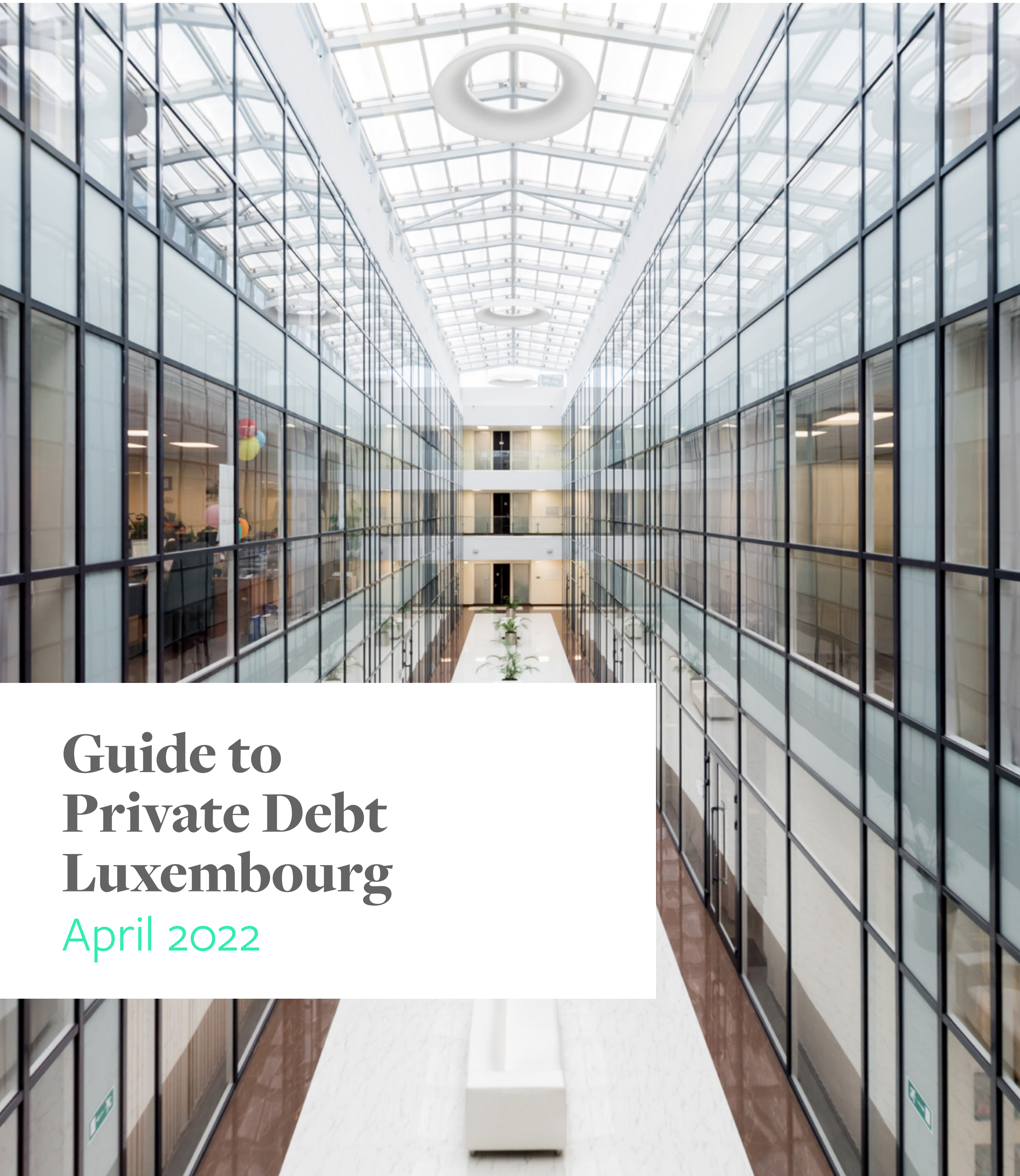


Guide to Private Debt Luxembourg

April 2022

Fund administration: how private debt stacks up

Private debt is increasingly seen as an asset class with high potential. Also described as non-bank lending, alternative lending, or private credit, private debt is an asset class comprised of higher-yielding, illiquid investment opportunities, typically targeting middle-market corporates across a wide range of strategies and risks, from senior secured debt to distressed debt.

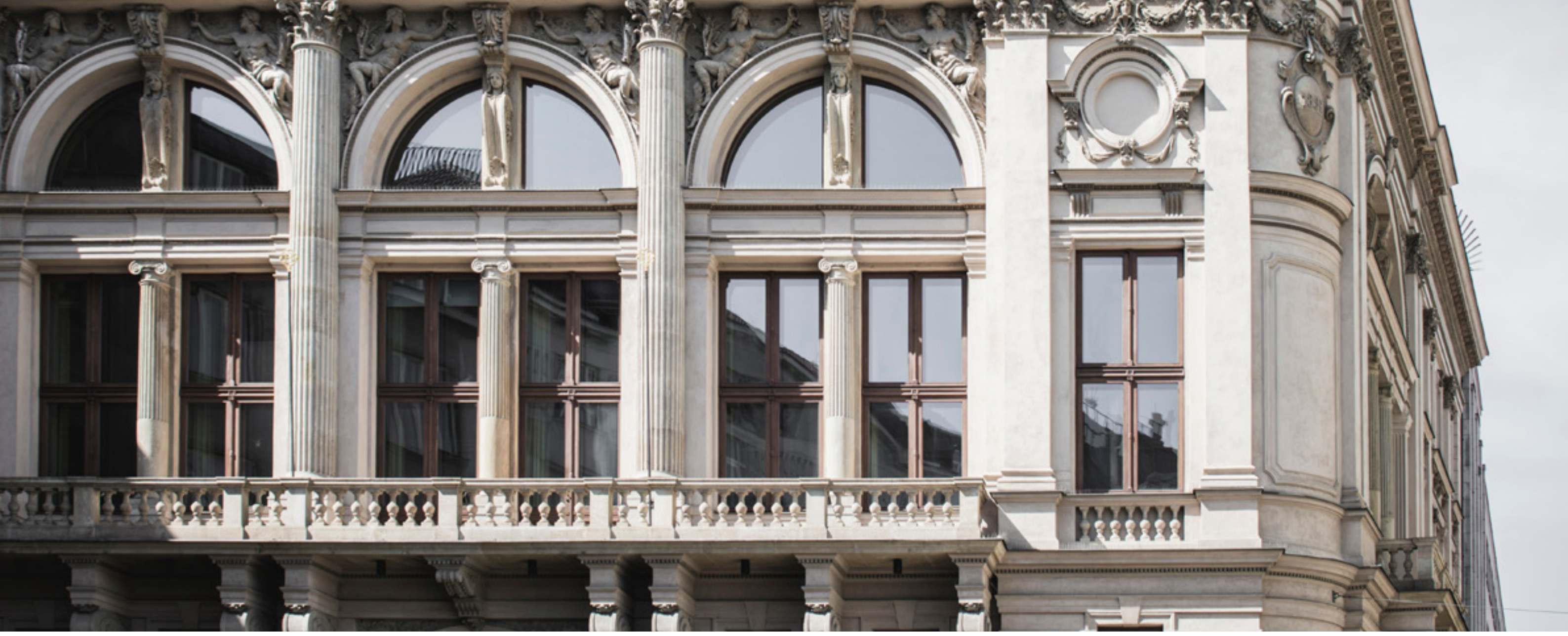
Private debt plays an essential role in financing the real economy. It offers an alternative financing option outside of the traditional banking system. This has been a welcome change to the post-2008 markets for borrowers and investors alike. Private debt offers borrowers speed, flexibility and customisation, whilst lenders and investors benefit from attractive risk and return propositions.

Private debt can be a more effective funding channel than traditional bank lending, explaining why it's been picking up speed with no signs of slowing.

Alternative lending is already an important asset class in the U.S. and has grown significantly in Europe recently. In a post-pandemic environment where banks are more reluctant than ever to take on higher-risk loans, continued financing of the real economy is a priority and makes the role of non-bank lending even more essential. According to Pitchbook, private debt accounts for 10-15% of total assets under management in the private market. And Preqin predicts that private debt will be one of the fastest-growing asset classes over the next five years, with a projected increase of 11.4% annually.

With momentum comes attention from regulators and policymakers. In the context of its Capital Markets Union initiative, the European Commission has recently introduced a proposition to amend the Alternative Investment Fund Managers Directive (AIFMD) in respect of loan origination funds. The Commission is proposing to establish a specific, harmonised regulatory framework for loan origination funds.

In this paper, we will look at private debt from an operational angle. Who are the key agents involved, and what are the potential pitfalls they should know about ahead of increased regulatory scrutiny? We will cover roles and responsibilities for private debt portfolios at any stage of the life cycle.



Fundraising cycle

The fundraising cycle for private debt funds is almost identical to other private asset classes, with Luxembourg consistently standing out as a domicile of choice. Backed by its robust legal, tax and regulatory environment, and a well-established alternative fund management and fund servicing industry, Luxembourg has become the leading domicile for private debt funds and a focal point of fundraising strategies in Europe and globally.

Most private debt funds are structured as alternative investment funds (AIFs) under AIFMD. It is still mostly a market for institutional and professional investors. As for other alternative asset classes, managers have been building their fundraising strategies on the success of the AIFMD marketing passport. Marketing has become a particular area of focus for regulators in recent years, notably with the recent implementation of the cross-border distribution of collective investment funds (CBDF) regime. More than ever, fundraising requires careful planning and monitoring of investor communications and marketing materials.

Structuring is important. A successful fundraise means offering the right fund structure to investors. Even more so as the environment is becoming increasingly complex on all sides: legal, regulatory, tax, accounting, sustainability, investor reporting, etc. Although most private debt funds adopt a typical closed-ended private fund structure, it is not a one-size-fits-all approach. That's where Luxembourg comes into play, with a broad range of structuring solutions:

- **Regulated and unregulated investment funds:** Most private debt funds are set up as unregulated AIFs. The reserved alternative investment fund (RAIF) regime has been quite popular with private debt fund managers in recent years. If a regulated fund is required to meet investor demand, the specialised investment fund (SIF) regime is generally the preferred option. European long-term investment funds (ELTIFs) are also more and more considered, in particular to facilitate the lending activity across European jurisdictions.
- **Closed-ended and open-ended structures:** Most private debt funds are closed-ended. However, as part of a broader trend in the alternative space, we tend to see greater demand for products such as semi-open-ended funds and evergreen funds.
- **Tax opaque or transparent vehicles:** A tax transparent entity such as the special limited partnership (SCSp) is generally the starting point for private debt funds. Depending on the investor base, a tax opaque structure such as a corporate RAIF may be more appropriate. Feeder funds and other access options are also available.
- **Professional investors only or retail options:** As indicated above, the private debt funds market is mostly addressed to professional investors. Here again, the broader trend in alternatives is to expand the investor base and offer alternative products to non-professional investors, where permitted (e.g. semi-professional investors). This may also impact the chosen fund structure.

Tax considerations represent another significant element in the structuring phase. Tax risks for the fund and the investors have to be correctly identified: withholding tax, income tax, with a particular focus on interest limitation and anti-hybrid rules, VAT implications, etc. The fund structure will need to be designed to achieve tax neutrality for investors.

Last but not least, a manager's approach to environmental, social and governance (ESG) criteria will be key in the fundraising cycle. ESG has been in the spotlight in recent years, with increased regulatory focus on disclosure and transparency under EU regulation. Investors expect fund managers to meet their ESG commitments and deploy a robust ESG methodology, with clear and complete disclosure and reporting. In this respect, collection of quality data is of utmost importance, and could be the next big challenge for private debt fund managers.

Investors choose the most suitable entry vehicle in the fund structure, and fund administration functions begin with the next cycle: investing.

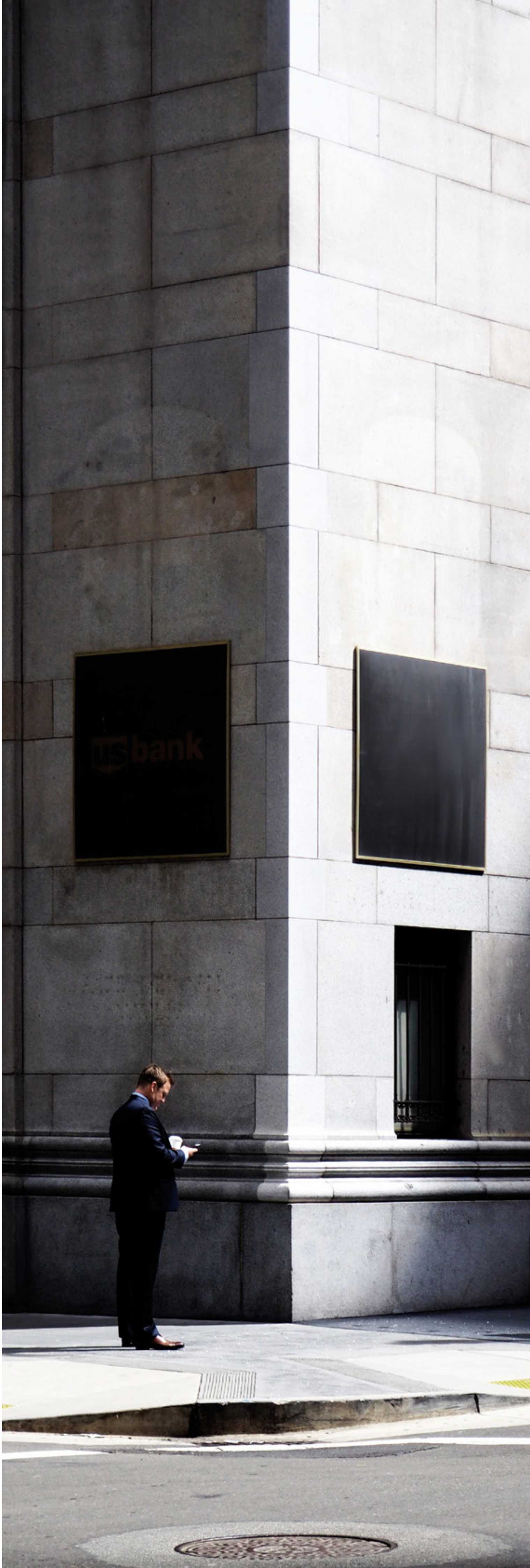
Investing cycle

- **Loan type:** Mezzanine, unitranche, senior secured, subordinated, high-yield, zero-coupon or collateralised assets
- **Lending type:** Loan origination or direct lending, syndication, participation or sub-participation
- **Underlying asset type:** Private equity, real estate, infrastructure, venture capital, etc.
- **Loan features:** Interest rate structure, cash interest, payment-in-kind, grace periods, equity kickers
- **Collateral:** Guarantees, pledge on cash accounts, security interest in underlying assets
- **Covenants:** Debt to EBITDA, interest to EBITDA, debt to equity, etc.

Regulators expect managers as well as fund directors to have a thorough understanding of the loan market to enable them to make best interest decisions for their investors. Luxembourg alternative investment fund managers (AIFMs) managing private debt funds are expected to put in place proper organisational and governance structures, have the necessary expertise and experience, and an appropriate risk management process covering all related risks, including credit and liquidity risks. In addition, secretarial teams form a crucial role in documenting transactions to provide evidence of investments or divestments.

The manager will need to ensure that the type of activity is permitted in the jurisdiction where the borrower is located and the activity is performed. Each country typically has its own local regime allowing, prohibiting or imposing conditions on granting credit. In certain countries, loan origination may be reserved to credit institutions or other types of authorised entities.

Downstream structuring of investments is important too. In this respect, Luxembourg offers a variety of options. In particular, securitisation vehicles subject to the Luxembourg law of 22 March 2004 on securitisation proved to be reliable and flexible instruments enabling a wide range of operations and transactions when it comes to private



debt, offering several structuring options, insolvency-remoteness and tax neutrality. The law was recently amended to increase this flexibility and take into account global, European and local market dynamics. It opens new opportunities in the active management of securitisation vehicles, extended financing arrangements for securitisation vehicles, and makes it easier for securitisation vehicles to securitise tangible assets.

Monitoring cycle

Fund administration and more specifically the loan servicing is a crucial element of the monitoring cycle of a debt structure. Specifics depend on the types of services a provider extends to its clients, covering the roles of calculation agent, loan agent, escrow agent, collateral agent, valuation agent and others.

Monitoring teams must ensure that the following features of private loans, granted directly by the fund or indirectly via intermediary vehicles, among others, are always kept updated:

- Reset dates
- Maturity
- Capitalisation
- Accruals
- Reorganisation events

Cash monitoring teams also have their own long list of responsibilities:

- Check cash interest at each payment date
- Ensure use of correct currency
- Verify amounts against expectations from calculation agents and clients, interest advice letters from facility agents, and bank account actual amounts, if any
- Conduct investigations in case of discrepancy
- Conduct a capitalisation exercise with payment in kind and all reorganisation events accounted for (such as partial reimbursement, maturity, distressed situation, or conversion)
- Move cash up through the structure periodically

Private debt portfolio valuation is another significant aspect of the monitoring cycle, including considerations such as internal or external assessment, valuation model, access to information, data quality, and sanity check methods.

Monitoring teams gather the documentation relevant for the proper application of withholding taxes, and ensure proper tax reporting (such as DAC 6, CRS, FATCA) and filing of tax returns is done. Fund management teams must continuously monitor tax-related developments to mitigate tax risks for the fund and its investors.

Collection and processing of ESG-related data is an increasingly important element in monitoring the portfolio.

Monitoring is an ideal entry point for technology, as it is repetitive, highly detailed and frustratingly inefficient if done wrong. Debt asset managers looking to increase operational efficiency and reduce risk should adopt a first-tier debt technology linked to a robust accounting and reporting system, allowing for full reconciliation of the portfolio.

Realisation cycle

Because cash flows are more frequent in a debt fund, the waterfall model must be activated more regularly and may follow a more complex allocation path. Depending on the prevailing debt asset classes, managers may also consider alternative incentive structuring and/or adjust the frequency of calculations and payments.

Where do other stakeholders fit in?

Depositories to understand risk mitigation factors
Depositories of AIFs are tasked with establishing and keeping records of the existence of assets. Debt financing often involves complex, tailor-made contracts, making them a source of errors and legal risks.

Time, care and attention are needed to understand the risk mitigation factors and the exact terms under which the fund is committed, including the treatment of assets, commitments and collateral of the fund.

AIFMs to ensure strong risk management systems
AIFs managed by authorised AIFMs are subject to significant regulatory requirements, and the controls for private debt are very similar to those for other alternative assets. AIFMD provides one of the most comprehensive sets of rules for alternative funds, ensuring sound and effective management of this diverse array of fund types.

Authorised AIFMs managing private debt funds are expected to:

- Ensure appropriate matching of the liquidity financing mechanism of AIFs with the liquidity profile of their lending activities
- Conduct due diligence on counterparties, including borrowers
- Implement strong systems to identify, monitor, manage and document all related risks

Private debt fund managers should focus on integrating creditworthiness, covenants and collateral during the investment acceptance process and in their risk monitoring. Because debt funds involve more cash flows, they require more time and resources to oversee delegated activities.

Otherwise, as with any other alternative investment strategy, AIFM teams must understand the features of each loan agreement, cash flow structure, risk mitigation factors, diversification effect, borrowers' creditworthiness, and liquidity profiles.

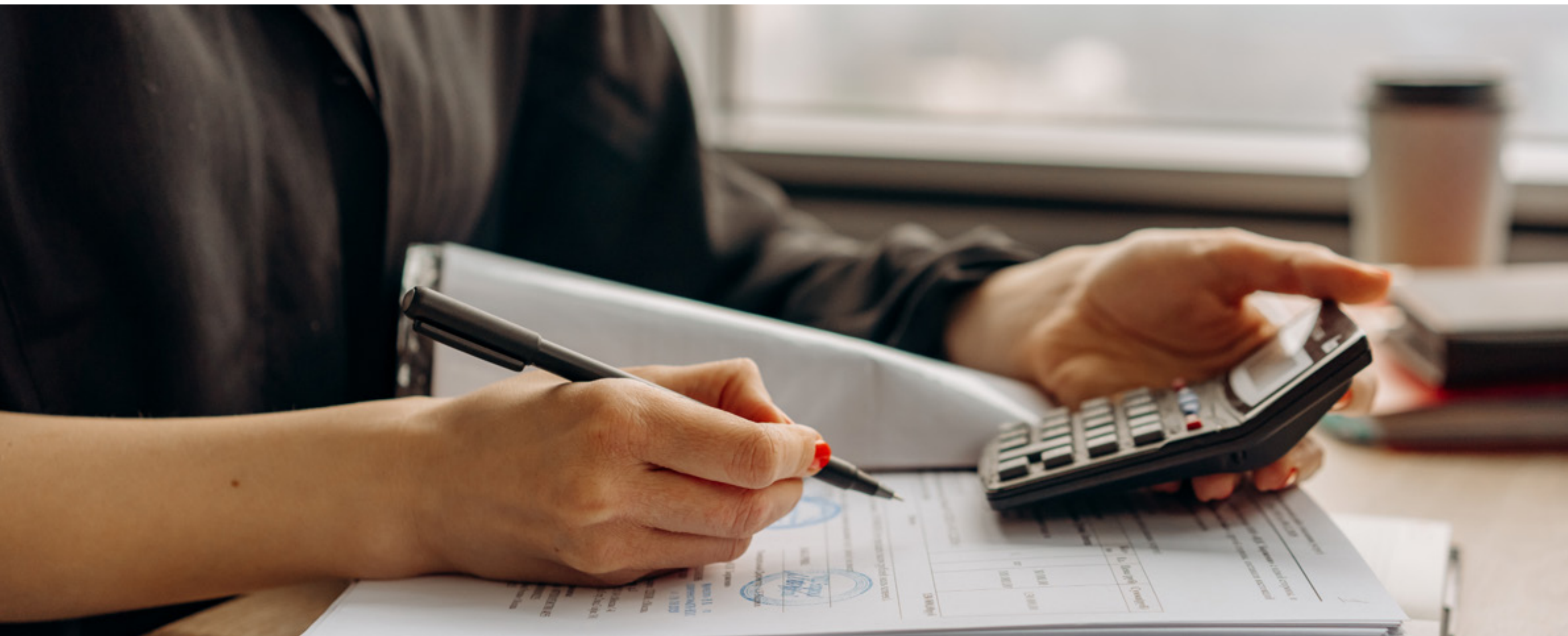
What's next

Tread with caution, but move forward
At the end of 2021, the European Commission published its proposal for a review of AIFMD. One of the key topics in the Commission's proposal is the new specific regime in respect of loan originating AIFs.

The objective of the proposal is to harmonise the regulatory framework for loan origination AIFs within the European Union and facilitate their activities. The Commission has indeed acknowledged that private debt structures are playing a critical role in today's economy. In order to recognise lending as a legitimate activity of AIFMs and allow AIFs to extend loans anywhere in the EU, including across borders, the proposal adds "originating loans" to the list of permitted activities for AIFMs.

The proposal imposes specific organisational requirements for AIFMs managing loan origination AIFs, in terms of risk management, granting of credit, and portfolio monitoring. It also adds certain requirements at the level of the loan originating AIF itself, as well as increased reporting and transparency obligations for debt funds.

More harmonisation and a level playing field between Member States is certainly welcomed by the industry as an opportunity to attract more investors to a broader, more developed private debt market in Europe.



The proposal does however raise a number of questions. Will the Commission's proposal effectively achieve the goal of sufficient harmonisation and facilitating cross-border operations of loan origination funds, given the existence of local credit regulations? Are the new requirements imposed at fund level appropriate for private debt funds, considering the variety of products? Is the proposed approach of imposing product-level rules consistent with AIFMD principles and investor expectations? Could there be side effects for the industry – and alternative investment funds more generally? These questions will need to be monitored as the proposal goes through the legislative process.

Find out more

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Gautier Despret

REGIONAL HEAD OF PRIVATE DEBT, EUROPE

IQ-EQ

+352 466 111 2168
gautier.despret@iqeq.com

Nicolas Bouveret

PARTNER, INVESTMENT MANAGEMENT

ARENDT & MEDERNACH

+352 40 78 78 978
nicolas.bouveret@arendt.com

Bram Eijsbouts

CHIEF COMMERCIAL OFFICER, LUXEMBOURG

IQ-EQ

+352 466 111 2390
bram.eijsbouts@iqeq.com

Claudia Hoffmann

COUNSEL, INVESTMENT MANAGEMENT

ARENDT & MEDERNACH

+352 40 78 78 9313
claudia.hoffmann@arendt.com

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