Private Debt Funds: Regulatory evolution under AIFMD 2

Private Debt Funds are a fairly recent phenomenon in terms of alternative asset classes, but they are certainly on the rise. This category of financial products investing into existing loans in the private sector (loan participating funds) or issuing loans themselves (loan origination funds) have seen a tremendous increase in interest: In the past year alone, their assets under management in Luxembourg have increased by no less than 45% pursuant to a recent survey performed by ALFI and KPMG.

Although still a fairly small market segment in absolute figures compared to private equity or real estate, with around 268 billion EUR in assets under management in Luxembourg, the last few years, with disappearing returns in public debt titles due to the low interest environment, have sparked a las- ting appetite for them. Another driver is the continuing trend of traditional banks to disengage from corporate financing, which should mean that financing alternatives through debt funds are not only here to stay but necessary.

Luxembourg has been a favorable environment for this new trend since its emergence. The confirmation of the regulator CSSF in its FAQ on the AIFM Directive that both loan participation and origination are permitted activities, accompanied by the requirement that a specific license for Luxembourg AIFMs is necessary in this case, has allowed for a smooth integration of this asset class into the existing regulatory framework provided by the AIFM Directive.

This combination of pragmatism and appropriate regulatory oversight (for which Luxembourg in particular is known) made it even more surprising that additional regulation for loan originating funds is now proposed to be included in the upcoming amendment of the AIFM Directive. From its conception, the directive has always been considered as a set of rules for managers of alternative funds, not (as the UCITS Directive) as regulating funds directly, even less so specific asset classes - there are currently no specific rules for the principal types of funds such as real estate or private equity. It appears debt funds are, in that sense, a victim of their success: The rather arbitrary use of terms like "moral hazard" or "investor protection" in the current draft and the absence of an in-depth market survey to serve as foundation for the need for additional rules make it difficult to under- stand the need for more regulation in this sector.

However, as the final version of the directive is expected to be agreed upon early next year and will most likely enter into force sometime in 2025, compliance with it and the proposed rules on loan origination funds will become necessary. At the moment it is being discussed between the European Comission who made a first proposal about a year ago, the European Council and the European Parliament. It therefore appears useful to take stock of some of the currently proposed rules, even though these could still change during the ongoing trilogue.

In the first place, there are some proposals that seem not particularly controversial. That goes for example for agreeing as such that loan participation and origination are permissible strategies to pursue, as already done by the CSSF in Luxembourg years ago; or that any AIFM engaging in these activities needs to have a specific expertise and appropriate internal procedures to assess and monitor the risks related to such loans, such as the credit risk or liquidity risk in terms of the maturity spread within the portfolio, or also the valuation of the loans. This is already part of the approval process in case of the application for a license to manage debt funds, which then begs the question why such requirement needs to be an explicit part of the amended directive.

While these requirements are commonplace and could also have been implemented by level 2 or 3 rules, other elements are more prescriptive.

The obligation for a strict risk diversification requirement of no more than 20% of a loan originating fund's capital for a single borrower is proposed; at first glance a good idea, and in practice the vast majority of loan origination funds will exceed this requirement anyway: the average number of investments per debt fund in Luxembourg is 52 according to the above mentioned survey.

On the other hand, the reason behind this limit is unclear, where for instance widely popular Luxembourg alternative funds such as SIFs have used a diversification limit of 30% per issuer for over 15 years, and an even lower limit could for example prevent the financing of a particularly attractive unicorn that has capital requirements exceeding this threshold – also taking into account the fairly small sizes of current debt funds. Then there is a proposed retention requirement: Loan originating funds should keep 5% of the notional value of the loans they originate, something that will be burdensome and complicated to do in practice; it could also be argued that the concerns linked to this requirement – proper due diligence of the borrowers and a prevention of random lending activities that are then immediately sold on to third parties – could also be accommodated with less invasive rules.

The same applies to a proposed leverage limit of 150% of the loan originating fund's capital: Not only is the purpose behind this rule, preventing highly leveraged credit activities, in practice largely irrelevant as few debt funds use leverage; also, the current proposal could prevent simple hedging strategies that are used to safeguard the fund against currency or interest rate fluctuations from being employed. It seems particularly arbitrary in view of the fact that other asset classes such as private equity rely on leverage far more extensively and have functioned very well without any quantitative limits.

Another element is the prohibition to grant loans to specific entities, such as the AIFM and depositary and any of their group entities. Driven by the intention to prevent conflicts of interest, there already exist sufficient rules in this regard in the AIFM Directive, and there are constellations imaginable where the blank prohibition of such lending activities would not be justified.

Another item under discussion is the prescription to only use closed-ended structures for debt funds that have a portfolio of more than 60% of originated loans. The liquidity mismatches generated by using open-ended funds for illiquid assets, which under stress then become closed-ended in reality, have been on the radar of ESMA for some time, but rightly so almost exclusively in the real estate sector where open-ended funds are routinely used. As far as Luxembourg debt funds are concerned, only 17% of them are open-ended, and not all of these will be loan originating funds (the latter having a market share of 44%). It appears more appropriate to integrate this aspect into the use of liquidity management tools (e.g. redemption gates, lock-up periods or the structuring of notice periods) than to prohibit the use of a structure that in some asset classes such as microfinance has been proven to work very well.

The initial proposal of the European Commission did not provide for an exemption for the granting of shareholder loans from the suggested loan origination rules. This could have a detrimental effect on private equity funds that routinely use this tool and would be captured by the new rules inadvertently. However, it appears that such an exemption will make it into the final set of rules, and it would make sense for such exemption to be general in nature as any credit risk related to such loans can be monitored. The same consideration applies to the initial absence of grandfathering provisions for existing debt funds, which have been added during the trilogue discussions, the necessity of which appears particularly blatant.

Lastly, there are proposed reporting obligations on the portfolio of originated loans which should be considered with caution. Disclosing too much information such as individual borrowers and nominal values of loans granted to them would be an invitation to abuse and infringe confidentiality obligations that are (for good reasons) market practice anywhere in the industry.

It can be hoped that the above discussions will end in a result that does not stifle the evolution of this new asset class, which is contributing to the financing of different sectors of the economy and provides a welcome alternative to bank lending, in particular for new market entrants. The regulatory deluge we have seen over the last decade should also not let us forget that before any regulation must come the question on whether it is absolutely necessary, and whether regulatory micro-management does not undermine the objective by contributing to excessive complexity.

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