association of the
luxembourg fund industry

Loan fund survey 2018

Tracking the rising star of alternative investments

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Introduction

Camille Thommes

Director General of ALFI

As the European Commission's Capital Markets Union project moves ahead, aimed at unlocking funding for Europe's growth, it is encouraging greater diversity in funding and the facilitation of market-based financing. As a result, non-bank intermediation — such as financing through loan funds — continues to gain momentum.

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 growth — benefits that regulators and policymakers in Europe are well aware of.

Luxembourg has long-standing experience in both loan origination and secondary market trading.

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

David Capocci

Head of Alternative Investments

2018 marks ten years since Lehman Brothers' collapse triggered the financial crisis that went on to transform the finance sector and the economy in general.

One hallmark of this post-crisis era has been that banks now face much stronger regulation, notably of their lending activities. Specifically, they have had to implement greater capital requirements and stronger risk management processes.

Out of these circumstances, the private debt industry has emerged and steadily grown. Offering an alternative to traditional banks in the global market, the success of private debt houses has been bolstered by higher returns for investors and asset managers.

Naturally, these changes are also reflected in Luxembourg's fund market, which has mirrored the steady increase in private loan funds' assets under management (AuMs). As at mid-2018, Luxembourg loan fund AuMs had increased by a significant 23.5% on the mid-2017 figure that we reported in our first joint KPMG/ALFI loan fund survey, published last year.

The percentage of loan funds set up as reserved alternative investment funds (RAIFs) — the newest fund structure to have been introduced in Luxembourg — remains stable compared to last year. We expect RAIFs to gain greater market share in the future, not just for loan funds but for the alternative fund industry in general.

Despite the regulatory and tax changes on the horizon, the loan fund industry looks to remain a healthy and growing one within the Luxembourg financial market in the coming years.

Snapshot

€49bn

aggregate capital invested in regulated loan funds as at mid-2018

75%

of loan funds (excluding UCITS) are SIFs

69%

of investors are European

The investment strategy is mainly

23.5%
increase in AuMs compared to 2017

35%
senior loans

22%
high yield bonds

Source: KPMG/ALFI loan fund survey

Fund structures

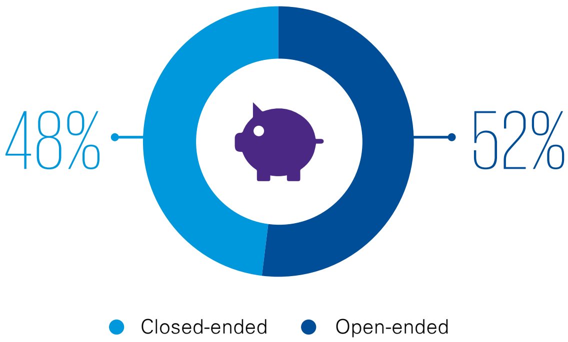
Loan fund categories

Based on their investment strategies, loan funds can be classified as either loan-originating funds or loan-participating funds:

- A loan-originating fund is any type of fund that is, according to its investment strategy, allowed to grant and restructure loans (i.e. to subsequently amend 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 its investment strategy, a loan-participating fund is not allowed to grant loans.

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. A slight majority (52%) 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 either as regulated or unregulated funds. The former are authorised and supervised by Luxembourg's supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF).

In order of the least regulated structure to the 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)
- Specialised 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)

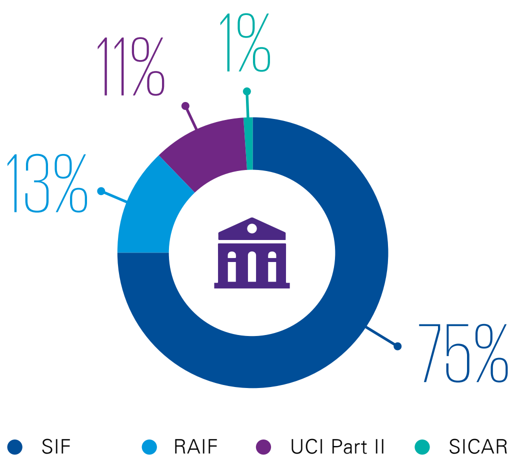
UCITS are open to retail investors while Part II funds are open to all types of investors. SIFs, SICARs and RAIFs are reserved for "well-informed investors" — that is, institutional investors, professional investors or other investors who confirm that they adhere to the status of "well-informed" investors and either (i) invest a minimum of €125,000 or (ii) have been assessed by a credit institution, an investment firm or a management company, resulting in a certification of their ability to understand the risks associated with investing in the fund.

Regarding assets, UCITS can only invest in transferable securities and other liquid assets (as detailed by article 41 of the law of 17 December 2010). No restrictions apply to the eligible assets for Part II funds, SIFs or RAIFs (although Part II funds must obtain prior approval of their investment objectives and strategy from the CSSF). SICARs can only invest in securities that represent risk capital (as detailed by CSSF circular 06/241).

UCITS, Part II funds, SIFs and SICARs are all subject to prior approval and authorisation by the CSSF.

RAIFs are itself not subject to CSSF approval, but must be managed by an authorised external alternative investment fund manager (AIFM), which is required to regularly report to the CSSF on the RAIF. In contrast, UCITS, Part II funds, SIFs and SICARs are all subject to direct supervision by the CSSF.

Figure 2: Loan funds[1] by legal regime



Source: KPMG/ALFI loan fund survey

Alternative investment funds set up in the form of Luxembourg limited partnerships (SCS/SCSp) can also invest in any type of assets. If they are managed by an EU AIFM, they can market their partnership interests via a specific passport to professional investors across the EU.

As can be seen in Figure 2[2], SIFs dominate Luxembourg's loan fund market — accounting for 75% of the market — followed by RAIFs (13%) and Part II funds (11%), while the use of SICARs is marginal (1%).

SIFs being loan fund managers' first choice of structure (excluding UCITS) can easily be explained by their flexibility regarding investment policy, as well as by their regulatory regime. Further, having now been available for a decade, this vehicle is well known.

Compared to last year, the percentage of loan funds set up using RAIFs has remained constant, at about 13%.

We expect RAIFs to gain greater market share in the future.

The RAIF — which was launched in 2016 — represents a strong alternative to the SIF. It possesses the features and flexibility of the SIF and the SICAR, but is less regulated: only the RAIF's AIFM is subject to direct supervision by and reporting to the CSSF, thus removing the double layer of regulation and enabling a quicker time to market.

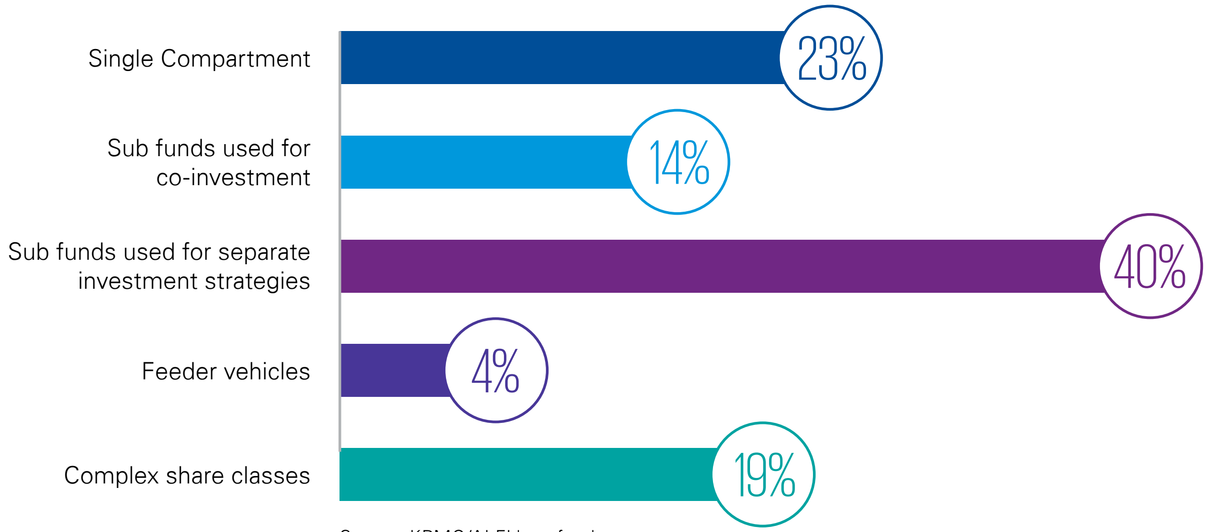
Figure 2 shows that SICARs are barely used by loan fund promoters. This can be explained by their restricted investment policy — meaning they can only be used to invest in risk-bearing securities.

Loan funds can be set up under the UCITS framework through the use of tailored indices and derivatives, but this option is not used to any significant degree — mainly because of the strict liquidity requirements in terms of assets. Nevertheless, for the sake of completeness, we mention this option in the survey.

1. excluding UCITS
2. ibidem

In terms of structuring loan funds, promoters have a choice between single compartments or multiple compartments. Figure 3 shows the split between these types as at 30 June 2018 — it can be seen that the percentage of sub-funds used for separate investment strategies is higher than that of single compartment funds. Complex share classes mean that different management and performance fee structures can be managed for different investors.

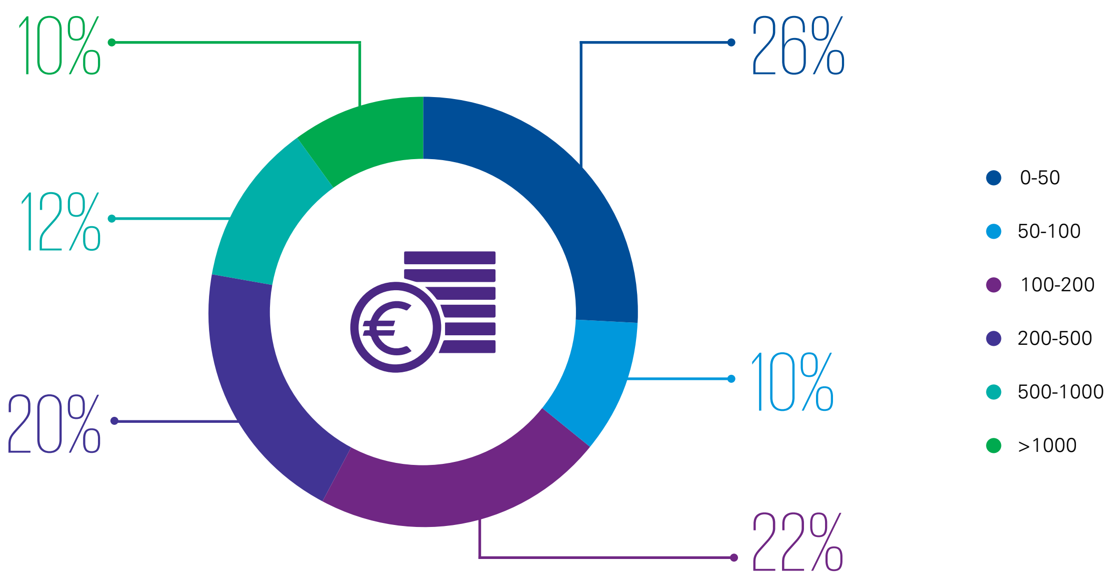
Figure 3: Loan fund structures



Source: KPMG/ALFI loan fund survey

As last year, the majority of funds range up to €50 million in size (Figure 4). Notably, large funds — i.e. those with a total commitment exceeding €1 billion — represent 10% of the total number of loan funds (versus 11% in 2017). As at 31 July 2018, the regulated market of loan funds represented about €49 billion (compared to €40 billion as at mid-2017).

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



Source: KPMG/ALFI loan fund survey

Unregulated investment vehicles

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

Compared to regulated vehicles, these unregulated vehicles are highly flexible — and cost less to set up and operate since they require no CSSF approval, reporting or supervision.

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

For those loan fund managers in the unregulated market, the first vehicle of choice is the SOPARFI, which tends to be preferred over the unregulated SV. Indeed, SOPARFIs are widely used amongst investors due principally to their accessibility and flexibility, and the fact that they are well-known to investors and promoters alike.

Transformation of the international tax landscape

The international tax landscape is in constant motion and constitutes a real challenge for loan fund actors and, more generally, alternative investment players — who must work to ensure their continuous compliance with evolving tax requirements, while remaining efficient and sustainable in the market.

The forthcoming entry into force of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument", or MLI) — expected in 2019/2020 in Luxembourg — as well as the Anti-Tax Avoidance Directive (ATAD) — effective from January 2019 for the first directive and January 2020 for the second directive — will significantly alter Luxembourg's tax framework.

For example, with the MLI, the concept of substance will evolve with the principal purpose test (PPT) introduced in Action 6 of the BEPS reports. The PPT is an anti-treaty abuse clause that allows contracting states to "deny the application of the provisions of their treaties when transactions or arrangements are entered into in order to obtain the benefits of these provisions in inappropriate circumstances". An example of such a transaction could be the setting up of a special purpose vehicle (SPV) in Luxembourg, with the main purpose of obtaining the benefit of a treaty.

Such a provision will require alternative investment funds (AIFs) to reconsider their substance levels, holding structures and operational models, in order to comply with the new international standards and ensure double tax treaty access for their investment platforms.

The ATAD is intended to provide a minimum level of protection for the internal market and to strengthen the average level of protection against aggressive tax planning. Member States of the EU will have until 31 December 2018 to transpose the ATAD into their national laws and regulations, which should be applicable from 1 January 2019. On 19 June 2018, the Luxembourg government released its draft law implementing the ATAD, providing for new rules on: limitation of interest deduction, exit taxation, general anti-abuse rules, controlled foreign company rules and rules against hybrid mismatches.

The limitation on interest deduction and the anti-hybrid provisions should be particularly relevant for SOPARFIs engaged in the loan fund market, since regulated investment funds are generally exempt from corporate income tax and net wealth tax, and thus would not need debt financing of their loan receivables.

Luxembourg's draft ATAD law provides for a limitation of the deductibility of net interest expenses — i.e. taxable interest income less deductible interest expenses — of up to 30% of the taxpayer's adjusted EBITDA or €3,000,000, whichever is higher (calculated yearly).

For SOPARFIs engaged in the back-to-back intragroup financing of plain vanilla loans, this provision should not trigger adverse tax implications since the company would realise an arm's length margin on this financing activity. Furthermore, assuming that a gain on distressed debt/non-performing loans is included in the definition of interest (or equivalent), this new rule should not adversely affect SOPARFIs.

The anti-hybrid provision contained in the draft ATAD law foresees a non-deductibility of interest charges under a debt instrument in cases where the payment on the instrument gives rise to a deduction without inclusion (or a double deduction), and where the mismatch is attributable to differences in the characterisation of the instrument or the payment — for example, if the payment is seen as an interest payment in the payer's country and as a dividend payment in the recipient's country.

At the European level, hybrid instruments are already targeted by the current wording of the EU parent-subsidiary directive, which foresees taxation at the level of the recipient of the hybrid interest income (i.e. dividend) in cases where such charges have been deducted at the level of the subsidiary.

Hybrid instruments with third countries will be affected by "ATAD 2", which extends the scope of the anti-hybrid provision to third countries. ATAD 2 should be implemented and applicable in EU Member States from 1 January 2020. It foresees a non-deduction of the expenses in relation to the hybrid instrument at the level of the subsidiary. Loan fund players will thus have to take these new rules into account in structuring their debt investments going forward.

Regulatory outlook

The regulatory reform agenda has continued steadily at global and EU levels, and the present landscape reflects the current policy priorities: financial stability and systemic risk; maintaining an open and well-functioning EU financial market; and promoting sustainable private finance. The main initiatives of interest to loan fund managers are summarised below.

EU Commission proposals on non-performing loans

In March 2018, the European Commission presented reform measures addressing the risks in Europe's banking system related to high levels of non-performing loans (NPLs). NPLs are loans where the borrower is unable to make the scheduled payments to cover interest or capital reimbursements. When the payments are more than 90 days past due, or the loan is assessed as unlikely to be repaid, the loan is classified as an NPL.

The measures also include a proposal for a directive on credit servicers, credit purchasers and the recovery of collateral. This new EU initiative is expected to foster the development of secondary markets for NPLs by harmonising requirements for credit servicing and the transfer of bank loans to third parties across the EU.

The key points of the proposal, which is still under discussion, are as follows:

— The activities of credit servicers are defined — and rules for common standards for authorisation, supervision and conduct rules have been set. This will mean that operators respecting these rules can be active throughout the EU without separate national authorisation requirements.

— Banks and borrowers may agree in advance on an accelerated mechanism to recover the value from loans guaranteed with collateral. If a borrower defaults, either the bank or another secured creditor is able to recover the collateral that underpins a loan in an expedited way, without going to court. Out-of-court collateral enforcement is strictly limited to loans granted to businesses, and subject to safeguards — with consumer loans being excluded.

— A new reporting requirement is on the way, obliging purchasers of bank loans to notify authorities when acquiring a loan.

Systemic risk authorities focus on liquidity risk in open-ended funds

The asset management sector has been under scrutiny by the European Systemic Risk Board (ESRB), given concerns that increased financial intermediation by investment funds may result in the amplification of any future financial crisis. At the end of 2017, the ESRB issued a set of recommendations calling for additional legislative measures to: reduce excessive liquidity mismatches; bring in stress testing of liquidity risk; and introduce liquidity management tools for redemptions (such as redemption fees, redemption gates or the ability to temporarily suspend redemptions). Given the highly illiquid nature of loans, managers should expect attention from the regulator if they structure open-ended loan funds.

Sustainable finance and ESG

The European Commission has made its first legislative proposals to establish a framework to foster more sustainable private investment — a priority of the Capital Markets Union (CMU). These proposals intend to provide institutional investors, including asset managers, with clear guidance on how to integrate environmental, social and governance (ESG) factors into their investment decision-making processes, as well as on how to improve transparency to investors regarding the processes and how asset managers achieve their sustainability targets.

The disclosure requirements mainly cover:

— online publication of the entity's written policy on the integration of sustainability risks into its investment decision-making processes

- pre-contractual disclosures on: the procedures and conditions for integrating sustainability risks in investment decisions; the extent to which these risks are expected to have a relevant impact on the returns of the financial products; and the consistency of remuneration policies
- information, for financial products that target sustainable investments, on any designated index or on how the investment target will be reached
- online publication, for each financial product, of a description of the sustainable investment target — as well as the methodologies used to assess, measure and monitor the impact of the investment
- periodical reports describing the overall sustainability-related impact of the financial product through relevant factors and, where relevant, its impact relative to any designated index.

Facilitating cross-border distribution of funds

In March 2018, the EU Commission published a proposal package as part of the CMU, aimed at improving the distribution frameworks for AIFs and UCITS. This stemmed from criticisms that the regimes were burdensome, unclear and subject to "gold-plating" by national legislators. If adopted as proposed, the key changes would be as follows.

- Member States would no longer be in a position to require AIFMs that market AIFs to retail investors to have a physical presence in the countries where those AIFMs market their funds, process investors' orders, make payments and provide the fund information and documentation.
- A definition of pre-marketing would be introduced in the Alternative Investment Fund Managers Directive (AIFMD), allowing AIFMs to test the appetite of investors in a Member State before launching a notification process for the fund.
- Common rules on marketing communications, with an equally prominent presentation of the risks and rewards linked to the purchase of funds instruments, would be introduced.
- AIFMs targeting retail investors would have to notify authorities of all marketing communications that they intend to use directly or indirectly.

Guidance on the substance rules for Luxembourg investment fund managers

In the summer of 2018, the CSSF issued Circular 18/698, which sets out extensive prescriptive guidance on its expectations regarding organisation, operations and substance, as well as on the management information systems and regulatory reporting to be in place to facilitate its ongoing supervision of investment fund managers (IFMs).

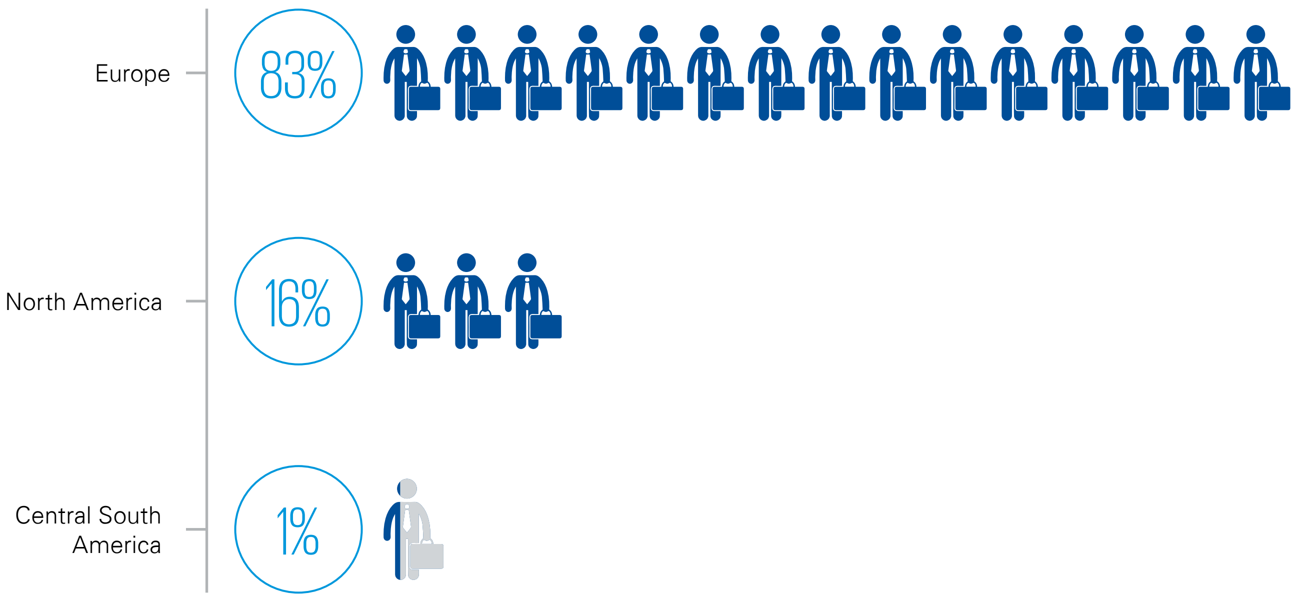
The new circular is a useful compilation of guidance on the required level of local substance, how core business activities and internal control functions should be organised — including the conditions for the delegation of activities — and the concept of proportional application of the rules.

Overview of key data

Initiator origin

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

Figure 5: Initiators' origin by region



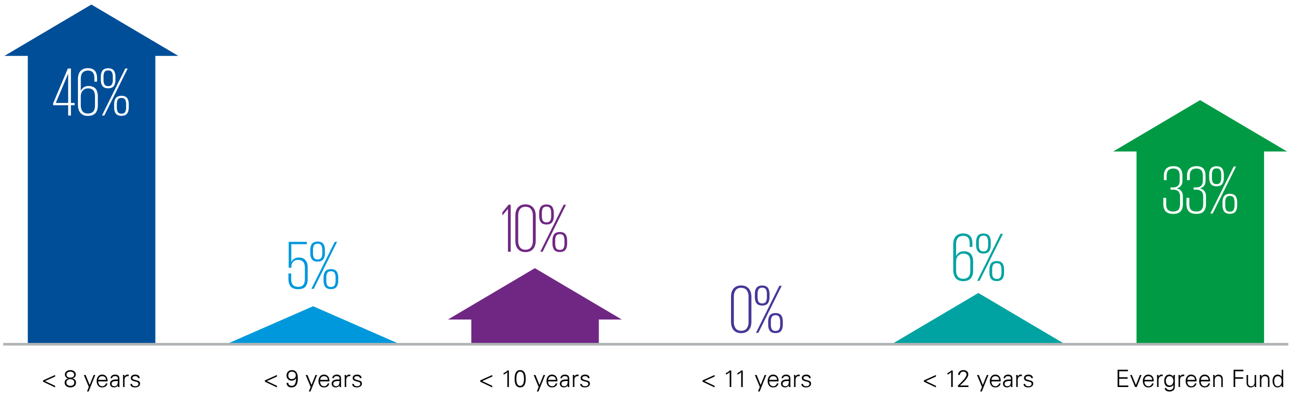
Source: KPMG/ALFI loan fund survey

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 104.

With respect to maturity, 46% of the funds have maturities of up to eight years, a small percentage have maturities between nine and 12 years, and a third of the funds are evergreen funds (Figure 6).

Figure 6: Loan funds by maturity

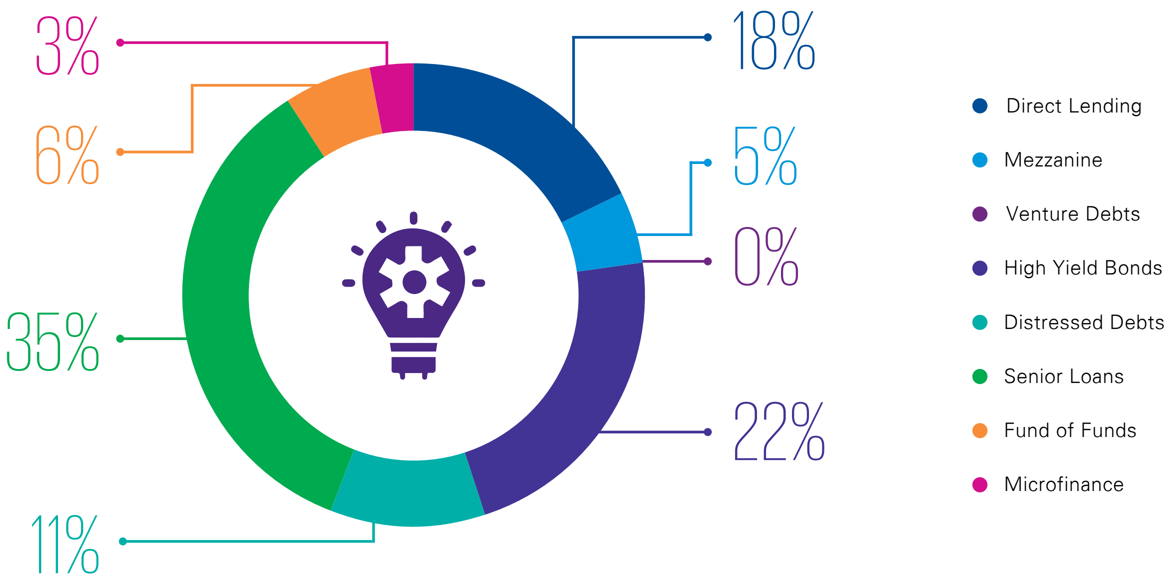


Source: KPMG/ALFI loan fund survey

Investment strategy

The investment strategy of Luxembourg loan funds is mainly focused on three loan strategies (Figure 7): senior loans (35% of funds), high yield bonds (22%) and direct lending (18%).

Figure 7: Loan funds by investment strategy

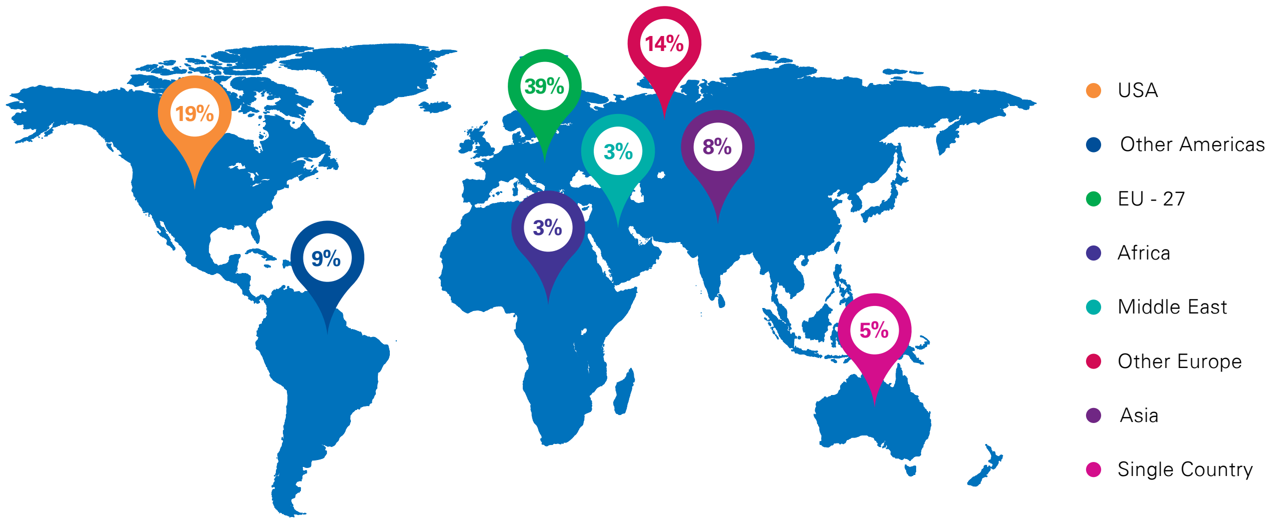


Source: KPMG/ALFI loan fund survey

Geographical investment target

Most of the loan funds (95%) have a multi-country investment approach. The preferred investment targets (Figure 8) are in the EU (39%) and the Americas (totalling 28%).

Figure 8: Loan funds by geographical investment targets

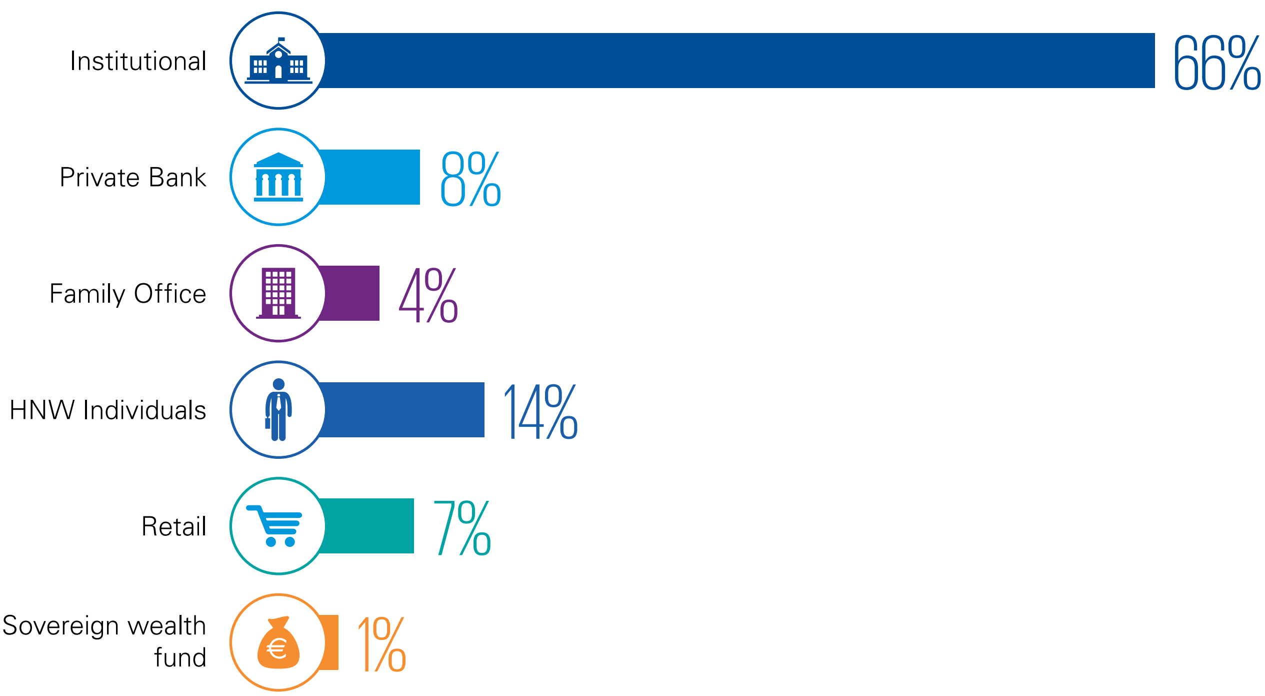


Source: KPMG/ALFI loan fund survey

Investor type and origins

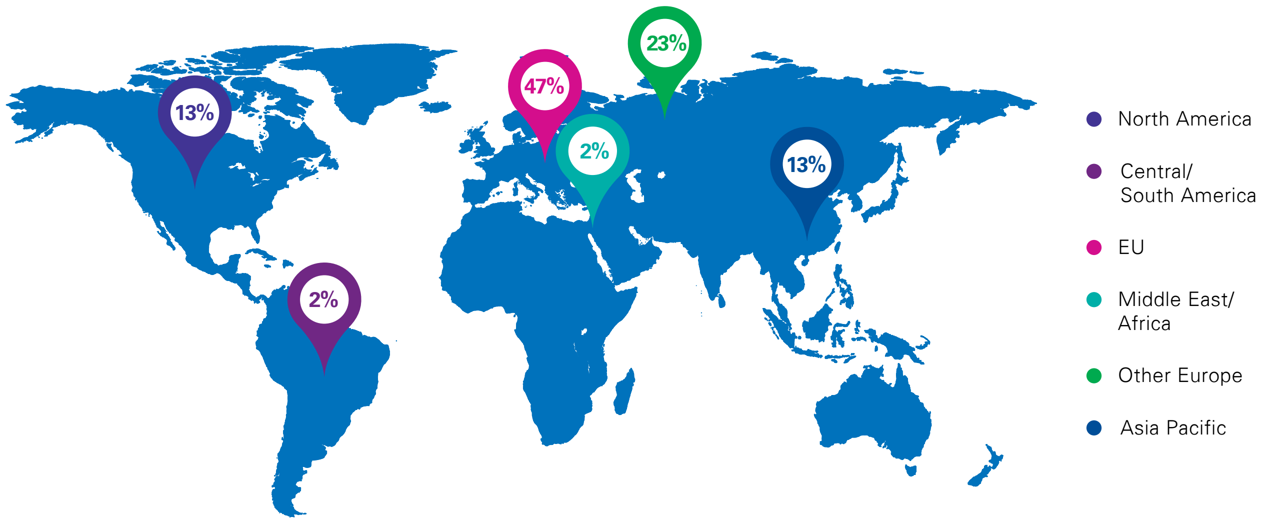
Unsurprisingly, the main tranche of investor type is institutional investors (66%), followed by high net worth (HNW) individuals (14%) and private banks (8%) (Figure 9). These investors come mainly from EU countries (Figure 10). Two thirds of the funds have between one and 25 investors per fund (Figure 11).

Figure 9: Loan funds by investor type



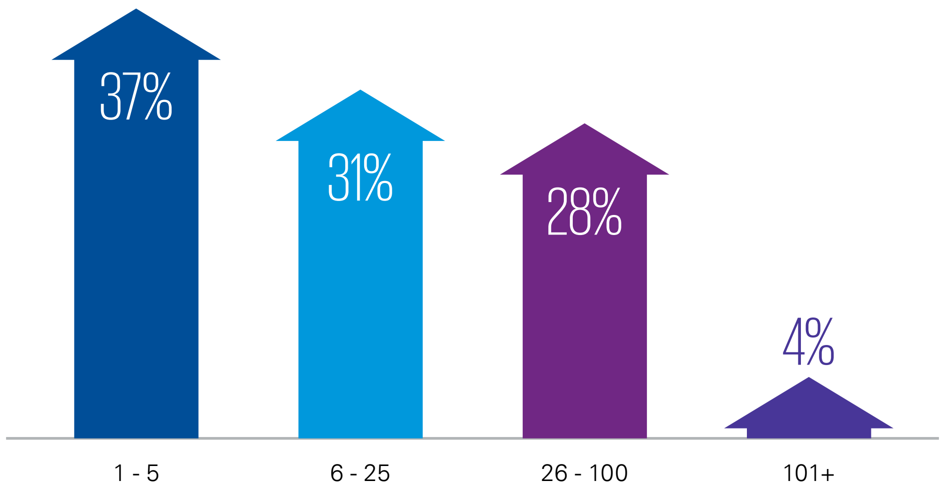
Source: KPMG/ALFI loan fund survey

Figure 10: Loan funds by investor origin



Source: KPMG/ALFI loan fund survey

Figure 11: Loan funds by number of investors

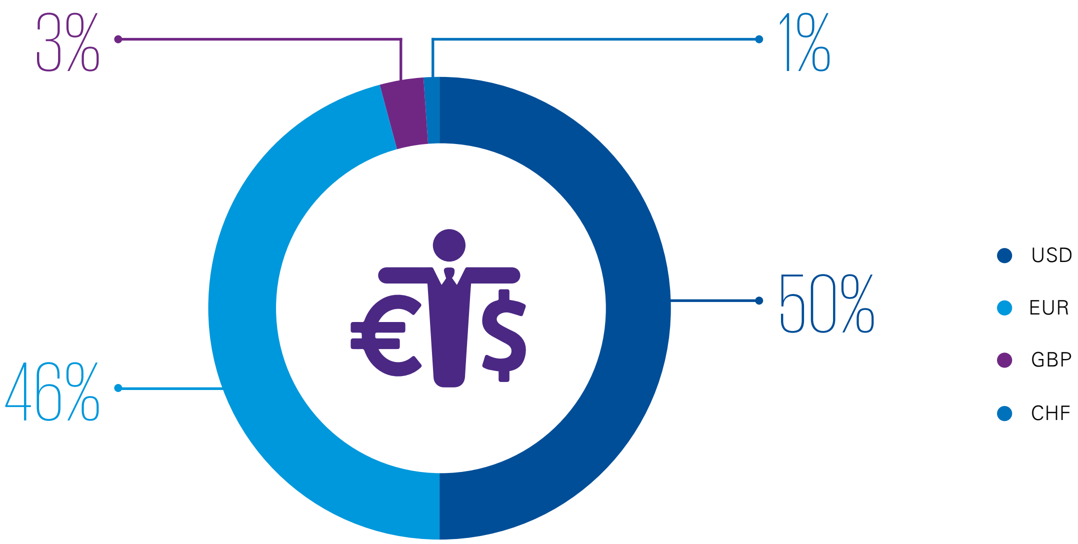


Source: KPMG/ALFI loan fund survey

Financial statements

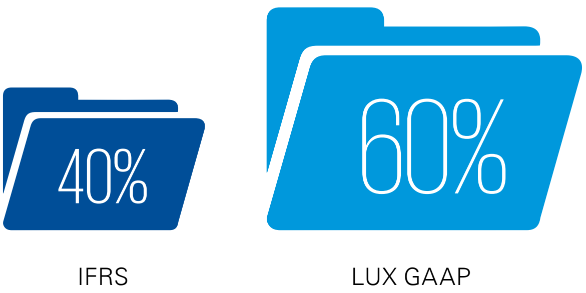
The financial statements of Luxembourg loan funds are mostly prepared under the Luxembourg GAAP accounting standard (Figure 12). These accounts are prepared in US dollars by a small majority of funds (50.4%), followed shortly by euros (46%) (Figure 13). The majority of funds (61%) do not consolidate their assets (Figure 14).

Figure 13: Loan funds by currency



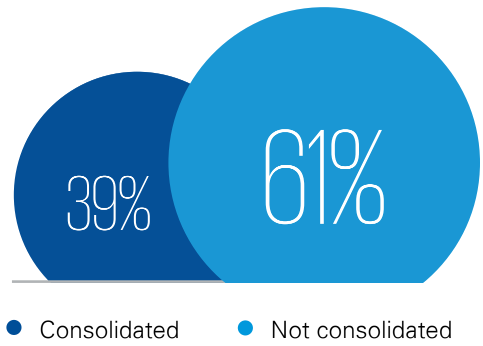
Source: KPMG/ALFI loan fund survey

Figure 12: Loan funds by accounting standard



Source: KPMG/ALFI loan fund survey

Figure 14: Loan funds consolidation



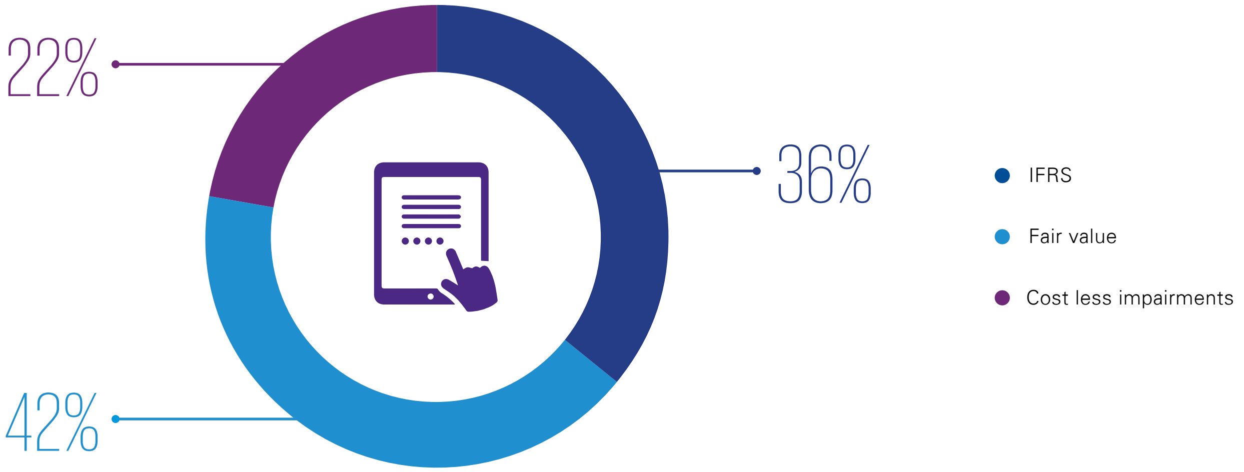
Source: KPMG/ALFI loan fund survey

Investor reporting

The reporting methodology used is mainly fair value (42%), followed by IFRS (36%) and cost less impairments (22%) (Figure 15).

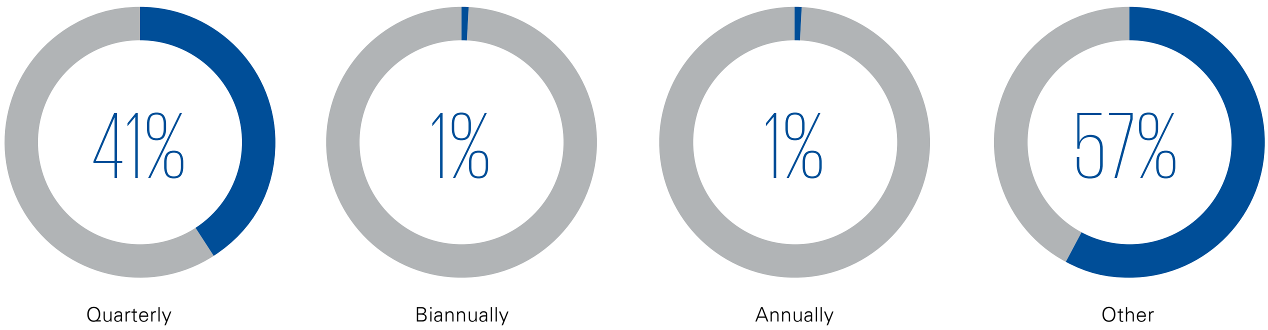
US GAAP is not used at all by the surveyed funds.

Figure 15: Loan funds by investor reporting methodology



Source: KPMG/ALFI loan fund survey

Figure 16: Loan funds by frequency of NAV computation

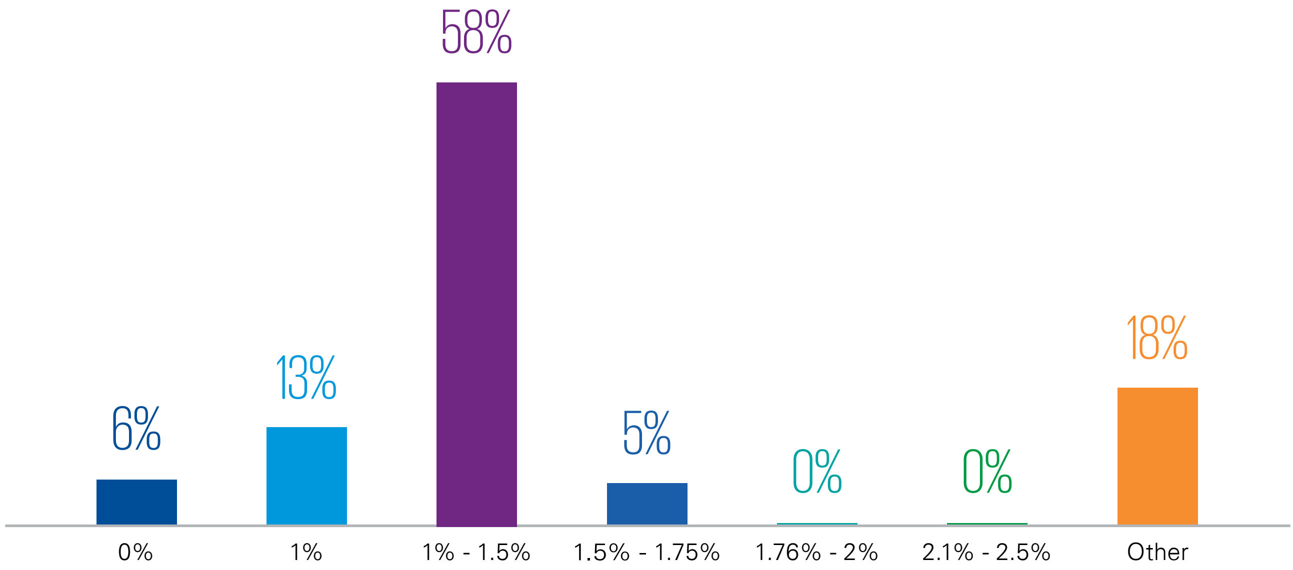


Source: KPMG/ALFI loan fund survey

Management fee

Management fees are typically between 1% and 1.5%, with a small proportion at up to 1% (Figure 17).

Figure 17: Loan funds by management fees charged

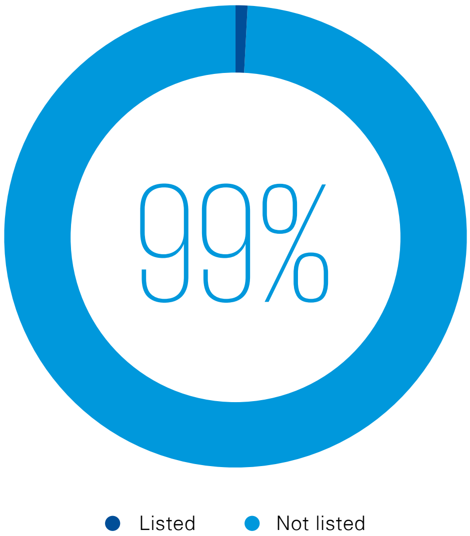


Source: KPMG/ALFI loan fund survey

Other information

Only a small percentage of funds — less than 1% — are listed on a stock exchange (Figure 18).

Figure 18: Proportion of loan funds listed on a stock exchange



Source: KPMG/ALFI loan fund survey

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