Private debt fund survey 2022

Harnessing the momentum of a buoyant market

kpmg.lu

Page 3
Introduction

Page 7
Fund structures

Page 11
The voice of private debt managers

5
Snapshot

18
ESG integration for private debt - the challenge of data collection

Page 21
Let's tokenize it!

Page 23
The "unshell" directive (ATAD 3)

25
Viewpoint: quotes from depositaries

28
Overview of key data

Page 27
Regulatory outlook

Page 35
About this research

Introduction

Camille Thommes
Director General of ALFI

The latest survey conducted by KPMG illustrates once again the continuous growing appetite of investors for private debt funds.

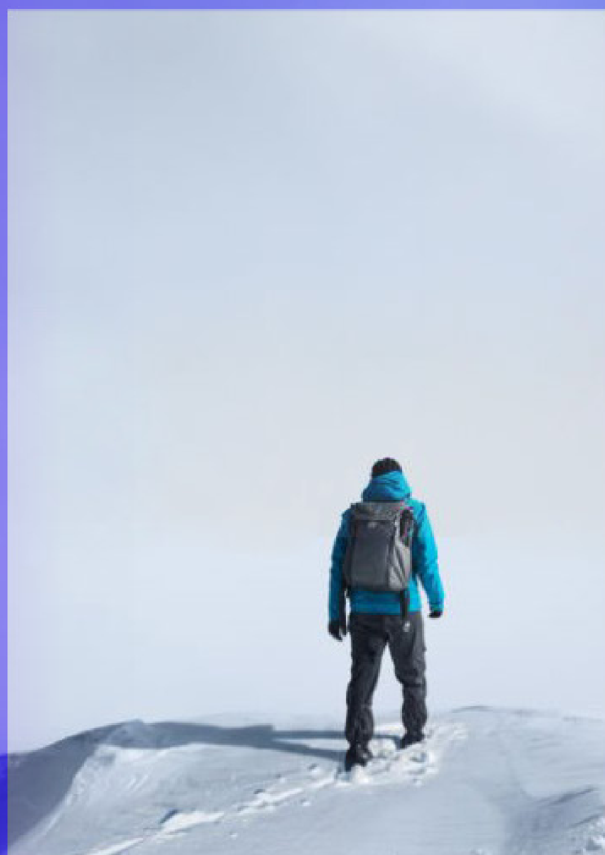
Indeed, private debt funds have experienced a 45.4% average growth of AuM compared to last year's survey, reaching EUR 267.8bn by June 2022. Amidst a challenging market environment with rising interest rates, private assets continue to offer attractive investment opportunities and an appealing risk adjusted return for investors.

The survey shows that private debt asset managers are improving decision-making through data analytics and artificial intelligence, making processes more cost efficient. In addition, tokenisation of investment vehicles and underlying portfolios have started to emerge.

Moreover, sustainability in private debt, is gaining in importance. Beyond regulatory compliance, asset managers are integrating ESG considerations into investment strategies to respond to growing investor demand. This survey shows that 3 out of 4 private debt funds fall into article 6 of the SFDR and 23% into article 8, i.e. funds that promote environmental or social characteristics.

The Luxembourg fund centre remains the domicile of choice for this asset class. Initiators of private debt funds in particular appreciate not only the attractive legal toolbox with the unregulated special limited partnership (SCSp) as well as the reserved alternative investment fund (RAIF) but also value the expertise and sophistication of market participants servicing that segment.

On behalf of ALFI, I would like to express my gratitude to KPMG for their support and to the multiple market participants for their active contribution to this year's survey.



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

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

While the COVID-19 pandemic gradually wound down in 2022, the year has also been marked by disruptive geopolitical conditions, uncertainties, and volatility in the global economy.

In these challenging circumstances, the Luxembourg private debt market demonstrated its resilience once again by expanding at the same remarkable pace as 2021. This sixth edition of the KPMG/ALFI private debt fund survey finds the average growth in assets under management in 2022 has reached 45.4%,* with the market now reaching €267.8 billion.**

The demand for financing remains robust, while banks are reducing their lending activities amongst ongoing regulatory capital issues and substantial loan loss provisions due to the pandemic. As a result, we expect the private debt market's steady and healthy growth to continue in the coming years.

Recent European data forecasts a 17.4% compound average annual growth over the next 5 years for the private debt industry. Despite the recent turbulence, we are confident the market will hold this course.

Regarding fund structuring, unregulated special limited partnerships (SCSp) and reserved alternative investment funds (RAIF) remain private debt managers' Luxembourg fund vehicles of choice. 85% of unregulated private debt funds are set up as Luxembourg SCSp, while 45% of indirectly supervised private debt funds are RAIF. In line with last year's results, RAIF loan funds continue to forge ahead, boasting another 9% increase this year.

The EU remains the top geographical target for investments, favored by 43% of our respondents, with other European countries (28%) and North America (12.5%) bringing up the rear. Regarding regulation, the proposed second Alternative Investment Fund Manager Directive (**AIFMD 2**) introduces a new framework of common minimal rules for loan-originating funds, including retention requirements, a review of credit granting policies and procedures, and concentration limits. It is not expected to come into force before 2025.

The EU is also currently reviewing the European long-term investment fund (**ELTIF**) Regulation, with more flexibility expected for ELTIFs and clearer portfolio diversification and distribution rules. This should brighten these structures' future and offer an alluring option to loan-originating fund managers for retailization.

Sustainability is also a major concern. Private debt fund managers must integrate environmental, social, and governance (**ESG**) factors into their decision-making process, ensure compliance with the Sustainable Finance Disclosure Regulation (**SFDR**), and improve their data quality to meet future reporting needs. This survey found that most funds (75%) are classified under SFDR Article 6 and 23% under Article 8. We expect the number of Article 8 and 9 funds to surge in the coming years.

Last but not least, we expect digitalization and blockchain technology to revolutionize the private debt market in the next few years, reducing the cost of loan origination, lowering barriers to entry, and increasing the asset class's liquidity.

Before we sign off, we would like to thank everyone who took part in the 2022 private debt fund survey, especially the market players of this vibrant ecosystem who inspired us in our discussions.

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

* Average growth between June 2021 and June 2022 based on data provided by depositaries surveyed.
** Total assets under management based on data provided by depositaries surveyed. This does not cover all the market and only includes regulated funds and indirectly supervised investment vehicles, such as RAIF, SIF or SCSp AIF.

€267.8 billion

Total AuM

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

45.4%

Average growth of AuM compared to last year

*Average growth between June 2021 and June 2022 based on data provided by depositaries surveyed

85% SCSp

Vehicle of choice for unregulated AIF debt vehicles

45% RAIF

+9% compared to 2021

-7% SIF

compared to last year

Investment target

43 %
Region EU

28 %
Other Europe

12.5 %
North America

Investment strategy

64 %
Direct lending

13 %
Mezzanine

ESG

75 %
Article 6 SFDR

23 %
Article 8 SFDR*

* For the funds for which we received the information, 23% of them promote environmental or social characteristics, or a combination of the two.

Fund structures

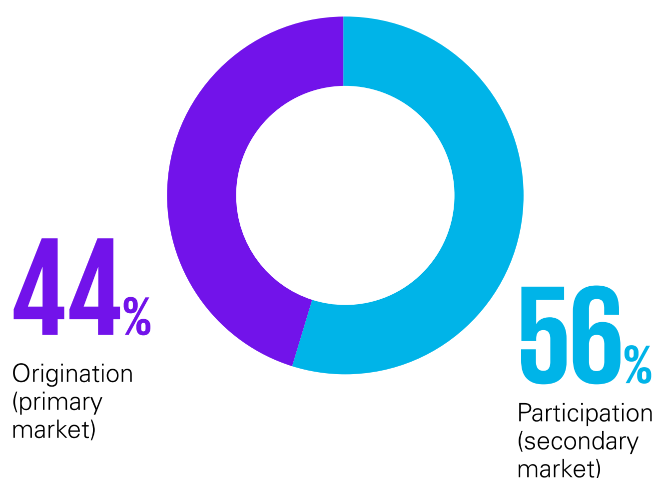
Debt fund categories

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

/ A debt-originating fund is, according to its investment strategy, allowed to grant (so called "loan origination or primary market") and restructure debts. In other words, it can amend debt conditions such as prolongation or deferral.

/ A debt-participating fund is allowed to partially or fully acquire and restructure existing debts from third parties (i.e. banks and other institutions), either directly from the lender or in secondary markets where these debts are traded. According to its investment strategy, a debt-participating fund is not allowed to grant debts.

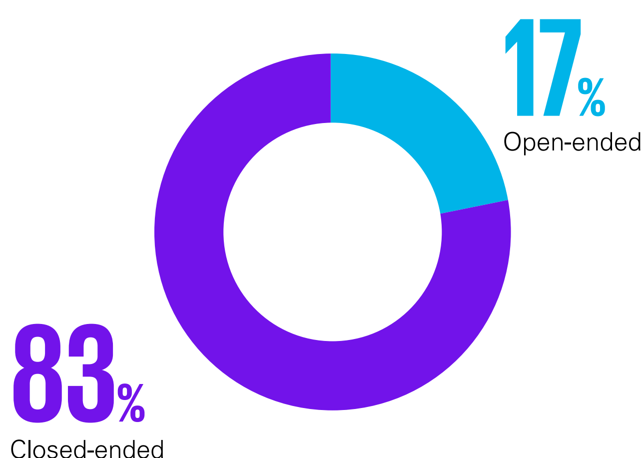
Figure 1:
Debt originating and debt participating funds



Source: KPMG/ALFI debt fund survey

Debt funds can be open- or closed-ended, depending on the type of investors and the underlying asset type. Similar to last year, the vast majority (83%) of Luxembourg debt funds are closed- ended (Figure 2).

Figure 2:
Open and closed-ended debt funds



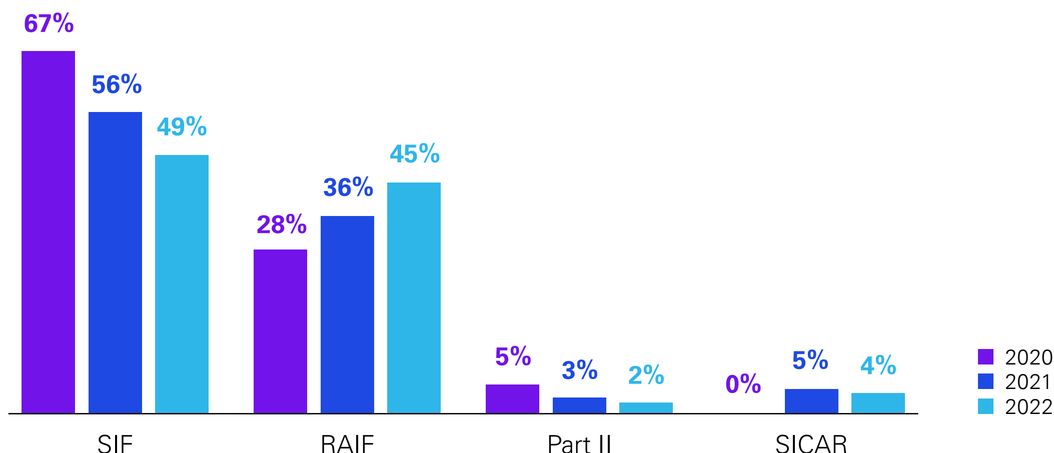
Source: KPMG/ALFI debt fund survey

Regulatory framework

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

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

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



Source: KPMG/ALFI debt fund survey

Regulated fund vehicles[1]

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

/ Reserved alternative investment funds (RAIFs): funds subject to the law of 16 July 2019[2], as amended.

/ Investment companies in risk capital (SICARs): funds subject to the law of 15 June 2004, as amended.

/ Specialized investment funds (SIFs): funds subject to the law of 13 February 2007, as amended.

/ Part II funds: funds subject to part two of the law of 17 December 2010, as amended.

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

(i) invest a minimum of €125,000 or

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

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

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

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

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

As seen in Figure 3[4], SIFs still dominate Luxembourg's debt fund market at 49%, followed by RAIFs (45%), SICAR (4%) and Part II (2%).

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

Similar to last year, the percentage of debt funds set up using RAIFs continue to grow (i.e. +9%) and the percentage of funds set up as SIF continue to decrease (i.e. -7%).

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

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

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

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

Unregulated (and indirectly supervised) investment vehicles

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

Absence of CSSF's authorization and supervision

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

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

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

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

Legal forms

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

Securitization Vehicles (SVs)

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

Advantage of unregulated/ indirectly supervised investment vehicles

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

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

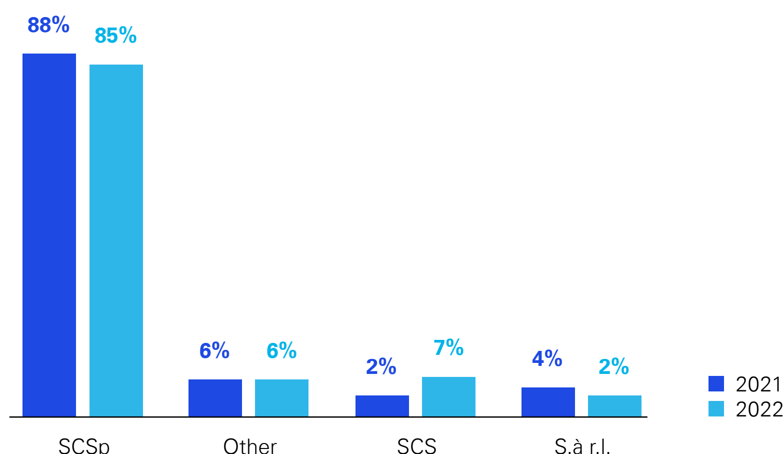
Unregulated AIFs set up as SCSs, SCSp or SOPARFIs can also invest in any type of asset. If they are managed by an EU AIFM, they can market their partnership interests to EU-wide professional investors with a specific passport.

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

Similar to last year's survey, we extended the data collection within depositary banks to unregulated AIFs investing in debts. Thanks to the various depositary banks who collaborated with us on the 2022 debt fund survey, we managed to get a broader view on the unregulated part of the debt fund market.

Based on the data collected, the favored vehicle of debt fund managers in the unregulated market[7] is still the SCSp (85%), who tend to prefer it to the Sàrl (2%) and SCS (7%). SCSp are widely used mainly due to their accessibility and flexibility — and also because they are well-known to investors and promoters.

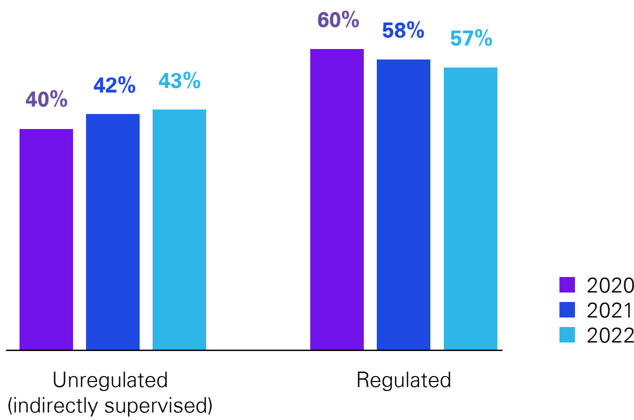
Figure 4:
Unregulated (AIF) debt fund by legal regime



Source: KPMG/ALFI debt fund survey

5. Article 3, §2 and §3 of the law of 12 July 2013 on Alternative Investment Fund Managers
6. Based on the definition of AIF: "any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive."
7. The data for the unregulated debt funds market only refers to AIFs. No data has been collected for unregulated non-AIF vehicles.

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



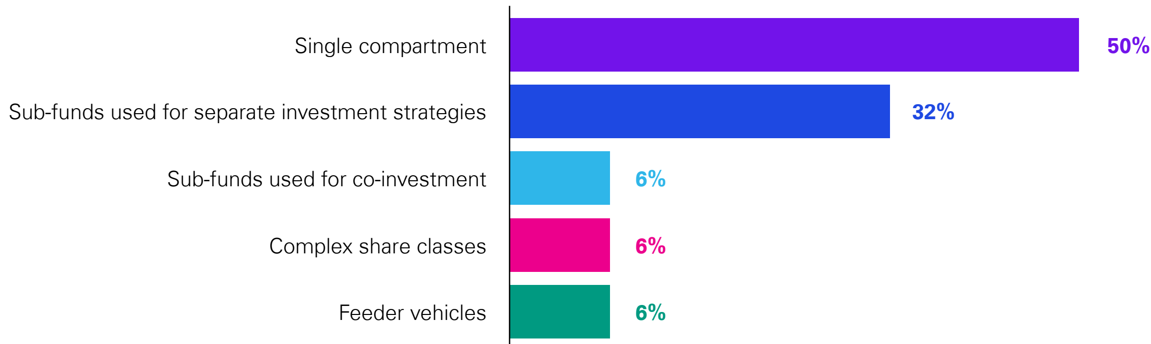
Source: KPMG/ALFI debt fund survey

Figure 5 shows that, similar to last year, most of the Luxembourg debt funds are regulated funds while 43% are unregulated (but indirectly supervised) investment vehicles. We however can notice a small decrease in regulated fund vehicles (-1%).

Regarding debt fund structuring, promoters can choose between single or multiple compartments. Figure 6 shows how these types are split as of 30 June 2022. Similar to last year, the percentage of single compartment funds is higher than sub-funds used for separate investment strategies.

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

Figure 6:
Debt fund structures

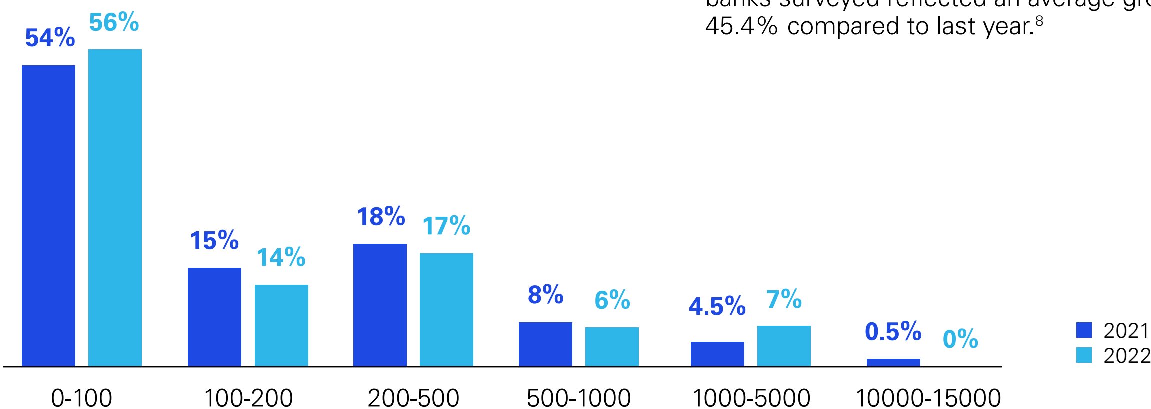


Source: KPMG/ALFI debt fund survey

Like last year, most funds range up to €100 million in size (Figure 7). Notably, mid-size funds — i.e. those with a net asset value of between €100 million and €500 million — represent 31% of the total number of debt funds. As of 31 July 2022, and based on CSSF data, the directly regulated market of debt funds (i.e. SIF, SICAR, Part II) represented around €77.1 billion AUM (compared to €67.6 billion of AUM in mid-2021). These numbers should however be taken carefully since these exclude AUM invested in RAIFs and other indirectly supervised and unregulated investment vehicles.

Based on the information received from the depositary banks, the total AUM as at 30 June 2022 for regulated funds and indirectly supervised investment vehicles is approximately €267.8 billion. Moreover, the depositary banks surveyed reflected an average growth in AUM of 45.4% compared to last year.[8]

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



Source: KPMG/ALFI debt fund survey

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

The voice of private debt managers

Roland Toppen
Chief Financial Officer
at MV Credit

What do you see as an important market trend in Private Debt offerings?

Private debt has evolved from a niche asset class to a vital portfolio allocation. We have seen that this asset class can generate consistent, stable returns when managers invest in non-cyclical industries and attractive businesses. Historically, private debt has provided returns with low volatility compared to other asset classes. We witness an important market trend of clients looking for a combination of private debt (yield), public debt (liquidity) with integrated ESG, offering private market access with some liquidity in an otherwise fully illiquid asset class. There are parties responding to this market trend by offering so called hybrid fund structures combining the returns of private debt investments with the liquidity offered by public debt investments and on top of that add ESG (SFDR 8) to this. In current market circumstances the need for more open ended (evergreen or open-ended) structures is considered very important by many institutional clients. Obviously, clients are looking at solutions in different currencies and in levered and unlevered offerings. We expect an increase in demand for these types of products as well as new investor types, such as non-institutional players.

Matthew Maguire
Director, Finance & Strategy and Head of ESG
at Park Square Capital, LLP

What is your view on the current implementation of ESG and SFDR on the market? Have you faced any challenge in implementing ESG-related KPIs

The integration of environmental, social and governance ("ESG") into the investment cycle across private asset classes has seen a material shift in recent years, with 75% of ManCos in Luxembourg now considering ESG as a cornerstone of their enterprise-wide strategy.

At Park Square Capital, we have considered ESG factors in our decision-making since inception, supplementing traditional financial analysis by reviewing management practices of material ESG factors. Our investment philosophy is deeply ingrained in fundamental credit analysis, understanding the downside risks and avoiding losses, as we believe this ultimately drives outperformance over the long-term. We support the notion that ESG issues are business issues that need to be properly evaluated and understood in order to make high-quality investments.

Global regulation has helped to drive ESG into the mainstream and Europe has arguably been leading the way. Since it was first announced in late 2019, the Sustainable Finance Disclosure Regulation ("SFDR") has become one of the most influential policies advancing ESG integration in financial markets. The regulation aims to establish a transparent and level playing field around the degree to which financial products have environmental and social characteristics or sustainable objectives by requiring standardised disclosures from asset managers at entity and product level. These disclosures allow financial market participants to directly distinguish and compare the ESG credentials of funds marketed in Europe which are classified as article 6, 8 or 9 depending on their level of ESG integration. Article 8 funds which promote environmental and / or social characteristics have become the benchmark for asset managers when establishing new products, with 45% of funds managed by Luxembourg ManCos classified as either article 8 or 9[1].

One of the key inputs required to make these disclosures is ESG data. The Principal Adverse Impact ("PAI") Indicators provide investors with a framework to assess the impact of external sustainability factors on prospective investments as well as existing portfolio companies. However, the mandated collection of this data presents a challenge for some managers that are faced with limited data availability. The ESG data gap is an issue not just for European asset managers subject to the SFDR, but asset managers all over the world, as corporate disclosures on ESG-related information are accelerating, driven by a combination of regulatory requirements, investor demand, and stakeholder pressures. At Park Square, we have seen a significant uptick in requests from our investors for fund-level and asset-level sustainability indicators, as they are also subject to emerging ESG regulation in their respective industries or regions. One of the key metrics that our investors are focused on is measuring greenhouse gas emissions, which is an important step towards long-term decarbonization and limiting global warming as laid out in the Paris Agreement.

The increasing demand for ESG data from regulators and investors was the catalyst for Park Square to distribute its first ESG questionnaire to all portfolio companies in late 2021. The questionnaire aligned with the template published by the Institutional Limited Partners Association's ("ILPA") Data Convergence Project, and nearly 70% of our portfolio of European borrowers completed it. As companies, funds and managers become more adept at collecting and reporting ESG data, and the issuance of ESG incentivized loans increases, we expect to see the response rate of our questionnaire closer to 100% in the coming years.

Park Square firmly supports the idea that greater consideration of ESG factors and associated transparency by both companies and investors is a positive given that what is bad for business from an ESG perspective is also likely to be bad for business from a credit investment perspective.

1. KPMG Luxembourg's Large-Scale Management Company Survey 2022

Andrew Haywood
CFO, COO and Partner
at Park Square Capital, LLP

Is this European Private Credit's Moment?

So far, 2022 has been a year of significant market volatility amidst an environment of higher inflation, rising interest rates, heightened geopolitical tensions and global economic slowdown. The 10-year US Treasury yield has more than doubled and the European Central Bank is raising rates quickly, which is a paradigm shift away from the accommodative monetary policy of the last decade.

The economic conditions are challenging, but we expect the demand for leveraged loan financing to remain strong. The private equity industry has record dry powder, M&A activity has slowed but not stopped, and banks are retreating ever further from corporate lending.

In this environment, we expect performance of private credit portfolios to be robust. Private loans are typically floating rate, have covenant protection and priority in capital structures. They also are shorter dated than bonds and are underwritten based on detailed due diligence of a business's prospects and cash flows.

These credit assets can deliver incrementally higher returns and current income as base rates increase whilst not materially increasing risk or reducing the current value of the asset. We believe that private credit, with its floating interest rate and priority in the capital structure, offers an attractive risk adjusted return compared to many other asset classes. Therefore, private credit should be a cornerstone of investors' balanced portfolios.

Private credit markets open for business & gaining market share

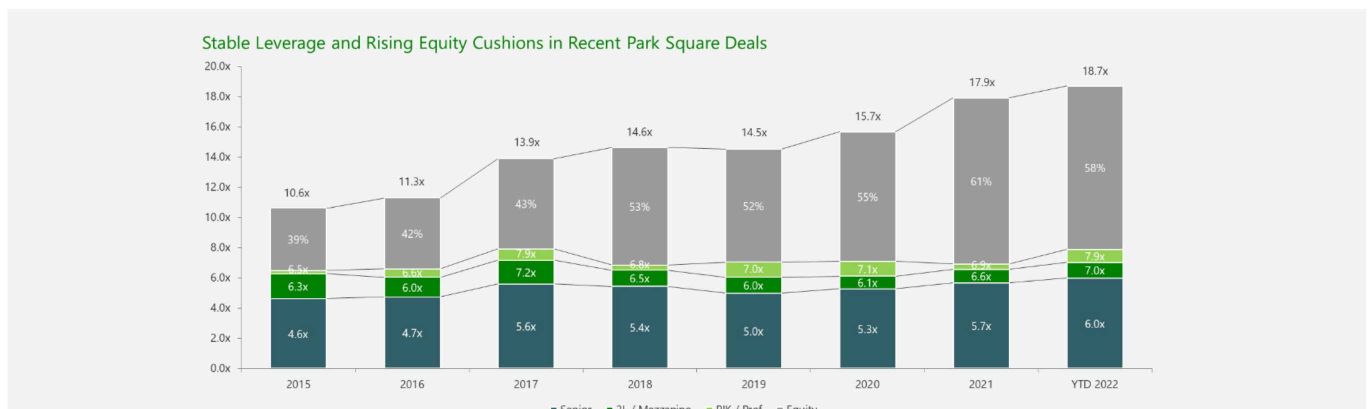
The broadly syndicated loan and bond markets rely on banks to function. A bank or banks will underwrite a deal and then look to sell to investors. In a volatile market like this one, banks are unwilling or unable to perform this function. Meanwhile, the private credit markets are open for business and gaining material market share.

Private equity sponsors often prefer privately placed funding of their deals, particularly in periods of market volatility. Private credit solutions are tailored on a deal-by-deal basis and provide flexible documentation, certainty of execution and pricing, with a greater ability to amend terms if the deal requirements subsequently change. These are all key advantages that users of leverage value highly.

According to market studies which track alternative lending, the proportion of investments funded by private credit versus banks has flipped from a 20/80% split in 2012, to a 80/20% split in 2021, a trend we expect to continue.

Why private credit offers attractive risk-adjusted returns

While valuations in leveraged buyouts have increased in recent years, debt multiples have remained broadly stable. The graph below shows the development of valuations and capital structures of Park Square's investments over a seven-year period. The average level of equity contribution



from private equity sponsors has increased from 39% in 2015 to 58% in 2022. Theoretically this implies that the company profitability or valuation would have to fall by more than half before the value of the debt would become impaired.

In an environment of rising interest rates, inflationary pressure, and market volatility, we believe that private credit - with its floating interest rate, priority in the capital structure and ~50% equity cushions - offers a compelling risk-adjusted return compared to other asset classes. In fact, the private credit industry is expected to continue to grow and displace banks as the primary lender to privately owned corporates. Therefore we believe that private credit should be a key part of an investor's balanced portfolio.

Delivering outperformance relies on experience

While the overall characteristics of the asset class are positive, we believe that the key factor in a private credit investors outperformance is its ability to avoid losses over the long term. The teams that will deliver risk-adjusted outperformance are expected to be highly experienced throughout multiple investment cycles, have a well-tested and diligent investment process and experience with work out and recovery processes. Low historic loss rates are a key indicator of a diligent investment process and a culture of learning from previous mistakes leading to the constant refinement of investment strategies. At Park Square, having invested over $21 billion across 190 companies over the past 17 years, we have developed a strong credit culture and a well-refined investment process, resulting in a strong track record which has been tested through multiple vintages and market conditions.

Private credit should outperform on a risk-adjusted basis in this market but picking the right investment manager with the experience to capitalise on the opportunity remains key.

Christian Borner
Managing Director and Head of Alternative Assets at UBS Luxembourg

What is your opinion on the upcoming AIFMD 2 update on Loan Originating Fund (i.e. LOAF) ?

More than ten years after the introduction of the original Alternative Investment Funds Manager Directive (AIFMD), the EU legislature is now at an advanced stage of introducing amendments which will update the provisions of AIFMD with a view to enhancing the Directive. The amendment proposals are commonly referred to as 'AIFMD 2'.

One of the key amendments relates to loan origination funds, which have experienced increased popularity in recent years. Recent figures and ongoing trends show that alternative funds like loan originating funds are an important source of financing for entities that have no access to bank lending. Private debt has grown in maturity and became complementary to public funding and bank loans.

While the Commission acknowledged that the AIFMD has "generally worked well", it found there were still difficulties in monitoring and managing financial stability risks, including regulatory fragmentation in the loan origination sector.

The proposed amendments to the regime are limited to specific aspects and mindful of the spirit of the AIFMD as a manager's directive not aiming to regulate AIFs themselves. In the evolution of the legislative proposals we further overserve willingness to remove unnecessary risk retention requirements and avoid the creation of product specific rules.

As regards the content of the proposed changes, we note that a number of details will have to be determined at level 2/3 such as e.g. exemptions for „shareholder loans" to ensure that private equity and venture capital funds do not inadvertently fall into the loan origination regime, effects of single borrower concentration rules based on capital, commitments or overall subscriptions, means of demonstration of liquidity robustness.

AIFMD 2 will introduce common minimal rules for loan-originating AIFs with a view to achieving a level playing field across all EU Member States. AIFMs managing AIF granting loans will be required to implement effective policies, procedures and processes for the granting of loans.

For depositaries, the continued growth and evolving complexity of private debt funds requires specialist know-how and a thorough understanding of the fund structures, investment strategies and the control environments for ensuring investor protection.

While AIFMD 2 may create additional requirements for market players, it may well create an opportunity for the Luxembourg fund industry to further develop its expert pool and strengthen its financial services infrastructure

We currently see a willingness to increase the distribution of AIF to retail investors, what is your opinion in this respect? Do you think the revised LTIF regime could achieve such target?

Managers of alternative assets have been looking to expand the investor universe for their funds to a retail audience for a number of years. The trend of retail investors seeking alternative sources of returns that can offer diversification from traditional markets has been noticeable. There is a convergence here and the alternatives industry has been looking to take advantage.

A number of solutions have emerged including liquid alternative funds – or liquid alts – which have become almost a staple in the Europe-domiciled fund market.

In 2015, the ELTIF regulatory framework has created the possibility to launch a new type of funds dedicated to long-term investments which can be distributed on a cross-border basis to both professional and retail investors. However, since its adoption, only a limited number of ELTIFs have been launched due to significant constraints in the distribution process and stringent rules on portfolio composition.

The European Commission's proposal promises to improve ELTIF's attractiveness by removing the unnecessary barriers to retail investors, broadening the scope of the current eligible asset universe, reducing the threshold of eligible investment assets and adopting adequate diversification and concentration limits.

The envisaged changes have already re-sparked the interest of European fund managers for the ELTIF. If implemented in accordance with the needs of market participant the product will unlock untapped potential and has the potential to further drive "retailization" in private markets.

Interview

Laetitia Hamon, Head of Sustainable Finance at the Luxembourg Stock Exchange

Laetitia Hamon
Head of Sustainable Finance
at the Luxembourg Stock Exchange

Laetitia, what was the stimulus for your interest in sustainable finance, and all subjects linked to ESG in general?

After completing a 3 months' internship in waste management in Benin, West Africa, my interest in sustainability became very strong. I started searching for a degree that would allow me to deep dive into the topic: that's when I integrated one of the first Masters in the field, around 16 years ago.

As a fresh graduate looking for a job, I quickly realized that most offers related to sustainable development were in the communication field, which to me, meant a lot as to how companies were considering the topic in general.

As I preferred action to communication, I turned to the financial sector because it had the biggest leveraging power to make things move. At the same time, it was also the most skeptical. Finding concrete elements to convince the sector that sustainable finance was neither a niche nor a fad was what drove me forward at the time. Trying to

explain the opportunities and benefits of sustainable finance still stimulates me every day.

In your opinion, how did the private debt industry adapt to ESG regulations, and what developments can we expect for this industry?

Like any other sectors, the private debt industry has seen ESG related risks and ESG related disclosures rising to the fore. Private debt had, and still has, an important role to play in the recovery of the economy in a post-COVID era, notably to offer loans to corporates that were hit hard by the pandemic.

Performing ESG due diligence can, not only mitigate risks in private debt structures, but also generate alpha in key sectors contributing to climate mitigation or climate adaptation. The role of private debt is also essential in emerging markets that are the most impacted by climate change and the most in need of financing.

Finally, we have observed, notably on the Luxembourg Green Exchange (LGX) some PE houses using sustainability-linked bonds (SLBs) to attract funding. Unlike green, social and sustainability bonds, SLBs do not raise financing for specific green or social projects; rather, they are general purpose bonds for which the issuers commit to achieving specific sustainability objectives by a set deadline. This is for instance the case of EQT. Its SLB is conditioned to the achievement of several Key Performance Indicators (KPIs) such as greenhouse gas (GHG) emission reduction targets for EQT AB's but also for its portfolio companies. Other KPIs include increasing the percentage of women independent board members appointed at certain EQT Funds' portfolio companies. This trend has been confirmed by an strong increase in SLB issuances.

The COVID-19 crisis has completely disrupted the agenda and priorities of government and regulation bodies over the past 2 years. How has this pandemic affected the ESG political agenda and the content of future regulations?

Between 2020 and 2021, the social ("S") component in ESG has gained momentum. The pandemic has prompted investors to really look at where their money is going, further increasing interest in impact investing pursuing social goals. When the COVID-19 pandemic started spreading across the world, there was an immediate uptick in social and sustainability bond issuances addressing the devastating socio-economic fallout from the crisis. From April to September 2020, LGX welcomed EUR 17 billion worth of social and sustainability COVID-19 response bonds, mainly from major development banks, and we waived the listing fee for eligible response bonds.

According to the Climate Bonds Initiative, issuances with social themes quadrupled in volume during the first half of 2021, when compared to 2020. More than 30% of these issuances have been issued by the EU under its SURE programme, whose goal is to help protect jobs and workers across Europe in sectors heavily impacted by the pandemic. These pioneer social bonds are all listed on LuxSE and displayed on the Luxembourg Green Exchange (LGX).

In 2021, sustainability-linked bonds also gained considerable traction with EUR 91 billion worth of issuances worldwide, representing a tenfold increase from 2020. Issuances in the first half of 2022 suggest that SLBs are set to be the fastest growing GSSS bond category in 2022, as the issuer pool continues to diversify due to the increasing importance of transition financing. In terms of amount raised, SLBs listed on LuxSE and displayed on LGX in the first half of 2022 doubled compared to the same period in 2021.

Where do you see the industry to move over the next 12 month?

As a stock exchange our role not only involves stepping in to promote green finance and reorientating capital flows to sustainable projects but also strengthening environmental disclosure, growing green dialogue, and ensuring education around sustainable finance.

In November 2021, during COP26, we joined the Net Zero Financial Service Providers Alliance (NZFSPA) part of the broader Glasgow Financial Alliance for Net Zero (GFANZ). Service providers, and especially stock exchanges like LuxSE, have a crucial role to play in accelerating the transition to a low-carbon and more inclusive economy. We are currently working towards net zero emissions within our own operations and just as importantly, we are committed to ensuring our products and services support a high ambition, engaging with all our clients and stakeholders on sustainability matters and supporting them in defining credible pathways to net zero GHG emissions.

After COP26, it became even clearer that the private sector must lead the way and continue to set ambitious plans for the financing of activities with positive social and environmental impacts. Global challenges require collective responses, and global coalitions such as NZFSPA can inspire action and accelerate the climate transition across our industry.

In the next 12 months, I expect all financial market players to continue moving away from "thinking" and "pledging". It is now time to take concrete actions, as well as to actively set out transition plans, targets, and ambitious deadlines for the industry key players' own internal operations, investments, lending and funding practices.

ESG integration for private debt - the challenge of data collection

Over the past few months, European asset managers have been busy reshaping their investment products and strategies to ensure they comply with Sustainable Finance Disclosure Regulation (SFDR) rules and improving their data quality to meet future reporting needs.

While most sustainability investment funds — namely those classified as SFDR articles 8 and 9 — have a high exposure to equities, asset managers are increasingly considering changing their private debt funds into SFDR article 8 funds. However, this can be challenging, due to the difficulty of collecting the necessary data to measure and disclose the Principal Adverse Impact (PAI) of investments not measured at the issuer level.

For SFDR article 8 funds, asset managers must integrate environmental and/or social characteristics into their investment strategy by using defined indicators to measure these characteristics. In addition to these minimum requirements, and to better market their product to investor and under the second Markets in Financial Instruments Directive (MiFID II), asset managers can also include in their investment strategy, the PAI consideration, the proportion of the investment qualifying as sustainable under the SFDR or meeting the EU Taxonomy Regulation's criteria.

These requirements complicate the data flow that asset managers receive and process for private debt funds. For example, in June 2022, the European Securities and Markets Authority (ESMA) communicated that PAI indicators must be directly retrieved from underlying assets. This poses a problem for loans for which no direct environmental, social and governance (ESG) data is disclosed. Even though reasonable assumption can be used to assess PAI, there is no standardized market practices complexifying the impact comparison.

As a result, asset managers overseeing private debt funds need to consider and measure E or S characteristics based on the issuers' ESG performance and implement adequate due diligence processes to collect data from underlying asset.

Another option for asset managers is to directly invest in debt products that qualify as sustainable, such as sustainability-linked loans. However, those assets are not yet well developed nor standardized at EU market level, increasing the risk of greenwashing.

Regarding derivatives, swaps or other types of instruments, regulators do not currently consider them ESG-eligible assets. Therefore, private debt funds with a high proportion of these instruments could be challenged by local regulators regarding their depth of ESG integration.

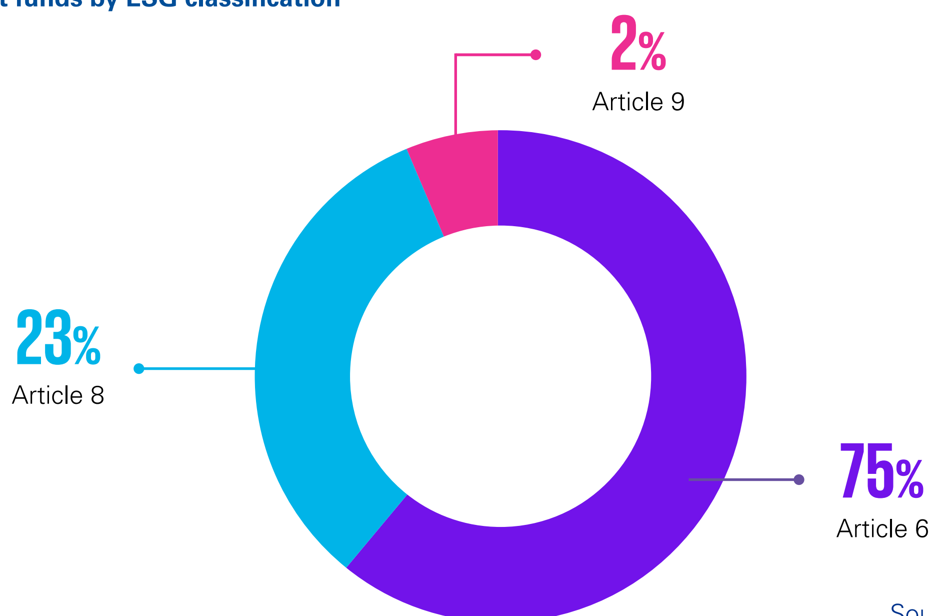
The move to article 8 SFDR classification is the first step in private debt funds' ESG journey. With the application of the SFDR's level 2 rules, the increase in reporting transparency, the need to measure impact to better market products under MiFID II and the rising regulatory scrutiny, asset managers must be ready to tackle the ESG private debt challenge.

This will require asset managers to adapt their due diligence process, work closely with intermediaries to collect more accurate ESG data, and adapt their portfolios to integrate sustainable investments. Asset managers will also need to communicate clearly on their on ESG and SFDR strategy to their investors and demonstrate achievement of the strategy for avoiding the risk of Greenwashing.

ESG classification

In this year's survey, we also included a specific question in relation to the ESG classification of the funds under the Sustainable Finance Disclosure Regulation (SFDR) (Figure 8). While the classification of the funds according to SFDR is still ongoing, for the funds for which we received the information, most of the funds are classified under article 6 (75%), followed by article 8 (23%) and article 9 (2%). Article 6 covers funds which do not integrate any kind of sustainability into the investment process. Article 8 are funds which promote environmental or social characteristics, or a combination of both, and article 9 are funds which must have a sustainable investment objective. We expect funds classified under article 8 and 9 to surge in the coming years.

Figure 8:
Debt funds by ESG classification



Source: KPMG/ALFI debt fund survey

ESG cornerstone in investor's demands

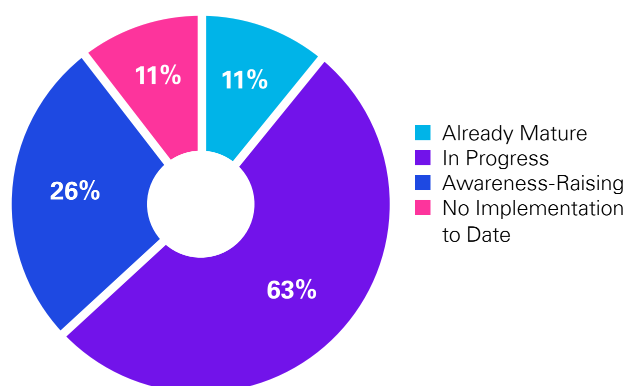
Lenders are utilizing sustainability-backed loans to incentivize middle-market companies to bolster their ESG procedures, and are customizing loans to be more sustainable. This ESG push comes as a response to growing demand among investors:

80% of investors claim that ESG is a vital factor in their investment decision making*.

50% of investors said they were willing to divest their capital from companies that were slacking on ESG issues*.

500Mn Target size of a new "Circular Plastic Fund" set up in collaboration by Lombard Odier and Alliance (currently fundraising)

Fund Manager Views on Where They are in the ESG-Implementation Lifecycle



Regardless of the clear appetite from investors for an ESG centered offering, there is still plenty of work to do towards reaching the maturity seen in other markets.

Only 11% of fund managers claim that their ESG integration in private debt funds is mature.

Some peers have already started focusing on ESG in private debt such as Allianz IG, which has set up a new unit in its sustainable investment division focusing on private markets.

*Source: Preqin's 2022 Investor Survey

Let's tokenize it!

Tokenization is spearheading the emergence of a new internet — the internet of value — impacting the centralized model of online value management. It offers natively digital, decentralized and peer-to-peer services accessible to all, challenging banks' business models and the financial sector's barriers to entry.

What is tokenization?

Tokenization is the creation of a digital representation (token) of a real-world object, such as a shareholding, debt instrument, an Andy Warhol painting, or a Ferrari F12. While all tokens are a digital representation of value that can be digitally traded or transferred, they can be classified into the following categories:

- Security tokens that are on-chain digital representations of underlying off-chain securities, such as private debt fund units, debt portfolios, or sui-generis financial instruments.
- Utility tokens that provide access rights to certain services or privileges, such as Filecoin (FIL) or a Basic Attention Token (BAT).
- Exchange tokens that are used as a form of payment, such as Bitcoin, Litecoin or Ethereum.

A token may hold the rights and features of multiple categories over time, and their characteristics may be so specific and unique to make them non-fungible (NFTs). However, all tokens result from the establishment of a legal link between the physical asset and its representative digital token.

Luxembourg will play a significant role in the tokenization of the private debt industry, either through tokenizing (i) the debt investment vehicle or (ii) the debt instrument itself.

The tokenization of vehicles holding debt portfolios

The alternative investment industry is increasing its focus on tokenizing units and shares of investment vehicles. In September 2022, KKR & Co. partnered with Securitize LLC, a leading digital asset securities firm, to tokenize an interest in KKR's Health Care Strategic Growth Fund II on the Avalanche public blockchain. While in Luxembourg, Natixis Asset Management announced a testing phase of FundsDLT's fund distribution platform in 2021, paving the way for the tokenization of investment fund and vehicle units.

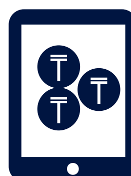
Beyond the typical advantages of tokenization, which include speed, convenience and accessibility, using blockchain technology to distribute investment vehicles has two main benefits:

1. **Disintermediation:** smart contracts enable programmable actions that can automate processes, such as maintaining the shareholder registry. They can also replace expensive functions like clearing and settlement and the use of transfer agents and intermediaries, such as distributors and placement agents. Removing these go-betweens can allow a (quasi) direct relationship with mass affluent investors, reducing costs and creating big economies of scale as a result.
2. **Instant settlement time:** tokens can be traded 24 hours a day and 7 days a week, with records updated within minutes or hours (depending on the underlying blockchain) simultaneously with valuations, compared to traditional T+3 and T+4 settlement times

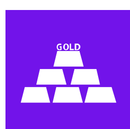
Representation of a real asset on the blockchain

Tokenization

2343823438448838333389485712571234



Realestate



Precious metals

Contracts and certificates

Bonds - equity

Tokenization of private debt portfolios

Despite private debt's recent popularity and significant opportunities, it still faces many challenges common to other asset types, including complex deal origination and low liquidity.

Tokenizing a private debt portfolio could deliver the following advantages:

1. **Reduction of loan origination, due diligence and monitoring costs:** private debt may be less transparent than public debt, as borrowers' P&L and balance sheets tend not to be circulated by data companies. Blockchain's transparency and trustworthiness can help issuers and investors reduce the costs of burdensome loan origination and due diligence processes, including sourcing, deal history and company analysis, as well as the continuous research of borrowers. This time and cost savings result in margin increases that can be leveraged to increase yields. For borrowers, the possibility to circulate their P&L and balance sheet data may help them access a wider investor base and reduce their financing costs.
2. **Increase of liquidity:** liquidity is a debt portfolio's ability to be readily converted into cash without affecting its market price. Tokenization slightly increases this liquidity and allows investors to quickly sell the token on the secondary market.
3. **Reduction of barriers to entry:** blockchain technologies powered by smart contracts can operate as transparent and honest market makers and connect small-to-medium-sized enterprises (SMEs) to lenders worldwide without using intermediaries. Borrowers could request loans from lending platforms instead of banks, giving them access to a greater portion of investors at better rates.

Entity type	Digital asset service regulation and requirements
Securitization vehicles	Allowed to invest directly or indirectly in virtual assets when dealing with nonprofessional customers and pension funds
UCITS and UCIs	Not allowed to invest directly or indirectly in virtual assets when dealing with nonprofessional customers and pension funds
AIFs	May invest directly (and indirectly) in virtual assets if their units are marketed only to professional investors.
Initiator	The initiator of an AIF must present each new project to the CSSF beforehand.
AIFM	If an AIFM manages an AIF that invests in virtual assets, the AIFM must obtain an authorization extension from the CSSF for this new investment strategy, called other-other fund virtual assets. It must amend its investment policy and control functions, for example to cover volatility, liquidity and technical risk. The investment fund manager (IFM) must be involved in the control of and access to cryptographic keys. The IFM needs to register as a virtual asset service provider (VASP) if providing any other services related to virtual assets.[1]
Fund depositaries	The IFM must select an eligible depositary and custodian for the virtual assets.

Conclusion

Currently, private debt investment involves multiple intermediaries, high costs and poor liquidity. Tokenization tackles these challenges by allowing economies of scale with disintermediation and increasing liquidity. In this respect, tokenization provides a technological advantage to asset managers, helping them become more versatile and competitive.

1. CSSF guidance on virtual assets - CSSF.
1. KKR Makes Piece of PE Fund Available on Public Blockchain - WSJ.
1. News - Natixis Asset Management to test blockchain with FundsDLT (next-finance.net).
1. BNP Paribas Asset Management, CAIA Association, and Liquefy Publish Research on the Future of Tokenisation in Alternative Investments | CAIA.

The "unshell" directive (ATAD 3)

On 22 December 2021, the European Commission issued a proposal for a Directive to fight the use of shell entities and arrangements for tax purposes (the third Anti-Tax Avoidance Directive, or ATAD 3). Based on this proposed text, we expect that the European Union's (EU) Member States will need to transpose ATAD 3 by 30 June 2023, with an application from 1 January 2024.

The ATAD 3 sets out a list of features, called "gateways", to filter entities at risk of lacking substance. High-risk entities — that meet all three gateways based on a self-assessment and do not benefit from a carve-out — will be required to report on their substance through their annual tax returns.

Companies that fall short of ATAD 3's substance indicators would be deemed "shell entities". Unless they can rebut this presumption, these entities would be denied certain tax benefits otherwise available through double tax treaties (DTTs) and EU directives. The data reported by in-scope entities would be covered by the automatic exchange of information between Member States and may be subject to tax audits.

The following areas of the draft proposal are particularly relevant to the alternative investment industry:

Carve-out: the draft ATAD 3 provides specific carve-outs for:

- regulated financial undertakings, e.g. regulated investment funds organized as specialized investment funds (SIFs) or reserved alternative investment funds (RAIFs)
- holding companies with no or limited cross-border elements — e.g. that manage domestic operational businesses — provided their beneficial owners are tax resident in the same jurisdiction, or where their shareholder or ultimate parent entity is resident in the same Member State
- entities with at least five qualifying full-time employees (FTEs), e.g. a master Luxembourg holding company with five FTEs.

Gateways: entities not in scope of any applicable carve-outs are required to self-assess their profile against ATAD 3's three gateways, assessed through a 2-year look-back period:

1. an income test: the entity would need to realize passive income, such as interest and dividends
2. a cross-border element: if most of the entity's revenue is generated from cross-border transactions, or the income is passed on to foreign entities
3. management and administration: the entity would need to outsource the administration of day-to-day operations and the decision-making on significant functions.

While we expect the alternative investment industry to meet the first two gateways easily, the third remains a key indicator to assess any potential reporting obligations.

The draft ATAD 3 does not clearly define the concept of outsourcing; however, both internal (agreement with associated enterprises[2]) and external delegation schemes (trust companies) seem to be generally targeted.

Therefore, Luxembourg SPVs must have sufficient internal resources to perform (i) the day-to-day management of the company and (ii) decision-making on significant functions. Regarding the latter, it is essential to focus on the composition and procedures of the boards of managers or directors.

If the third gateway is not met, reporting obligations and unfavorable tax consequences should not, in principle, be triggered under ATAD 3. However, as domestic tax laws may be more stringent, a specific impact study may be required for each relevant Member State.

2. It is interesting to note the European Parliament has proposed to exclude delegation to associated enterprises (resident in the same country as the reporting undertaking) from the outsourcing concept.

Impact on the private debt fund industry

According to the findings of KPMG Luxembourg's 2022 substance survey, private debt funds have a tendency to outsource more, with fewer FTEs per general partner on average compared to private equity and real estate funds. This is driven by several factors, including cost due to the loan origination business' low margins, and the higher volume of transactions.

Consequently, although the private debt segment also has the lowest average number of special purpose vehicles (SPVs) compared with private equity and real estate funds, private debt fund structures that use SPVs should carefully monitor ATAD 3's implementation[3].

For structures without SPVs, we expect ATAD 3's impact on the private debt industry to be limited, in practice, because:

— most regulated or indirectly supervised private debt funds are established as SIFs or RAIFs, which are expected to benefit from the regulated entity carve-out if they qualify as "undertakings"

— the unregulated private debt fund market's entity of choice is the Luxembourg SCSp, which would not benefit from double tax treaties and EU directives in any case.

At any rate, the full effect of ATAD 3 on the private debt fund industry will not be known until its final text is approved. In this respect, the European Parliament has proposed to postpone ATAD 3's application until 2025.

---

3. The European Parliament has also proposed to extend the "regulated entity" carve-out to SPVs held by regulated entities, which, in practice, could significantly reduce any of ATAD 3's potential effects on entities held by regulated private debt funds

Viewpoint: quotes from depositaries

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

"2022 has demonstrated a shift in preference amongst managers from participation in broadly syndicated loans to focus on direct lending and private debt transactions. Concerns in liquidity, the current inflationary environment as well as looming default rates will likely continue the trend of a move way from leveraged loan products through 2023. Administrators and asset servicers with expertise and technology that can support funds that are transitioning into the direct lending space will be in high demand."

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

"The last year witnessed continued growth for Luxembourg private debt investment funds across primary, secondaries and recoveries strategies. A more challenging global macro environment coupled with tightening in monetary policy will present both future challenges and opportunities. The broader macro economic challenges may manifest in higher default risks necessitating carefully constructed legal covenants to protect lender interests. The opportunities for credit funds may be found in the form of higher floating rate environments and continued borrower appetite for specialist and bespoke credit arrangements. For depositaries who are required to carry out the asset safekeeping and oversight, it is important to ensure continued focus on innovation and local expertise and skillsets to meet the growing demand and complexities of the success of alternative funds in Luxembourg."

Catherine Gauthier
Associate,
Brown Brothers Harriman
Luxembourg SCA

"Against the backdrop of the recent macro-economic turbulence in Europe, the shape of private investing is changing. Private Credit continues to grow in both popularity and deal size as borrowers turn to non-bank lenders as a source of financing. The syndicated loan market has slowed down, and according to LSTA statistics, the market size of Private Debt is estimated to be US$1 – 2 trillion, equal to or greater than that of Syndicated Loans. New opportunities are emerging in Europe where we are seeing an increase in direct lending opportunities in the small to mid-market sector.

Managers are differentiating by launching innovative products such as liquid multi-strategy credit funds, and co-mingled products with private-public portfolio mixes. The growing trend of retail and high net-worth investors who are increasingly attracted to private markets are driving managers to launch hybrid products such as ELTIFs and Evergreen funds, pushing the boundaries between traditional liquid and private market funds. ESG continues to play a significant role in investor reporting due to an increase in the regulatory reporting obligations for institutional investors. These trends have created a need for transparent reporting, with a greater focus on data and a high degree of operational efficiency.

Finally, as talent and resourcing continue to be a challenge, managers are seeking technology driven solutions to build scalable operating models and support these increasing demands for transparency in reporting."

Disclaimer: The views and opinions expressed are for informational purposes only and do not constitute investment or legal advice and are not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Views and opinions are current as of the date of the publication and may be subject to change.

Serge Weyland
Chief Executive Officer Edmond De Rothschild Asset Management (Luxembourg)

"We have seen continued growth in the private debt assets space. This growth has been especially strong in the infrastructure private debt sub-segment with strong net inflows coming from the DACH region. Furthermore, Luxembourg continues to be a domicile of choice for the private debt asset class."

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

"After coming out of the prolonged uncertainty of COVID, markets continue to rebound for demand of alternative private credit assets. Given the strong performance of the asset class and limited credit impairment, we continue to see outsized demand globally for the asset class. The challenge of keeping pace from a staffing and technology perspective continues, but with the right strategic plans and targeted investments, private credit managers and their investors can continue being strongly supported in 2023 and beyond."

Charly Guyot
Global Head of Loan Solutions of BNP Paribas, Succursale de Luxembourg

"Despite tough and volatile macro events, Private Debt fundamentals remain robust with significant growth expected by 2025. Increasing regulation on banks, shrinking balance sheet for the debt side, retail access and strong performance will keep propelling the asset class momentum."

Christian Borner
Head of Asset Servicing UBS Europe SE, Luxembourg Branch

"Alternative lending has grown considerably in Europe in recent years, with private debt developing into an established asset class in its own right, matching the needs of institutional investors and companies alike. The ability to service this business and its increasingly sophisticated clients efficiently and flexibly, is a key success factor amongst Luxembourg depositaries and service providers.
Even in a more challenging market environment the strong position of Luxembourg as a financial center will continue to create significant opportunities within the alternative asset industry and particularly in private debt."

Guillaume Castel
Head of Alternatives Luxembourg, State Street Bank International

"Investor appetite for private debt shows no sign of slowing down, despite interest rates increasing across the world. The Luxembourg market remains very attractive for institutional investors who continue to show interest in unregulated fund structures such as RAIF and SCSP, as well as considering launching European Long-term Investment Funds given the recent regulatory changes adopted by the EU authorities."

Guglielmo Manzoni
Head of Depositary and Fiduciary Services, HSBC Continental Europe, Luxembourg

"In the last few years investors have been looking for returns above the standard market interest rates and borrowers for a nimbler and more optimised way to get credit than traditional sources. The combination of private debt funds meeting this specific market demand together with Luxembourg developing an attractive regulatory framework and flexible legal structures, has been a tremendous element of expansion in the area of private debt funds for Luxembourg. In the private debt space, the integration of specialised service providers (i.e., fund administration, loan agency, loan administration, SPV accounting, banking solutions and depositary) into an efficient and seamless platform covering the end to end process and reporting for fund initiators is a clear differentiator in successfully meeting the loan funds service demand. The distinctive advantage of having fund administration and loan agency/administration services linked and integrated to one another is to reduce substantially the heavy administrative burden typically associated with private debt assets; it is also a key factor for the Depositary to be able to perform its monitoring duties in an effective way and ensure robust controls and protection of such assets."

Disclaimer: The views and opinions expressed are for informational purposes only and do not constitute investment or legal advice and are not intended as an offer to sell, or a solicitation to buy securities, services or investment products. All the information set out in this quote is provided on the best of HSBC's current knowledge and understanding of the relevant law, rules, regulations, directions and guidelines governing. HSBC makes no guarantee, representation or warranty and accepts no liability as to its accuracy or completeness. Future changes in such law, rules, regulations etc. could affect the information in this document but HSBC is under no obligation to keep this information current or to update it."

Regulatory outlook

Loan origination under AIFMD 2

To date, the EU lacks a common framework for loan-originating funds. With some countries implementing national regimes for alternative investment funds to originate loans, fund managers face a patchwork of requirements when overseeing cross-border funds.

In August 2020, the European Securities and Markets Authority (ESMA) sent a letter to the European Commission advocating for a specific loan origination framework within the Alternative Investment Fund Managers Directive (AIFMD) due to the potential role of debt funds in a post-COVID environment.

The European Commission took stock of ESMA's views, and the proposed AIFMD 2 introduces a new framework with common minimal rules for loan-originating alternative investment funds (AIFs). The proposal's key features include:

- requirements for annually reviewed policies and procedures for credit granting, credit risk assessment, administration and monitoring of loan portfolios
- limits on loans to one single borrower (20%) that applies from the date set in the prospectus until the fund starts to sell or redeem after the end of its life, and may be suspended up to 12 months when the AIF raises additional capital
- a 5% retention requirement on originated loans
- a closed-ended AIF is mandatory when the AIF engages in significant loan origination that exceeds 60% of the AIFs' net asset value
- a ban on lending to the AIFM's staff, depositary and delegates.

In July 2022, the European Parliament issued its latest draft report, and the European Council reached a compromise text for trilogue negotiations between the European Council, the Parliament and the Commission regarding the AIFMD 2's final version. While the European Council proposed several positive amendments, it also introduced some controversial additions. The text will likely undergo further changes during the trilogue proceedings, with some proposals being modified or dropped or others introduced. Given the legislative process' usual length, it's expected the AIFMD 2 won't come into force before 2025.

ELTIF 2

While the EU is still developing its framework for loan-originating funds, fund managers can already avail of the European long-term investment fund (ELTIF) Regulation. ELTIFs can grant loans across the EU to borrowers that meet the regulation's "qualifying portfolio undertaking" criteria, and benefit from a distribution passport to both professional and retail investors.

However, these advantages are balanced with some constraints. ELTIFs must follow strict portfolio diversification requirements and be managed by a specially authorized AIFM. They are also subject to rigorous and complex rules regarding distribution to retail investors.

Mainly due to these rigid requirements, the number of ELTIFs has remained modest. However, we're now seeing an emergence of ELTIFs in parallel to institutional loan funds, granting access to a new investor base demanding long-term investment solutions that impact the real economy.

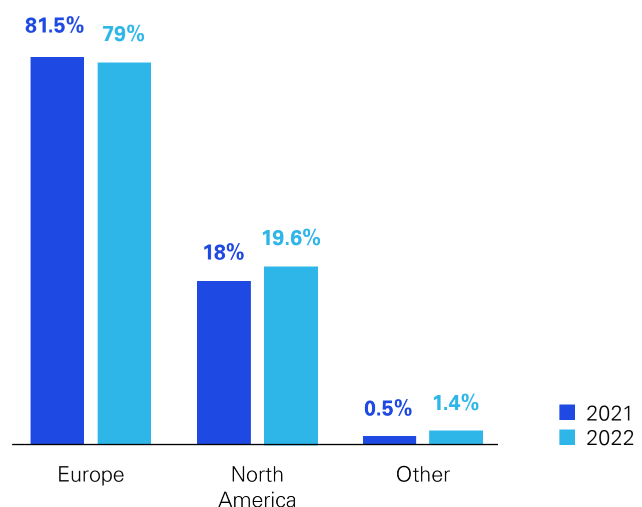
The EU is currently reviewing the ELTIF Regulation, and it is expected to provide more flexibility to ELTIFs and ease portfolio diversification and distribution rules. This should brighten the future of these structures and offer an alluring option to managers of loan-originating funds.

Overview of key data

Initiator origin

Similar to last year, the vast majority of debt fund initiators (promoters) in Luxembourg are from the EU, distantly followed by those from North America (Figure 11). Most of the initiators come from the UK (43.3%), followed by USA (19.6%) and Germany (14.2%) with only less than 1% coming from Luxembourg.

Figure 11:
Initiators - origin by region



Source: KPMG/ALFI debt fund survey

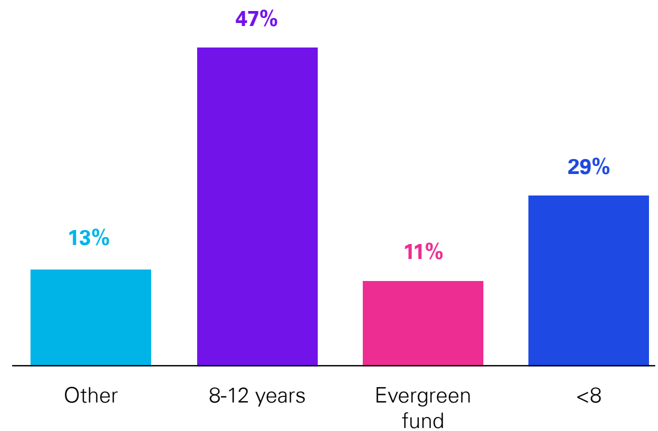
Investments per fund and holding period

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

Based on the information gathered, the average number of investments per fund is 52.

Regarding maturity, 47% of the funds have maturities between 8 and 12 years and 29% of the funds have maturities below 8 years (Figure 12). Regarding the maturity strategy, most of the investments are held to maturity (98%) with only a small percentage held for trading (2%).

Figure 12:
Debt funds by maturity

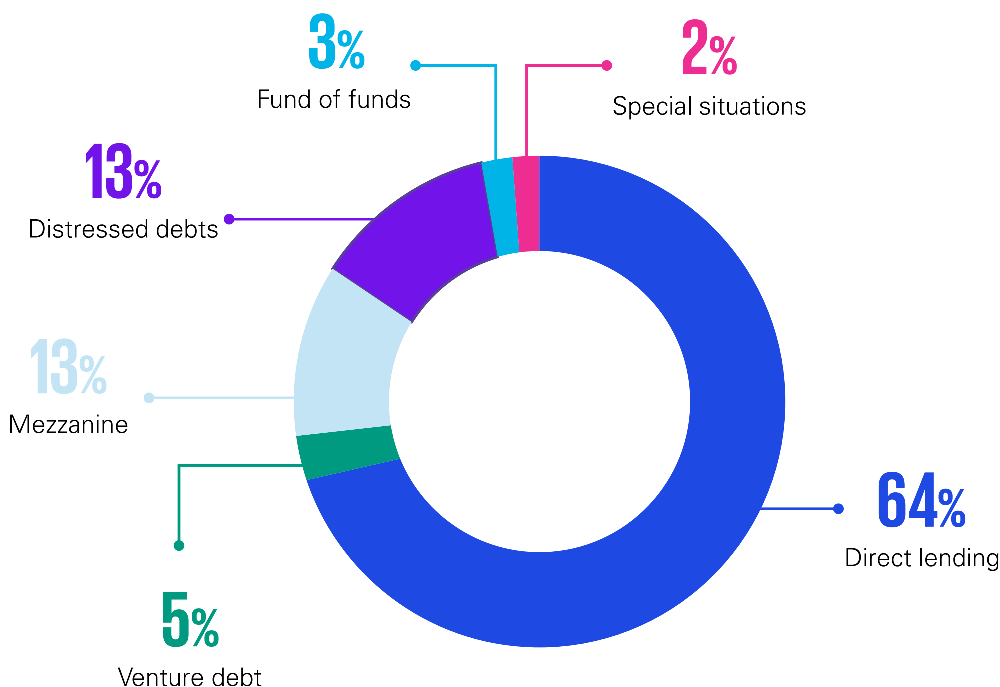


Source: KPMG/ALFI debt fund survey

Investment strategy

The investment strategy of Luxembourg debt funds is mainly focused on three debt strategies (Figure 13): direct lending (64%), distressed debt (13%), and mezzanine (13%). Compared to last year, this reflects a decrease in direct lending (-8%), and an increase in distressed debt (+1%), mezzanine (+2%), and venture debt (+4%).

Figure 13:
Debt funds by investment strategy

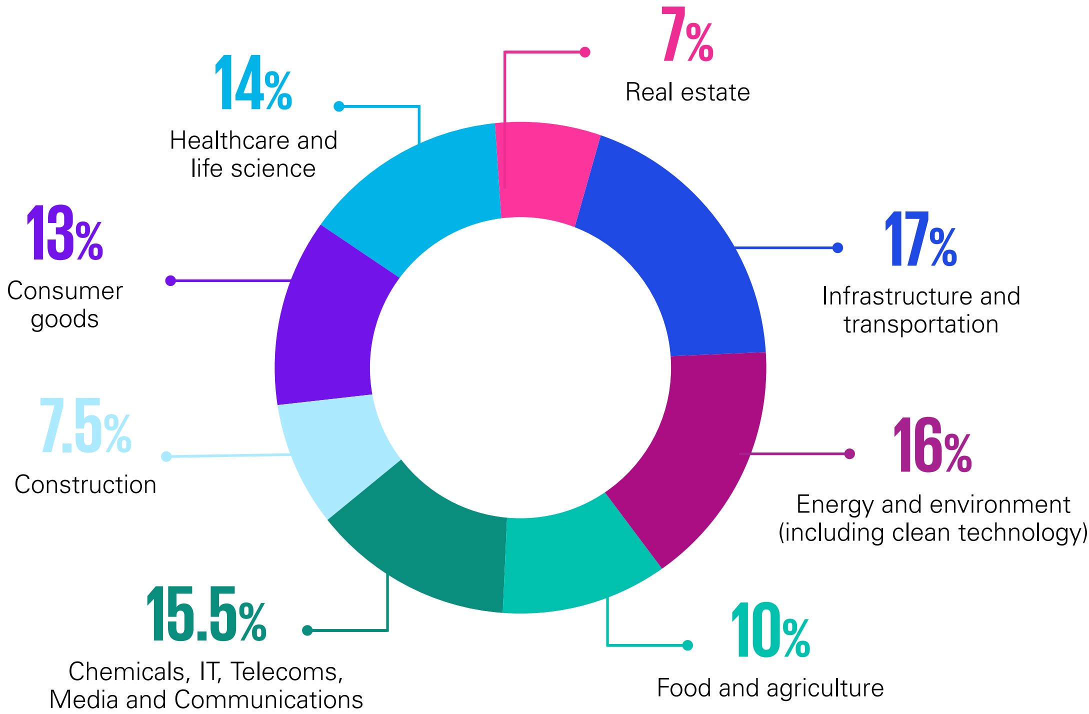


Source: KPMG/ALFI debt fund survey

Sector financed

Like in last year's survey, we included a specific question in relation to the sector financed. As reflected in Figure 14, there is an equilibrium between Infrastructure and transportation (17%), Energy and environment (16%), Chemicals, IT, Telecoms, Media and Communications (15.5%) and Healthcare and life science (14%).

Figure 14:
Debt funds by sector financed

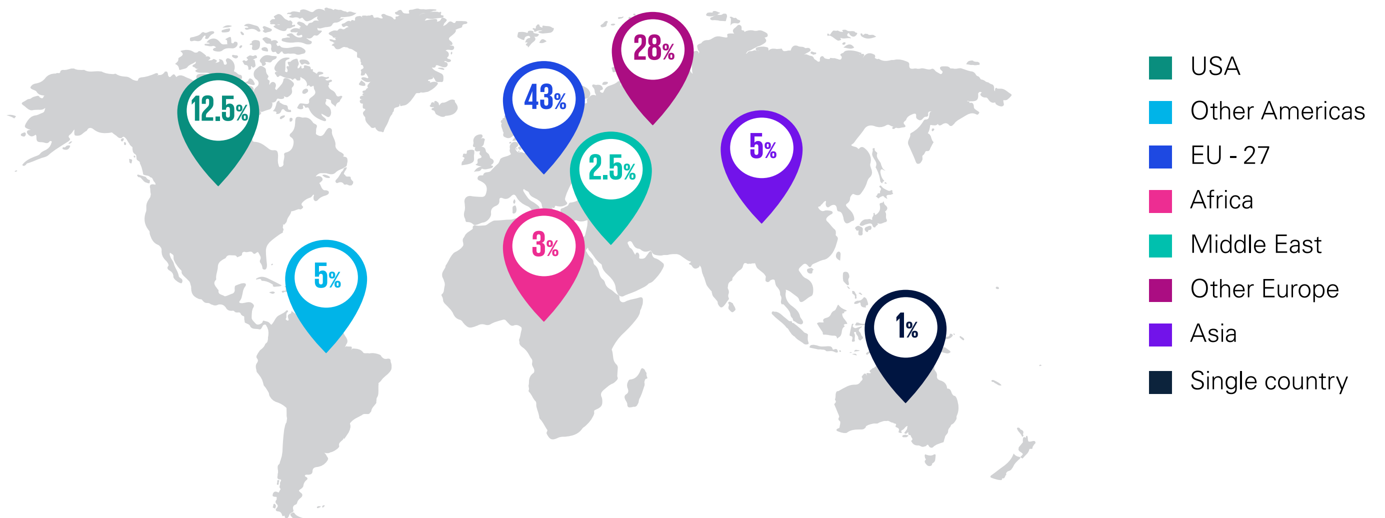


Source: KPMG/ALFI debt fund survey

Geographical investment target

Most debt funds (99%) have a multi-country investment approach. Similar to last year, the preferred investment targets (Figure 15) are in the EU (43%), other European countries (totaling 28%) and North America for 12.5%.

Figure 15:
Debt funds by geographical investment targets



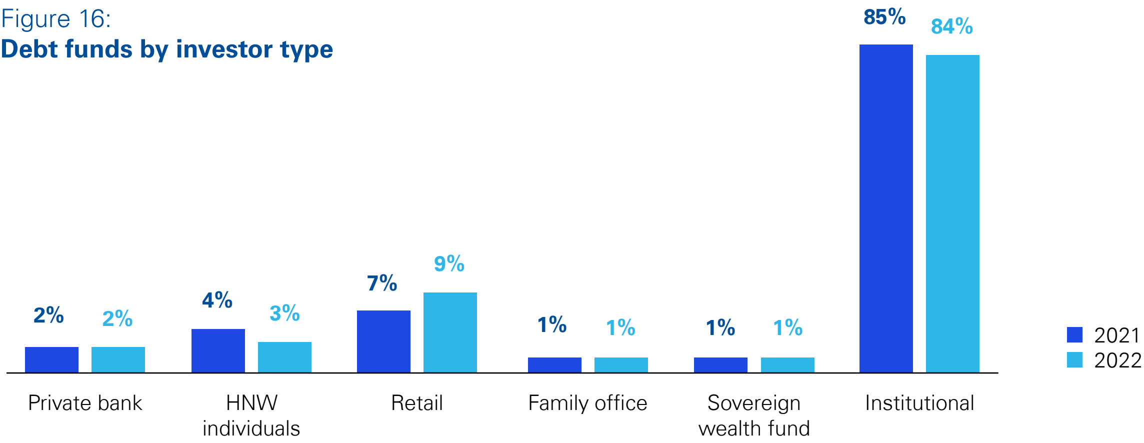
Source: KPMG/ALFI debt fund survey

Investor type and origin

Similar to last year, the main type of investors are institutional investors (84%), followed by retail investors (9%) and high-net-worth individuals (HNWIs) (3%) (Figure 16). Compared to last year, the percentage of institutional investors decreased (-1%) as well as HNWI (-1%), while retail investors increased (+2%). Most of the institutional investors are pension funds or insurance companies (51%).

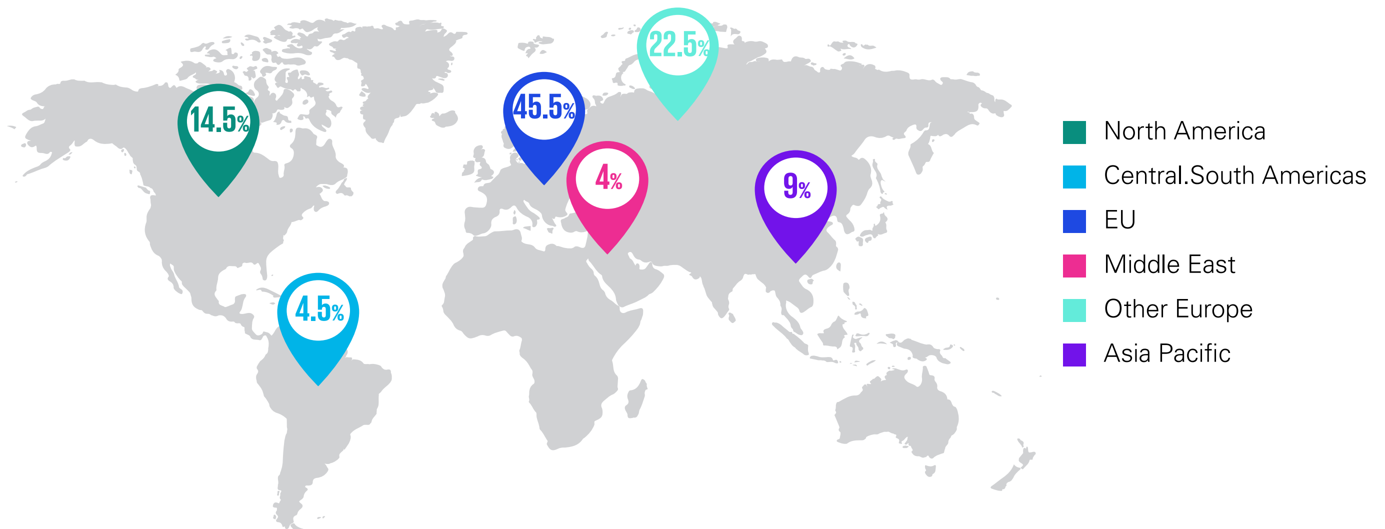
Similar to last year, these investors are mainly from EU countries (Figure 17). Seventy-six percent of funds have between 1 and 25 investors per fund (Figure 18).

Figure 16:
Debt funds by investor type



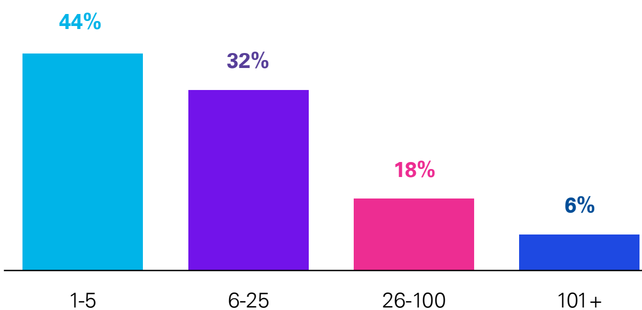
Source: KPMG/ALFI debt fund survey

Figure 17:
Debt funds by investor origin



Source: KPMG/ALFI debt fund survey

Figure 18:
Debt funds by number of investors

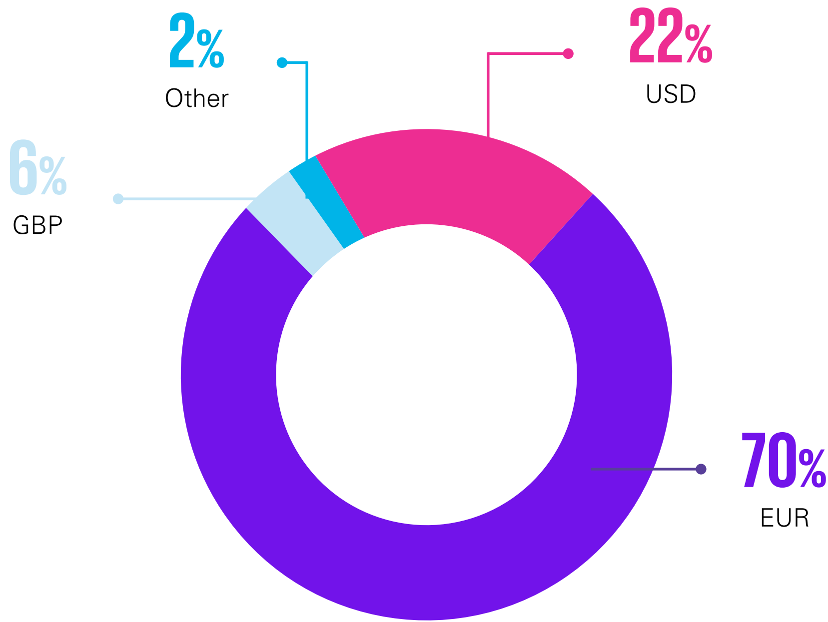


Source: KPMG/ALFI debt fund survey

Financial statements

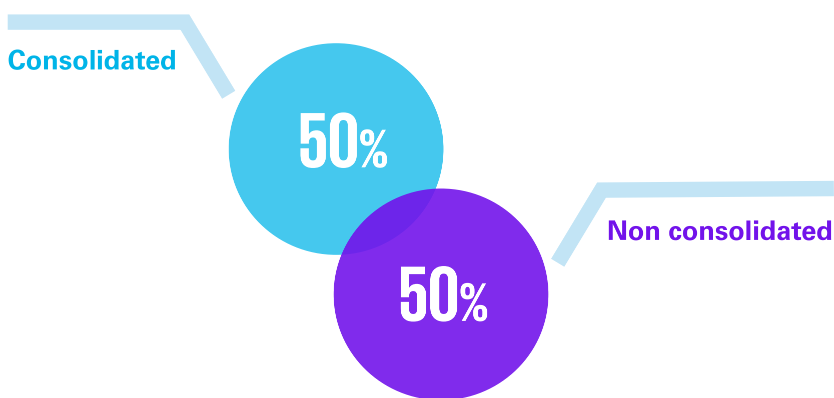
Like last year, the financial statements of Luxembourg debt funds are mostly prepared in euros (70%), closely followed by US dollars (22%) (Figure 19). Half of the funds (50%) consolidate their assets (Figure 20).

Figure 19:
Debt funds by currency



Source: KPMG/ALFI debt fund survey

Figure 20:
Debt funds consolidation

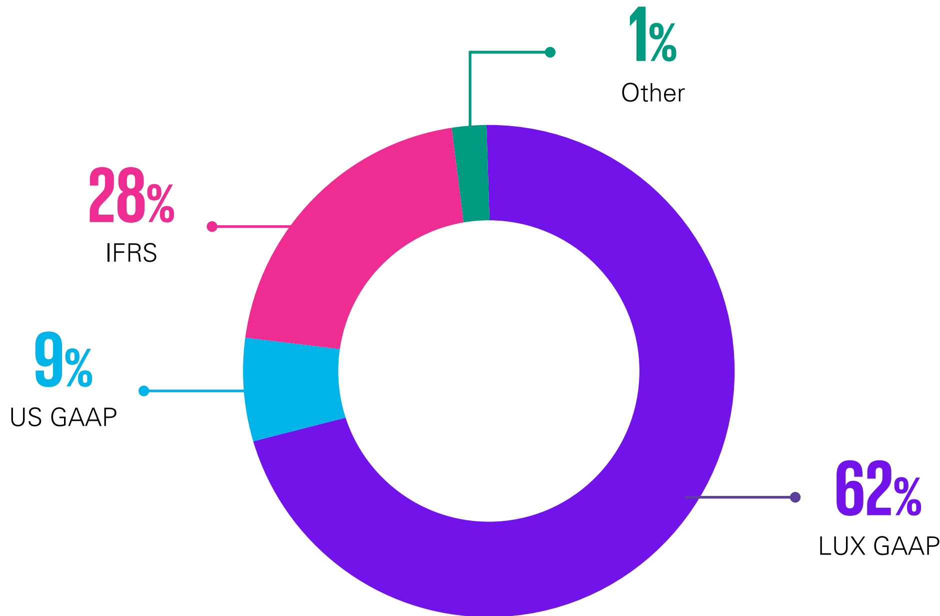


Source: KPMG/ALFI debt fund survey

Valuation methodology

The most popular valuation method used is fair value (66%), followed by cost less impairments (25.5%) and amortized cost (8.5%) (Figure 21).

Figure 21:
Accounting standard

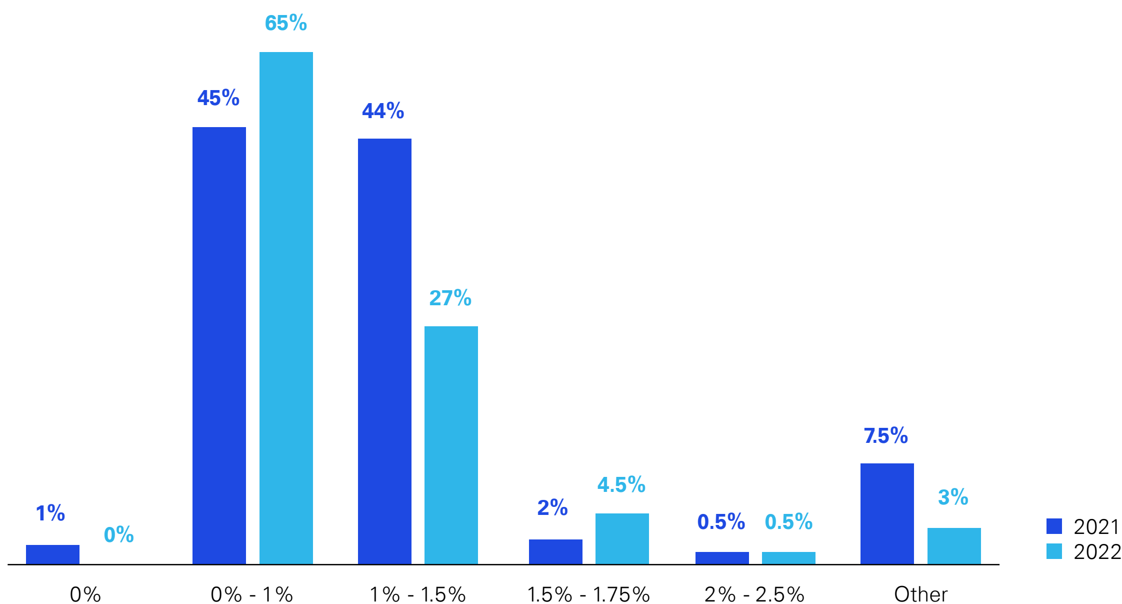


Source: KPMG/ALFI debt fund survey

Management fees

Like last year, management fees typically lie between 0% and 1.5%, with a small proportion above 1.5% (Figure 22).

Figure 22:
Debt funds by management fee charged

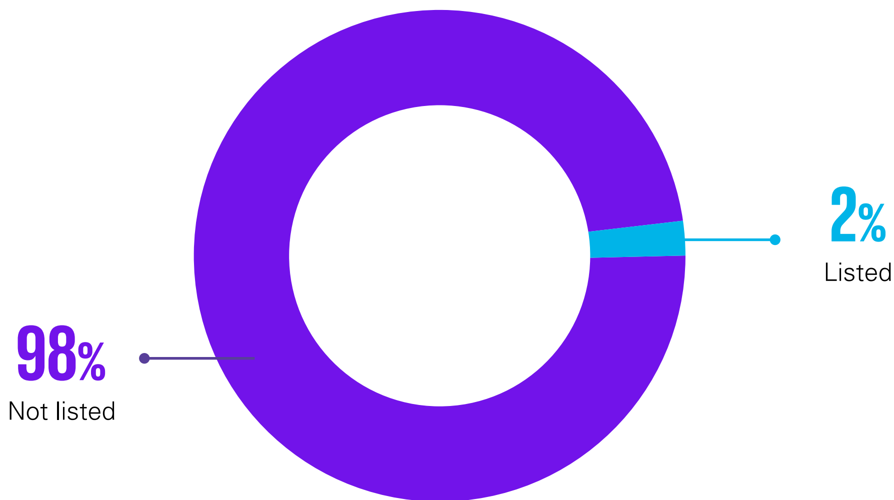


Source: KPMG/ALFI debt fund survey

Other information

Only a small percentage of funds (2%) are listed on a stock exchange (Figure 23). Furthermore, 76% of the funds do not use Separately Managed Accounts (SMA).

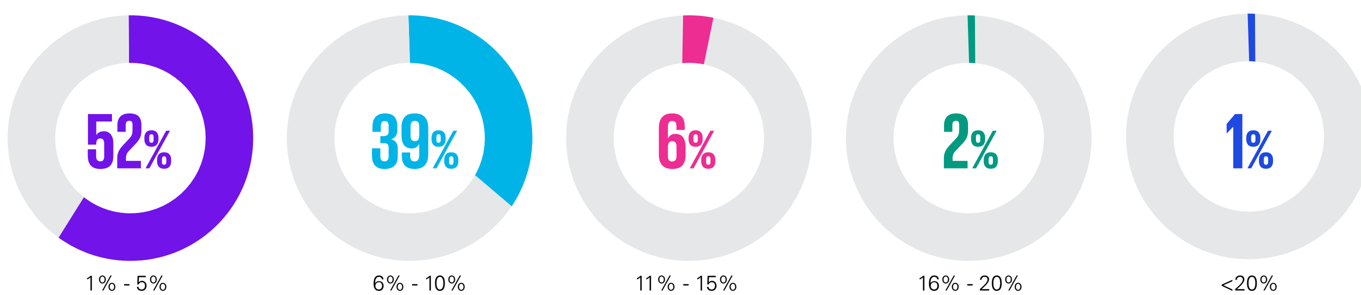
Figure 23:
Proportion of debt funds listed on a stock exchange



Source: KPMG/ALFI debt fund survey

Most of the funds have an expected return between 1%-5% (for 52%), followed by return between 6%-10% (for 39%) (Figure 24).

Figure 24:
Expected return



Source: KPMG/ALFI debt fund survey

About this research

Objectives

This study has two main objectives:

- Interpret current behaviors and structuring trends in private debt funds in Luxembourg and predict where they are headed.
- Provide qualitative insights based on numerical data.

Methodology

We received data from 11 depositaries acting on the market and representing 905 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 38 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.

The following depositaries/depositary banks were surveyed:

- Alter Domus
- Brown Brothers Harriman Luxembourg
- BNP Paribas, Succursale de Luxembourg
- The Bank of New York Mellon
- Citco Fund Services
- Citibank Europe
- Edmond De Rothschild Asset Management
- J.P. Morgan Bank
- HSBC Continental Europe
- UBS Europe
- State Street Bank

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 July 2022

Contact

Valeria Merkel
Partner Audit,
Public and Private
Asset Management &
Co-Head of Private Debt
T: +352 22 51 51 - 6732
E: valeria.merkel@kpmg.lu

Julien Bieber
Partner Tax,
Alternative Investments &
Co-Head of Private Debt
T: +352 22 51 51 - 5599
E: julien.bieber@kpmg.lu

KPMG Luxembourg, Société anonyme
39, Avenue John F. Kennedy
L-1855 Luxembourg

T: +352 22 51 51 1
F: +352 22 51 71

www.kpmg.lu

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.
© 2022 KPMG Luxembourg, Société anonyme, with registered office at 39, Avenue John F. Kennedy, L-1855 Luxembourg, registered with RCS Luxembourg under number B149133, and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.