association of the
luxembourg fund industry

DEBT FUNDS

An expanding asset class and alternative source of financing for the European economy

MAY 2023

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Introduction

Facts on non-banking credit intermediation

Non-bank credit intermediation in Europe represents a sizeable opportunity for debt fund managers. Tighter banking regulations and higher capital ratios imposed on banks have significantly reduced bank lending in Europe since the financial crisis of 2007-2008. Since then, non-bank credit has expanded rapidly, now exceeding bank credit in advanced economies and in the EU. Covid has recently also put pressure on bank balance sheets and reinforced the role of private lending to support the real economy together with large-scale government stimulus programmes worldwide. The past months have been marked by geopolitical uncertainties, rising interest rates and inflation. Private lending should nevertheless be fairly crisis-resistant and immune to inflation as it largely relies on floating rate characteristics and shorter maturities than traditional fixed income instruments.

Although a potential stagflation may ultimately lead to increasing pressure for borrowers to serve debt obligations and lead to increasing defaults, private lending is by design well equipped to endure sustained periods of high inflation while still providing investors with attractive risk-return opportunities.

Debt funds play an important role in addressing the imbalance in liquidity supply/demand and helping businesses raise capital and stimulate economic growth. Regulated funds or AIFs managed by a regulated AIFM provide an ideal tool and framework for non-banking financing solutions.

Debt funds and banks are working together to finance the real economy by providing capital to SMEs such as the German “Mittelstand” and investments in infrastructure, real estate assets etc. Bank lending alone will not provide the economy with the financing needed for a strong and rapid rebound[1].

Liquidity will also be needed in stress situations and times of rapid growth.

In the European Commission’s “Investment Plan for Europe”, measures like the implementation of the European Long-Term Investment Funds (ELTIF) Regulation were presented, which entered into force in 2015.

On 15 February 2023, the EU adopted the revised ELTIF framework (ELTIF 2), which is expected to enter into force in 2024. ELTIF 2 will provide ELTIFs with more flexibility and ease portfolio diversification and distribution rules. This should brighten the future of these structures and offer managers of loan-originating funds an alluring option.

In August 2020, 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. Once adopted, 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.

The Securitisation Regulation[2] created a general framework for EU securitisation structures and a specific framework for simple, transparent and standardised (STS) securitisation transactions – principally aiming at establishing a more risk-sensitive prudential framework for STS securitisations. Securitisation is a tool that, inter alia, can help mitigate credit supply problems by allowing banks to refinance loans, diversify their funding and benefit from capital relief. Luxembourg offers a dedicated and recently renewed legal framework for securitisation that goes beyond the EU definition and is often used in debt fund structures.

While the classification of the funds according to the Sustainable Finance Disclosure Regulation (SFDR) is still ongoing, most of the Luxembourg private debt funds are classified under article 6 SFDR (75%), followed by article 8 SFDR (23%) and article 9 SFDR (2%). Article 6 SFDR covers funds which do not integrate any sustainability factors into the investment process. Article 8 funds are those which promote environmental or social characteristics, or a combination of both, and article 9 funds must have a sustainable investment objective. We expect funds classified under article 8 and 9 to surge in the coming years. The lack of data across all markets but probably more specifically in private markets might be a driver for many market players to opt for article 8 instead of article 9 at this stage. The SFDR “Level 2” Regulation should provide the industry with the clarity it needs to move forward.

1 – Final report of the High-Level Forum on the Capital Markets Union, “A new vision for Europe’s capital markets”, June 2020.

2 – Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.

Why Luxembourg

With an average growth of 45.4% in assets under management (AuM) in Luxembourg compared to 2021, debt funds are one of the fastest-growing segments in the alternatives space[3]. The period between June 2021 and June 2022 also saw an increase in the overall size of the private debt market in Luxembourg, with total AuM reaching a record EUR 267.8 billion[4] (taking into account regulated funds and indirectly supervised investment vehicles).

The key benefit of Luxembourg is the quality on offer within its entire financial framework which includes flexibility and certainty of structures along with efficient management of complex cross-border distribution.

Placed at the heart of Europe, Luxembourg is ideally positioned to help global debt funds deal with the complexity of European financial market rules and regulations. Luxembourg is a stable and trusted jurisdiction, including with respect to taxation. The Luxembourg regulator explicitly confirmed that AIFs may engage in loan origination and loan participation/loan acquisition[5].

With over 71% of Luxembourg private debt funds being used to invest within the EU, and 79% of the investors coming from EU, Luxembourg is indubitably the ideal platform for pan-European and global marketing, with a proven track record in cross-border distribution. It can rely on more than 30 years of experience in supporting and servicing debt funds.

Over 90% of the top 30 debt fund managers worldwide are present in Luxembourg, and this is not expected to change[6]. Luxembourg offers an unparalleled breadth of solutions for debt funds. Luxembourg debt funds can originate loans[7], participate in loans and accommodate all types of debt strategies, including investments in secondaries, mezzanine and distressed loans.

Debt funds may be regulated or unregulated and may take any legal form permissible in Luxembourg, as a stand-alone fund or with compartments, whether they are open-ended, semi open-ended or closed-ended.

The most popular private lending vehicles amongst the Luxembourg toolbox are currently the Luxembourg Specialised Investment Fund (SIF) and the Luxembourg Reserved Alternative Investment Fund (RAIF). 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 and has been available for a decade.

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. The last years have seen a decrease of the launch of SIF vehicles in favour of RAIFs (i.e. from 67% SIFs in 2020 to 49% in 2022, and 28% RAIFs in 2020 up to 45% in 2022)[8]. RAIFs are expected to continue this level of growth in the future.

The Luxembourg special limited partnership (société en commandite spéciale – SCSp) remains the preferred unregulated vehicle for private debt fund managers (i.e., 85% of unregulated private lending vehicles are currently SCSp).

Within a debt fund structure, securitisation vehicles subject to the Luxembourg law of 22 March 2004 on securitisation are widely used as access or feeder vehicles. With the 2022 amendment of the law, Luxembourg securitisation vehicles have become even more flexible and can now, among other things, be 100% loan-financed and accommodate active management of debt portfolios.

Luxembourg is understandably proud of its flexible and clear legal framework for structuring and operating alternative investment funds. This is further reinforced by the longstanding and trusted relationships that exist between the Luxembourg regulator and regulators from other countries.

Luxembourg has the ability and track record to attract a highly educated talent pool from neighbouring countries, the rest of the EU and the world, with a multitude of nationalities (170) and languages spoken in Luxembourg.

Finally, Luxembourg is at the forefront of digitalisation and artificial intelligence development to support sustainable growth of the debt fund industry. The use of blockchain technology in the private debt landscape will certainly play a key role in the digitalisation of the asset class in the coming years.

3 – ALFI/KPMG Private debt funds survey 2022, page 5.

4 – ALFI/KPMG Private debt fund survey 2022, page 10. The survey is based on data from 11 depositaries acting on the market representing 905 funds (or sub-funds) investing in private debt.

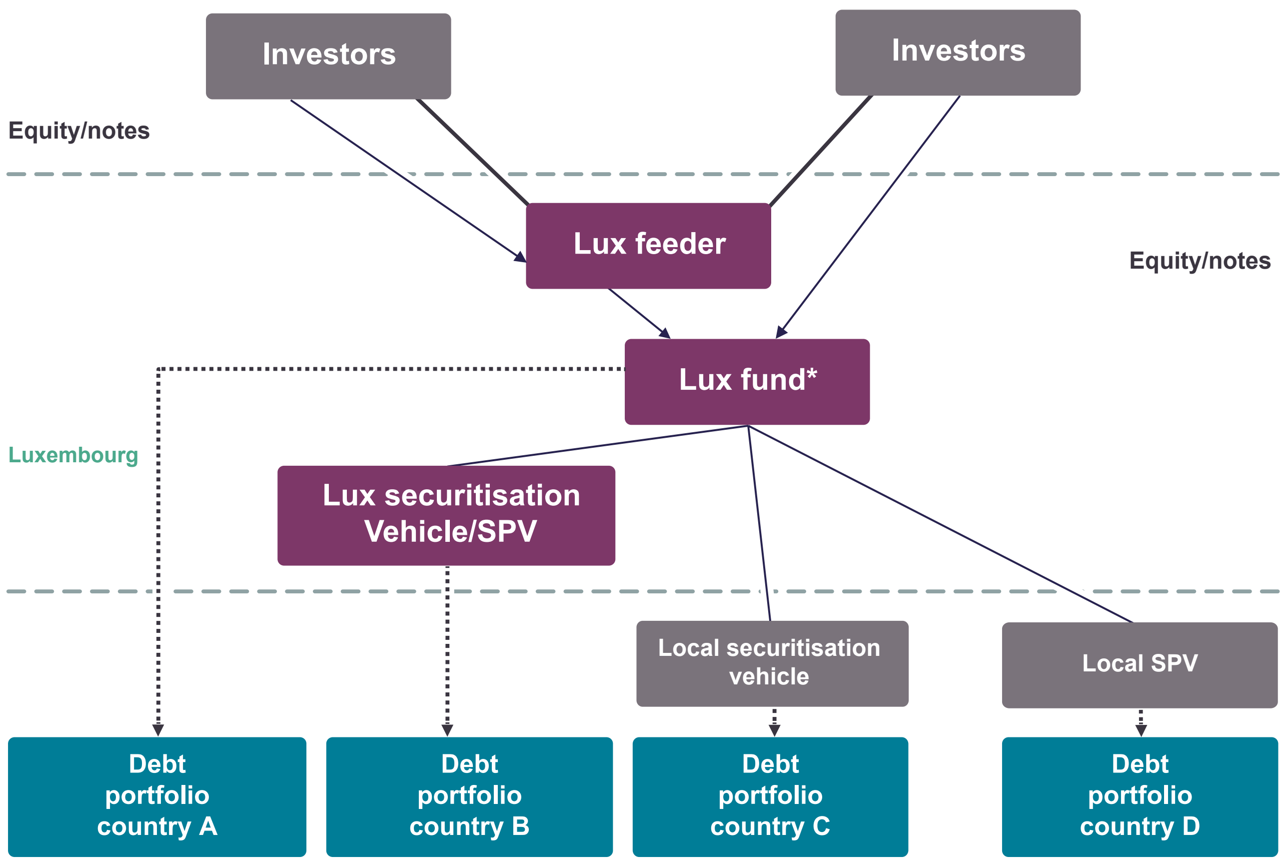
5 – See [CSSF FAQ on the AIFM law](#).

6 – This is the result of information included in the ALFI/KPMG Private debt fund survey 2022 compared to Private Debt Investors (PDI) data.

7 – No loans may be made to retail borrowers.

8 – ALFI/KPMG Private debt fund survey 2022, pages 8-9.

Example of a typical debt funds structure



** The Lux fund could take various forms. It could be a vehicle approved and supervised by the CSSF (e.g. under part II of the 2010 law or as a SIF or SICAR) or not (e.g. as a RAIF or as a company/partnership not governed by the RAIF law).*

Please see the comparative tables on the following pages. A Luxembourg fund may also be invested in through a feeder vehicle, depending on the investors' profiles.

Legal considerations

		Limited partnership[9]	SIF	SICAR
Distribution	EU passport[10]	Yes	Yes	Yes
	Private placement[11]	Yes	Yes	Yes
	Reverse solicitation[12]	Yes	Yes	Yes
Types of targeted investors	Professional investors	Yes	Yes	Yes
	Non-professional (retail) investors	No	Yes[13]	Yes[13]
Structuring	Types of companies	Limited partnerships[14]	Limited companies Limited partnerships[14]	Limited companies Limited partnerships[14]
	Contractual vehicles	No	Mutual funds	No
	Umbrella structures	No	Available	Available
	Open-ended[15] and closed-ended nature	Available	Available	Available
	Listing	Available	Available	Available
	Service providers	Depositary (if managed by a fully authorised AIFM)	Central administration Depositary based in Luxembourg	Central administration Depositary based in Luxembourg
Issue of securities	Equity (E)/debt (D) type securities	E/D	E/D	E/D
Diversification requirements		Not applicable	30% maximum in securities of the same type (e.g. of the same bonds issuer)[16]	No requirements
Techniques and strategies	Secondary market	Yes	Yes	Yes
	Origination	Yes	Yes	Yes
Eligible assets	Senior and junior loans Partly drawn credit Receivables Revolving credit Securitised debt Whole loans Unitranche debt Mezzanine debt	Yes	Yes	Yes (provided that the beneficiaries/ underlying assets constitute risk capital)
Supervision and auditor	Supervision of the vehicle	No	Yes	Yes
	AIFM supervision	AIFM registration regime or fully authorised AIFM regime (passports)	AIFM registration regime or fully authorised AIFM regime (passports)	AIFM registration regime or fully authorised AIFM regime (passports)
	Auditor	Only if managed by a fully authorised AIFM	Yes	Yes
Financial reporting	Accounting standards	IFRS, LuxGAAP or US GAAP	IFRS, LuxGAAP or US GAAP	IFRS, LuxGAAP or US GAAP
	Valuation of the loans: fair value or amortised cost?	Both are possible under certain circumstances	Fair value (unless different method provided for in the constitutive documents)[17]	Fair value

9 – Not subject to the SIF, SICAR, RAIF, UCI Part II and Securitisation law.

10 – Upon appointment of an EU authorised AIFM.

11 – National non-EU and EU rules apply, as the case may be.

12 – Reverse solicitation: is not a means of distribution per se since it is assumed that the potential investor approaches the fund/asset manager without any solicitation made by the fund/asset manager.

13 – to the extent that they qualify as "Well-Informed Investors"

14 – Limited partnerships (sociétés en commandite simples - SCS) with legal personality and special limited partnerships (sociétés en commandite spéciales - SCSp) without legal personality are the preferred legal forms for unregulated AIFs, but other legal forms may also possibly be opted for (such as limited companies like the corporate partnership limited by shares (société en commandite par actions - SCA), the public limited liability company (société anonyme - SA), or the private limited liability company (société à responsabilité limitée - S.à r.l.).

15 – For open-ended funds, due attention must be paid to liquidity management and to avoiding maturity transformation.

16 – See guidelines on risk diversification as detailed in CSSF Circular 07/309.

17 – Fair value is the best market practice for open-ended funds.

Legal considerations (continued)

		RAIF	Securitisation vehicles (subject to the law of 22 March 2004, as amended)	UCI part II funds (subject to part II of the law of 17 December 2010)
Distribution	EU passport[10]	Yes	Subject to conditions of the Prospectus Regulation[18]	Yes
	Private placement[11]	Yes	Yes	Yes
	Reverse solicitation[12]	Yes	Not applicable[19]	Yes
Types of targeted investors	Professional investors	Yes	Yes	Yes
	Non-professional (retail) investors	Yes	Yes (may trigger CSSF supervision)[13]	Yes[13]
Structuring	Types of companies	Limited companies Limited partnerships[14]	Limited companies and partnerships	For SICAVs/SICAFs: Limited partnerships Common funds
	Contractual vehicles	Mutual funds	Securitisation funds	Mutual funds
	Umbrella structures	Available	Available	Available
	Open-ended[15] and closed-ended nature	Available	Available	Available
	Listing	Available	Available	Available
	Service providers	Central administration Depositary based in Luxembourg	Custodian for liquid assets (only for supervised securitisation vehicle)	Depositary based in Luxembourg (if managed by fully authorised AIFM), Central administration
Issue of securities	Equity (E)/debt (D) type securities	E/D	E/D (incl. full loan financing)	E/D
Diversification requirements		30% maximum in securities of the same type (e.g. of the same bonds issuer) (a SIF-like RAIF) unless the RAIF decides to opt for the SICAR tax regime whereby it shall invest in qualifying risk capital (a SICAR like RAIF)	Not applicable	Risk diversification requirements are detailed in CSSF Circular 91/75 and are less stringent than the ones in application for UCITS. Specific restrictions are contained in • CSSF Circular 91/75 for funds investing in venture capital, futures, options, and real estate • CSSF Circular 02/80 for funds adopting an alternative investment strategy
Techniques and strategies	Secondary market	Yes	Yes	Yes
	Origination	Yes	Yes (restricted)	Yes
Eligible assets	Senior and junior loans	Yes (provided for the SICAR-like RAIF that the beneficiaries/ underlying assets constitute risk capital[19])	Yes	Yes
	Partly drawn credit			
	Receivables			
	Revolving credit			
	Securitised debt			
	Whole loans			
	Unitranche debt			
	Mezzanine debt			
Supervision and auditor	Supervision of the vehicle	No	No (unless securities are issued to the public on a continuous basis)	Yes
	AIFM supervision	Fully authorised external AIFM regime (passports)	No (unless SV qualifies as AIF)	AIFM registration regime or fully authorised AIFM regime (passports)
	Auditor	Yes	Yes	Yes
Financial reporting	Accounting standards	IFRS, LuxGAAP (or US GAAP)	LuxGAAP or IFRS	IFRS, LuxGAAP or US GAAP
	Valuation of the loans: fair value or amortised cost?	Fair value (unless different method provided for in the constitutive documents)[16]	Both are possible	Fair value (unless different method provided for in the constitutive documents)

18 – Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

19 – Not applicable for securitisation vehicles falling outside the scope of the AIFMD.

20 – Criteria defining "risk capital investments" are included in CSSF Circular 06/241.

About ALFI

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community, championing sustainable investing, mainstream and private assets. ALFI's mission is to promote Luxembourg as the world's leading cross-border investment fund centre, facilitate the transition towards more sustainable economies globally and empower investors to meet their goals.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

ALFI's mission is **lead industry efforts to provide solutions and make Luxembourg the most innovative international investment fund centre**.

Its main objectives are to:

Help members capitalise on industry trends

ALFI's many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond, to identify threats and opportunities for the Luxembourg fund industry.

Shape regulation

An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg's competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision making through relevant input for changes to the regulatory framework, implementation of European directives and regulation of new products or services.

Foster dedication to professional standards, integrity and quality

Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organising training at all levels, defining codes of conduct, transparency and good corporate governance, and supporting initiatives to combat money laundering.

Promote the Luxembourg investment fund industry

ALFI actively promotes the Luxembourg investment fund industry, its products and its services. It represents the sector in financial and in economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry. ALFI is an active member of the European Fund and Asset Management Association, of the European Federation for Retirement and of the International Investment Funds Association.

To keep up with all the news from ALFI and the fund industry in Luxembourg, follow us on LinkedIn, Twitter (@ALFIfunds), YouTube and Flickr.

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