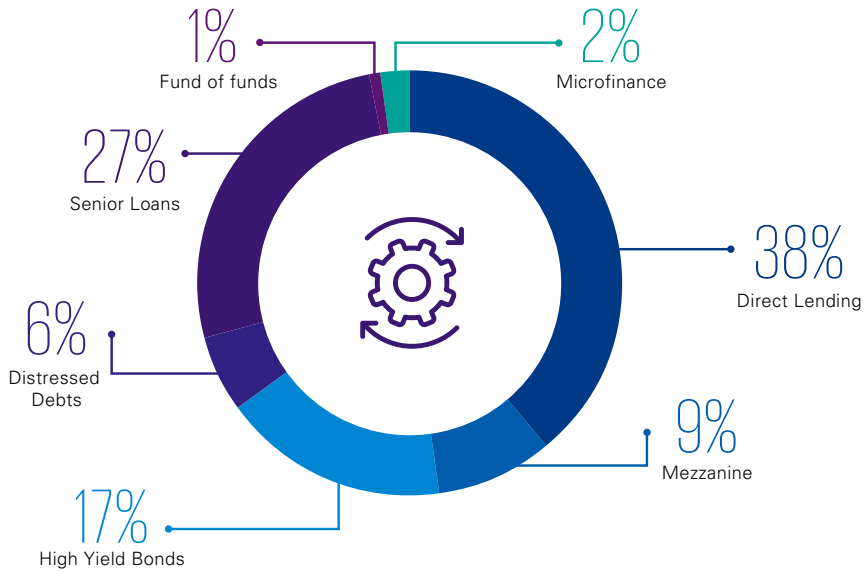


Source: KPMG/ALFI debt fund survey

Investment strategy

The investment strategy of Luxembourg debt funds is mainly focused on three debt strategies (Figure 10): direct lending (38%), senior loans (27%), and high yield bonds (17%). Compared to last year, this reflects an increase in direct lending (+6%) and senior loans (+2%), and a decrease in high yield bonds (-5%).

Figure 10: Debt funds by investment strategy

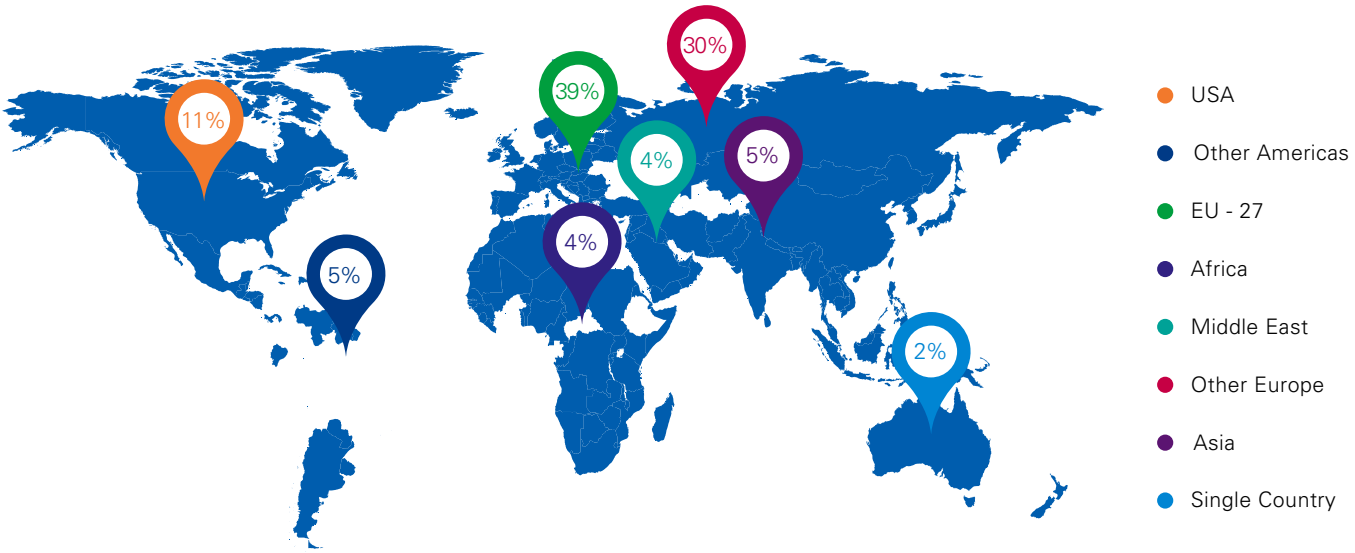


Source: KPMG/ALFI debt fund survey

Geographical investment target

Most debt funds (98%) have a multi-country investment approach. Similar to last year, the preferred investment targets (Figure 11) are in the EU (39%) and other European countries (totaling 30%).

Figure 11: Debt funds by geographical investment targets



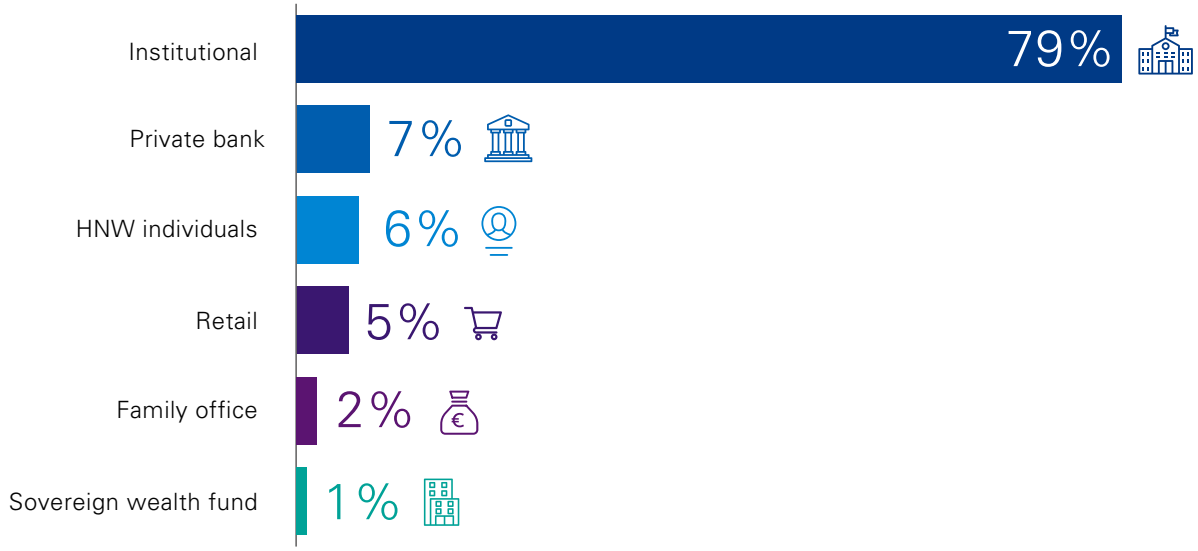
Source: KPMG/ALFI debt fund survey

Investor type and origin

The main type of investors are institutional investors (79%), followed by private banks (7%) and high-net-worth individuals (HNWIs) (6%) (Figure 12). Compared to last year, the percentage of institutional investors slightly increased (+1%), HNWIs decreased (-3%) and private banks increased (+1%).

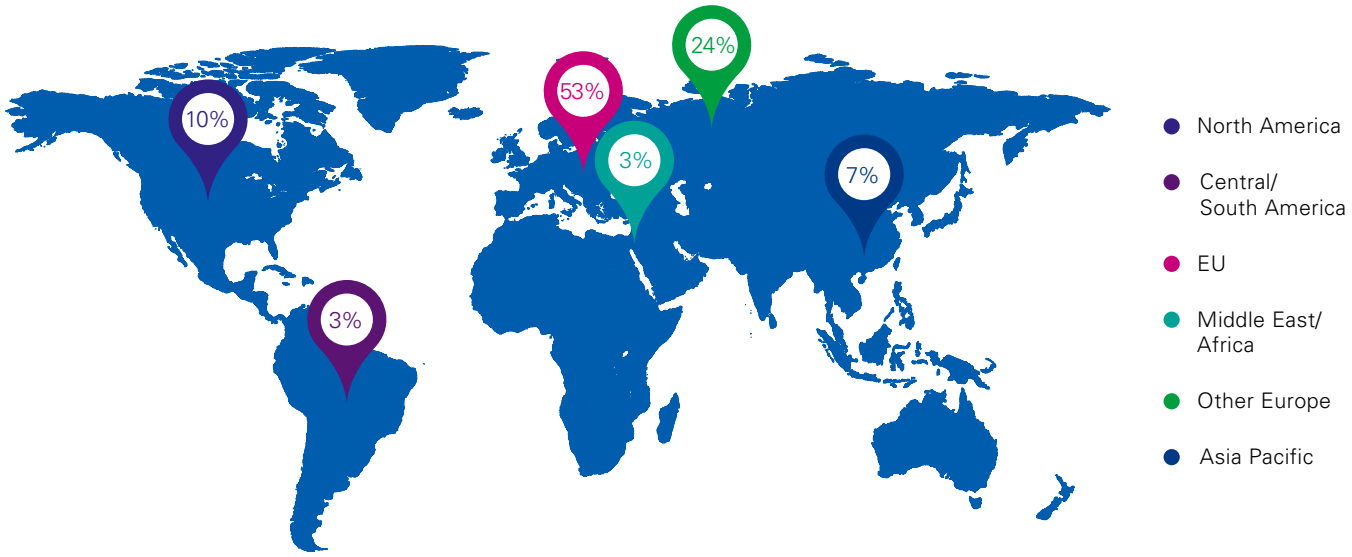
Similar to last year, these investors are mainly from EU countries (Figure 13). 72% of funds have between 1 and 25 investors per fund (Figure 14).

Figure 12: Debt funds by investor type



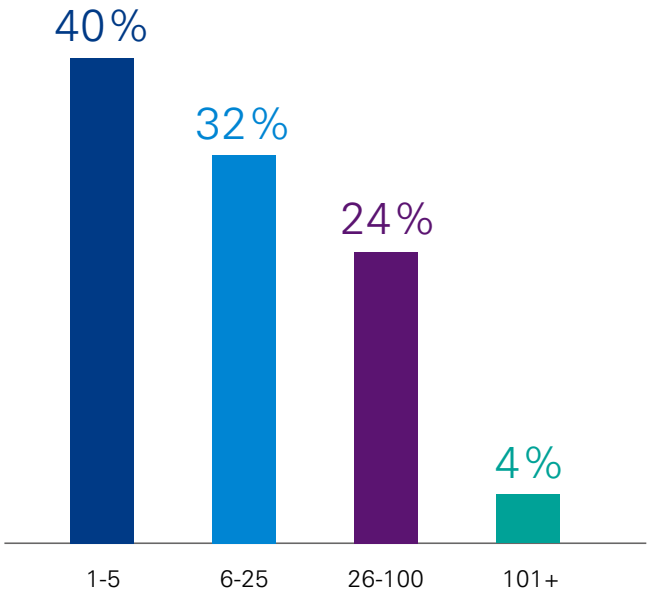
Source: KPMG/ALFI debt fund survey

Figure 13: Debt funds by investor origin



Source: KPMG/ALFI debt fund survey

Figure 14: Debt funds by number of investors

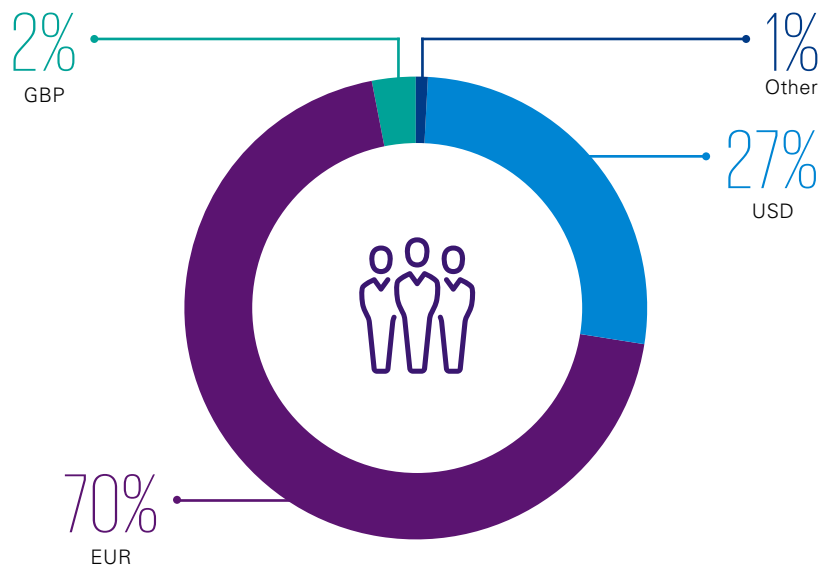


Source: KPMG/ALFI debt fund survey

Financial statements

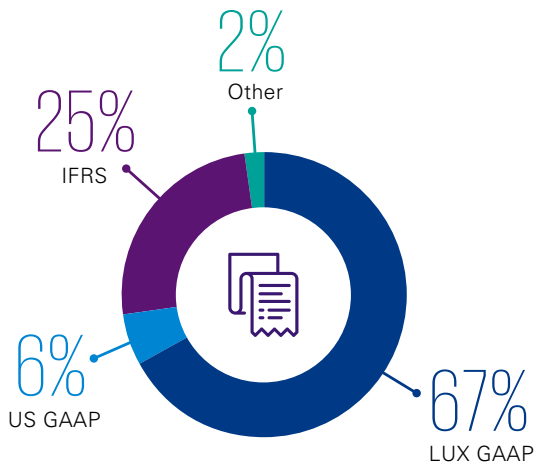
Similar to last year, the financial statements of Luxembourg debt funds are mostly prepared under the Luxembourg GAAP accounting standard (Figure 15). Like last year, these accounts are mostly prepared in euros (70%), closely followed by US dollars (27%) (Figure 16). The majority of funds (54%) do not consolidate their assets (Figure 17).

Figure 15: Debt funds by currency



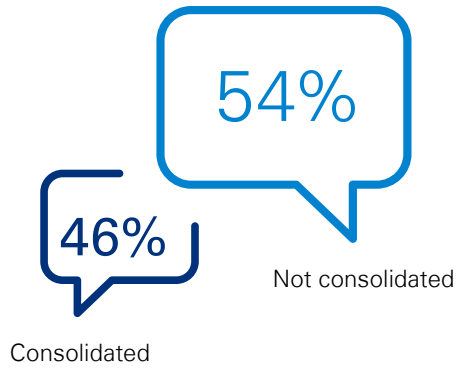
| Source: KPMG/ALFI debt fund survey

Figure 16: Debt funds by accounting standard



| Source: KPMG/ALFI debt fund survey

Figure 17: Debt funds consolidation

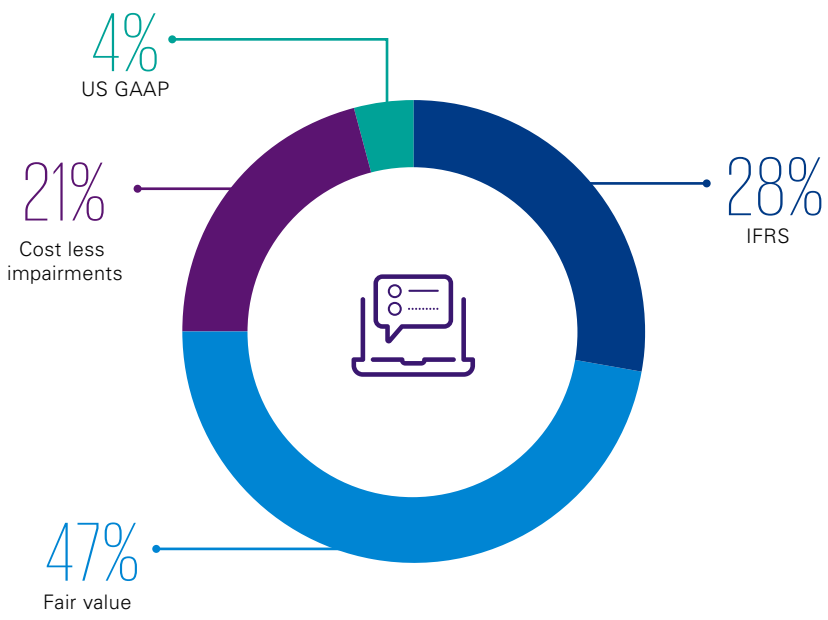


| Source: KPMG/ALFI debt fund survey

Investor reporting

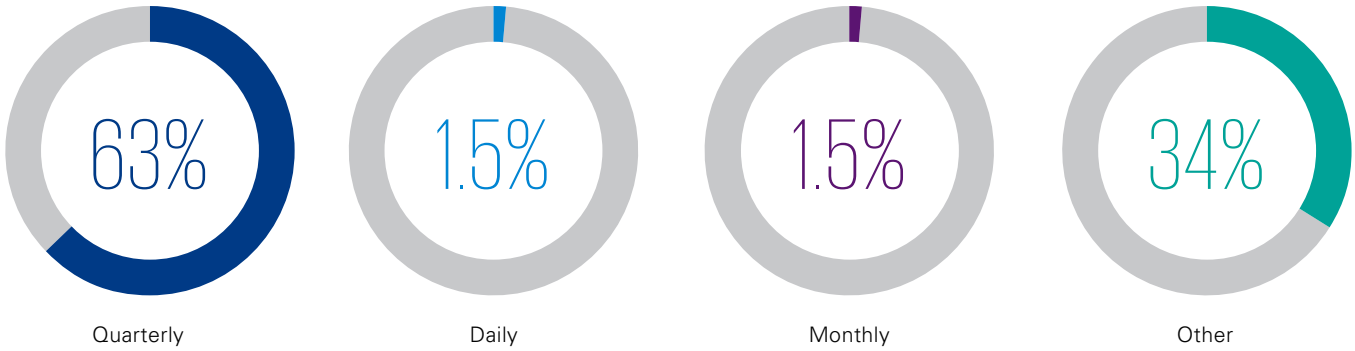
Similar to last year, the most popular reporting methodology used is fair value (47%), followed by IFRS (28%) and cost less impairments (21%) (Figure 18).

Figure 18: Debt funds by investor reporting methodology



Source: KPMG/ALFI debt fund survey

Figure 19: Debt funds by frequency of NAV computation

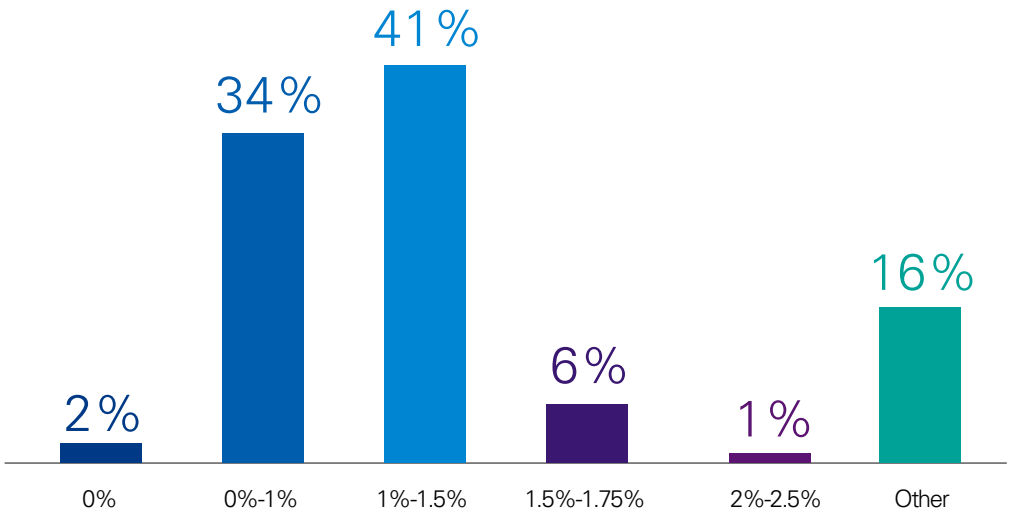


Source: KPMG/ALFI debt fund survey

Management fees

Like last year, management fees typically lie between 1% and 1.5%, with a small proportion above 1.5% (Figure 20).

Figure 20: Debt funds by management fee charged

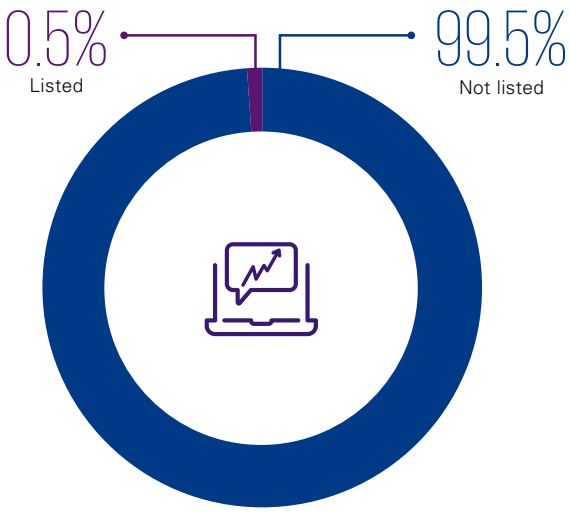


Source: KPMG/ALFI debt fund survey

Other information

Only a small percentage of funds (0.5%) are listed on a stock exchange (Figure 21).

Figure 21: Proportion of debt funds listed on a stock exchange



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 408 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 28 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.

We have included interviews with private debt players concerning their present and future views on the private debt fund industry in Luxembourg.

We have added a new element to this year's edition with the inclusion of quotes from the depositaries surveyed on their views and predictions regarding the opportunities and challenges that the private debt fund industry may face.

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 2020 by KPMG Luxembourg, in collaboration with ALFI.

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