Midi de l'ALJB

14 March 2017

Debt funds in light of Luxembourg law

ALJB SEMINAR
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Debt funds and direct lending

- *the regulatory perspective*
- *the investment fund perspective*
- *the tax perspective*

Alternative finance – *an animated European profile*

1. Debt funds – the regulatory perspective

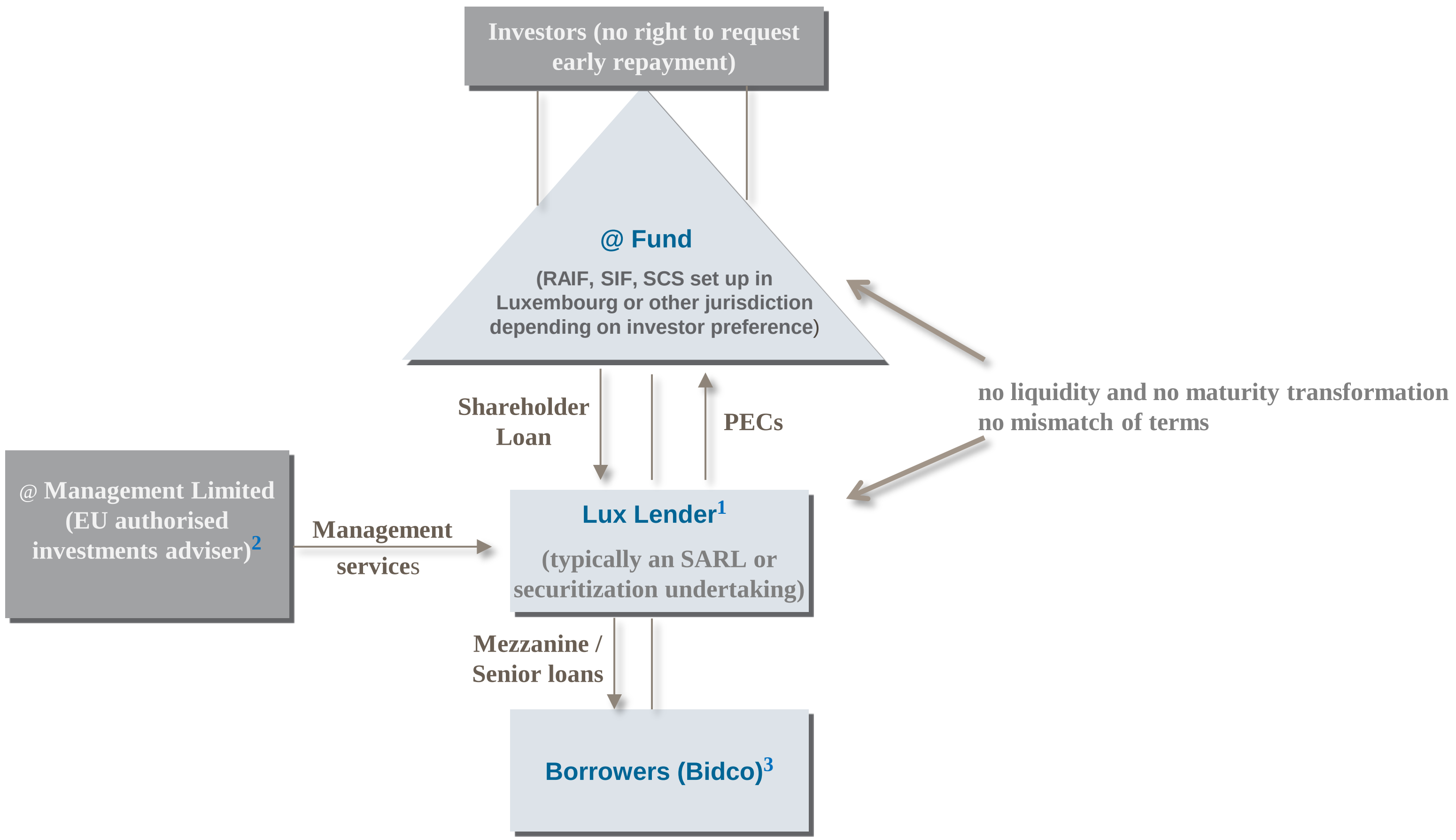
(1) DEBT FUNDS

1. *Structure*
2. *Legal framework*
3. *Exemptions*
4. *Practical guidance*

"The Grand Duchy of Luxembourg has a major role to play in the provision of *alternative finance* because of the presence, on its territory, of financing platforms created by promoters of securitisation undertakings, powerful private equity houses and asset managers, regulated and unregulated investment funds, pension funds and insurance companies, which all have significant financial resources and the strong desire to finance the real economy."

"Private equity looks to Luxembourg for access to single market" (FT 26 January 2017).

(2) DEBT FUNDS – *Structure*



[1] Banking Act 1993 license issues (see exceptions)

[2] MiFID license issues (solved through passporting)

[3] Local banking monopoly issues (solved through a Luxembourg fiduciary structure whereby a Luxembourg bank grants the loans)

(3) DEBT FUNDS – *Legal framework*

"Professionals performing lending operations are professionals engaging in the business of granting loans to the public for their own account."

Article 28-4 of the Banking Act 1993

(4) DEBT FUNDS – *Exemptions (by law)*

2

Covered bond banks

UCIs, SIFs, Pension funds, SICARs

Any person whose activity is governed by a sectorial law

1

Securitisation undertakings

3

Intra-group lending transactions

(5) DEBT FUNDS – *Exemptions (by interpretation)*

2

Unregulated lender is owned 100% by an exempt or a regulated person [1]

➔ "look-through" approach

3

Fully drawn loans (secondary basis)

➔ *Caveat*: time between origination and acquisition

4

New, undrawn or partially drawn loans (primary basis)

➔loans to "a limited circle of persons previously known to the lender/sponsor"

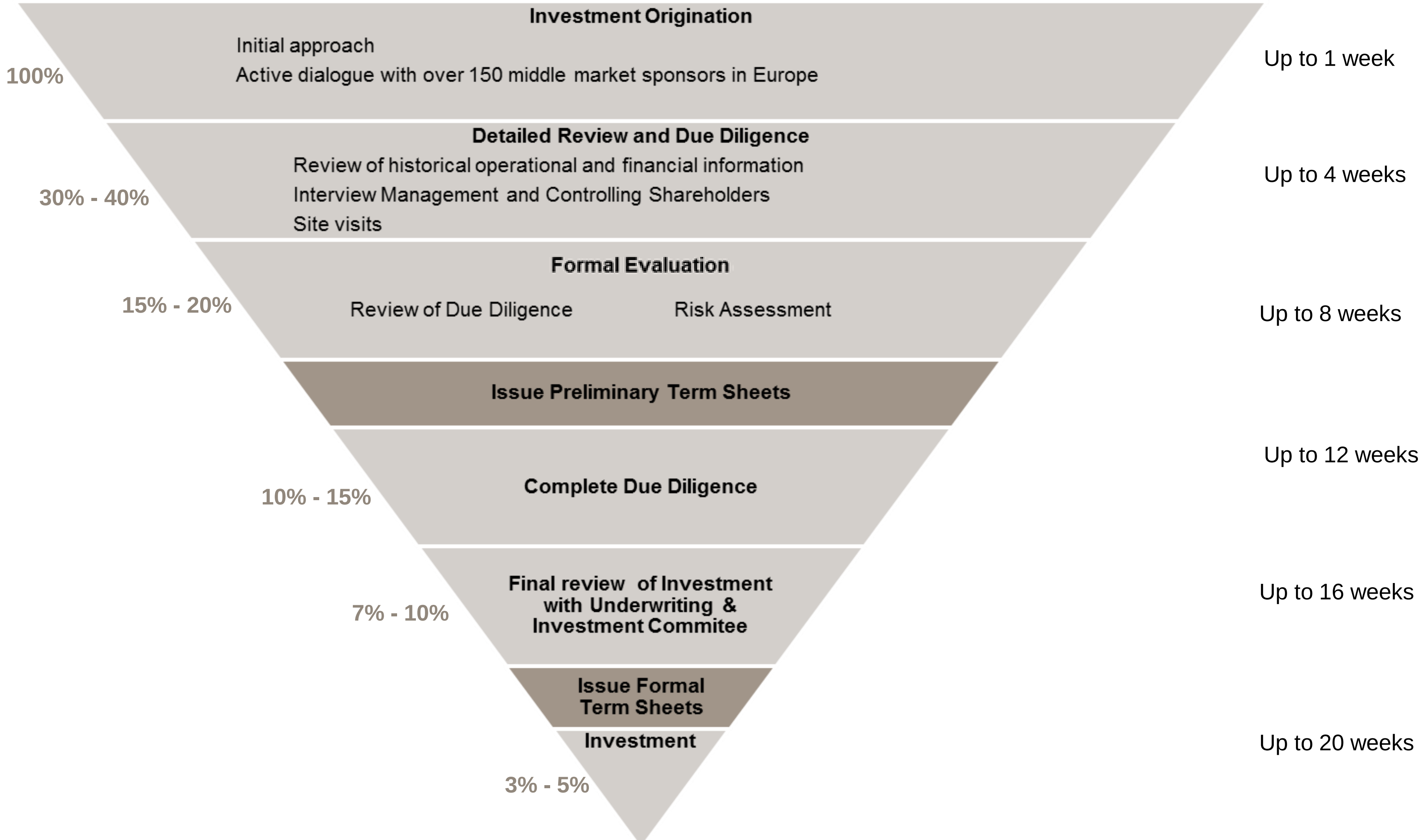
1

"One off" transaction

➔ no professional activity

[1] Securitisation undertaking mortgage bond bank UCIs, SIFs, pension funds, SICAR and person subject to a sectorial law

(6) DEBT FUNDS – *Practical guidance*



(7) DEBT FUNDS – *Practical guidance*

Transparent structure

Lux Lender held 100% by a regulated or an exempt person (or affiliated with a regulated entity (e.g. uni-tranch loan)). Because of that affiliation, the CSSF adopts a look-through approach (and article 28-4 does not apply to Lux Lender)

No canvassing of public

Lux Lender will not collect deposits or other repayable funds from the public (it will be entirely funded by sponsor)

No systemic risk

There will be no regulatory arbitrage and no maturity/liquidity transformation

"Limited circle of persons"

No legal guidance on number of borrowers (typically, 5 to 30)

Existing relationship before loan is granted

Borrowers are identified and will be personally known to sponsor and/or Lux Lender

Lux Lender characteristics

2. Debt funds – the investment funds perspective

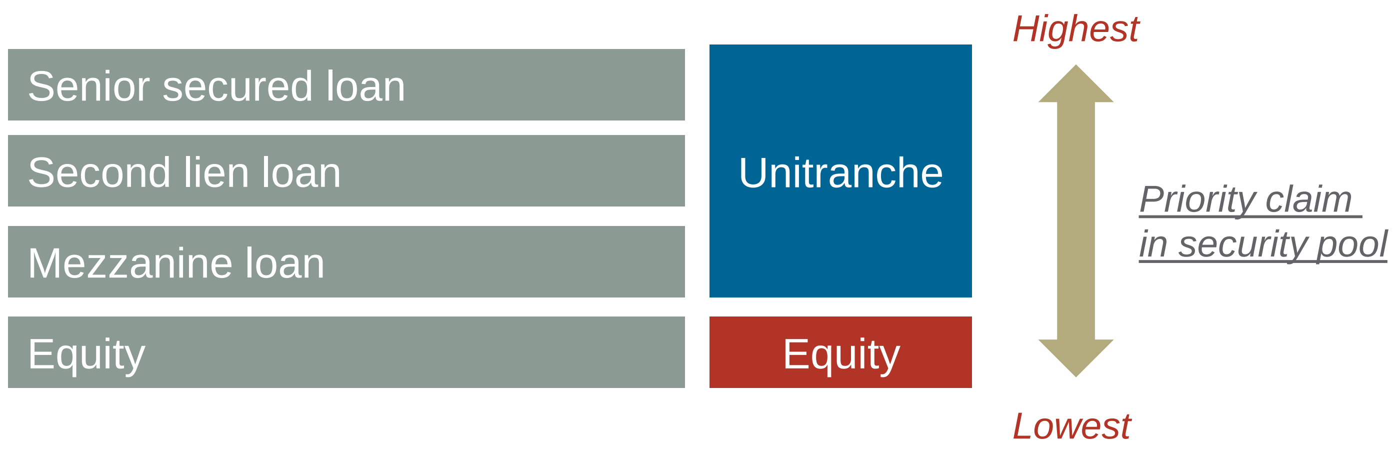
Content

I. Debt fund strategies

Various strategies depending on:

- Ranking of loans along capital structure (senior secured loans, subordinated, unitranche, etc.)
- Situation of borrowers (distressed debt, special situations, etc.)
- Market-sector and type of collateral (commercial debt, real estate debt, infrastructure debt, microfinance, etc.)
- Exposure to debt (origination vs. participation)

Typical capital structure of borrowers:



II. Loan origination funds vs. loan participation funds

Loan origination

Fund is the original lender of record

Loan participation

Fund buys loans originated elsewhere

Frontier may be blurred in certain circumstances (bank originates loans and transfers them right away to the fund)

III. Regulatory aspects

ESMA opinion on loan origination funds (April 2016)	– Opinion to EU Parliament, Council and Commission – ESMA is of the view that common approach at EU level would • contribute to level playing field • reduce regulatory arbitrage • facilitate take up on loan origination funds in line with CMU objective		
Key issues	**Fund manager**	**Fund structure**	**Investment activities**

	• Mandatory approval?
	• Risk management
	  • assessment of borrowers
	  • credit monitoring
	• Capability/experience of team
		• Closed-ended funds only	• No liabilities with a maturity shorter than loans originated
			• Limit on leverage?
			• Minimum risk diversification requirements?
			• No loan origination to individuals, financial institutions and other funds

III. Regulatory aspects (c'ed)

**CSSF AIFMD Q&A
Version 10
(9 June 2016)**

- Confirmation that Luxembourg AIFs/AIFMs may engage into loan origination/participation
  - Quid sub-thresholds AIFs/AIFMs?
- Luxembourg authorised AIFMs engaging in loan origination/ participation must have
  - proper organisational and governance structure in place
  - necessary expertise/experience
  - appropriate risk management system covering inter alia
    - credit risk
    - liquidity risk

III. Regulatory aspects (c'ed)

IOSCO Final Report on loan funds (February 2017)

– Survey over 24 jurisdictions
– Market environment
  - US: total AuM of loan funds: USD 218bn
  - Europe: main markets
    - Luxembourg (AuM: EUR 37.3bn)
    - UK (AuM: GBP 20.7bn)

Overview of specific loan origination fund regimes in key jurisdictions

	Ireland	France (ELTIF)	Germany	Italy
Closed-ended fund only?	Yes	In principle	Yes	Yes
Leverage limit?	100% of NAV	30% of NAV	30% of NAV	30% of NAV
Diversification requirements	Yes (max 25% " to an issuer or group")	Yes (max 10% in any qualifying portfolio undertakings)	Yes (max 20% per borrower)	Yes (max 10% per borrower)

IV. Fund structuring

	Part II funds	SIFs	SICARs	RAIFs	Unregulated LPs
Overview of Luxembourg fund vehicles	Max 20% exposure per borrower Appropriate vehicle for structuring of listed closed-ended fund vehicle	Max 30% per borrower	Risk capital only (e.g. mezzanine) Availability of tax exemption in case of investment in non-securitised debt?	No CSSF pre-clearance should be needed if managed by a Luxembourg AIFM	CSSF pre clearance needed, unless managed by a Luxembourg authorised AIFM

IV. Fund structuring (c'ed)

Open-ended, closed-ended or hybrid?

<u>Depends on:</u>

- Ability to value portfolio on each valuation date
- Liquidity – Mechanisms available to monitor liquidity risk
  - Semi-open-ended structures (redemptions only if cash available)
  - Liquidity buffer and credit line
  - Gates

<u>Types of structures:</u>

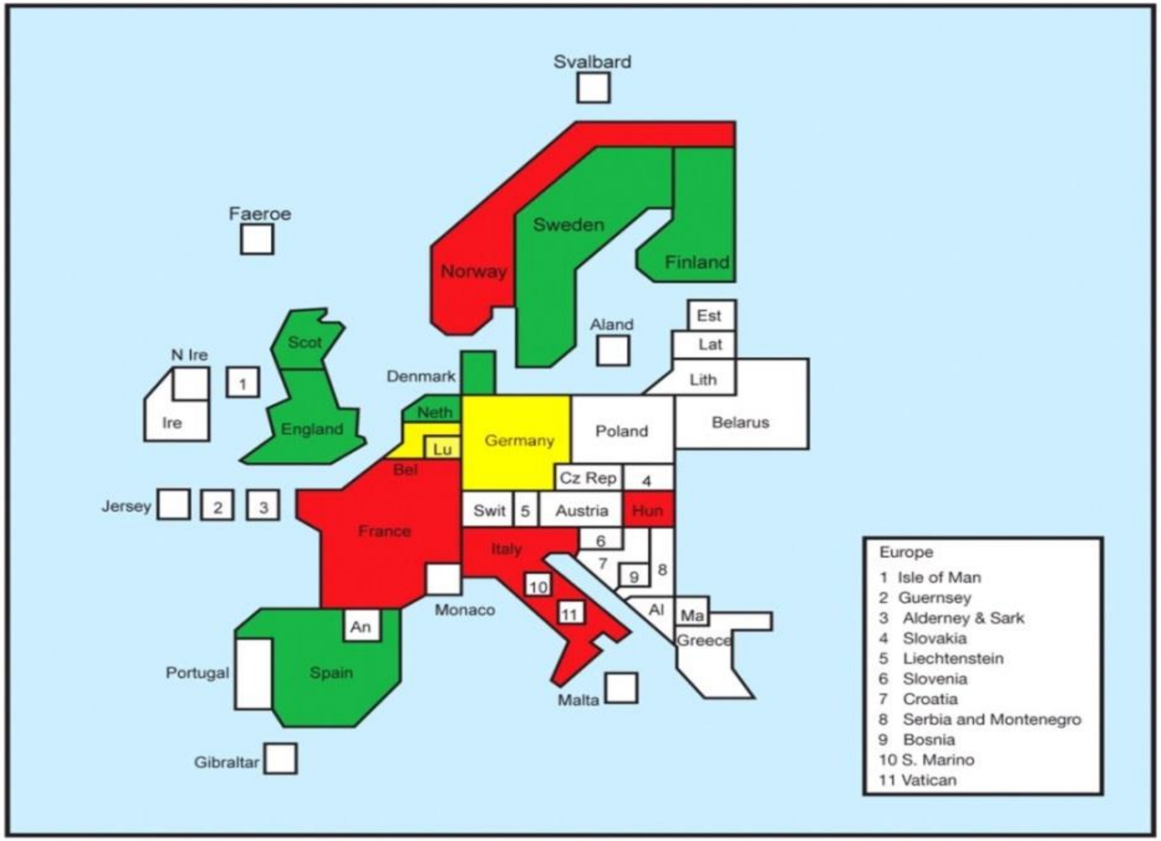
- PE-type (closed-ended, capital drawdown structure, limited duration)
- HF-type (open-ended, unlimited duration)
- Hybrid structures (eg, closings, issue at NAV, lockup)
- Closed-ended listed vehicle (evergreen, active secondary trading)

IV. Fund structuring

Key structuring issues	– Remuneration structure • NAV based remuneration (HF-type) • Remuneration based on commitments (during commitment period) or invested capital (after commitment period) and share of profits (PE-type)
Conflicts of interest	– Relationship with sponsor bank – Lending to targets held by (other equity) funds of fund manager

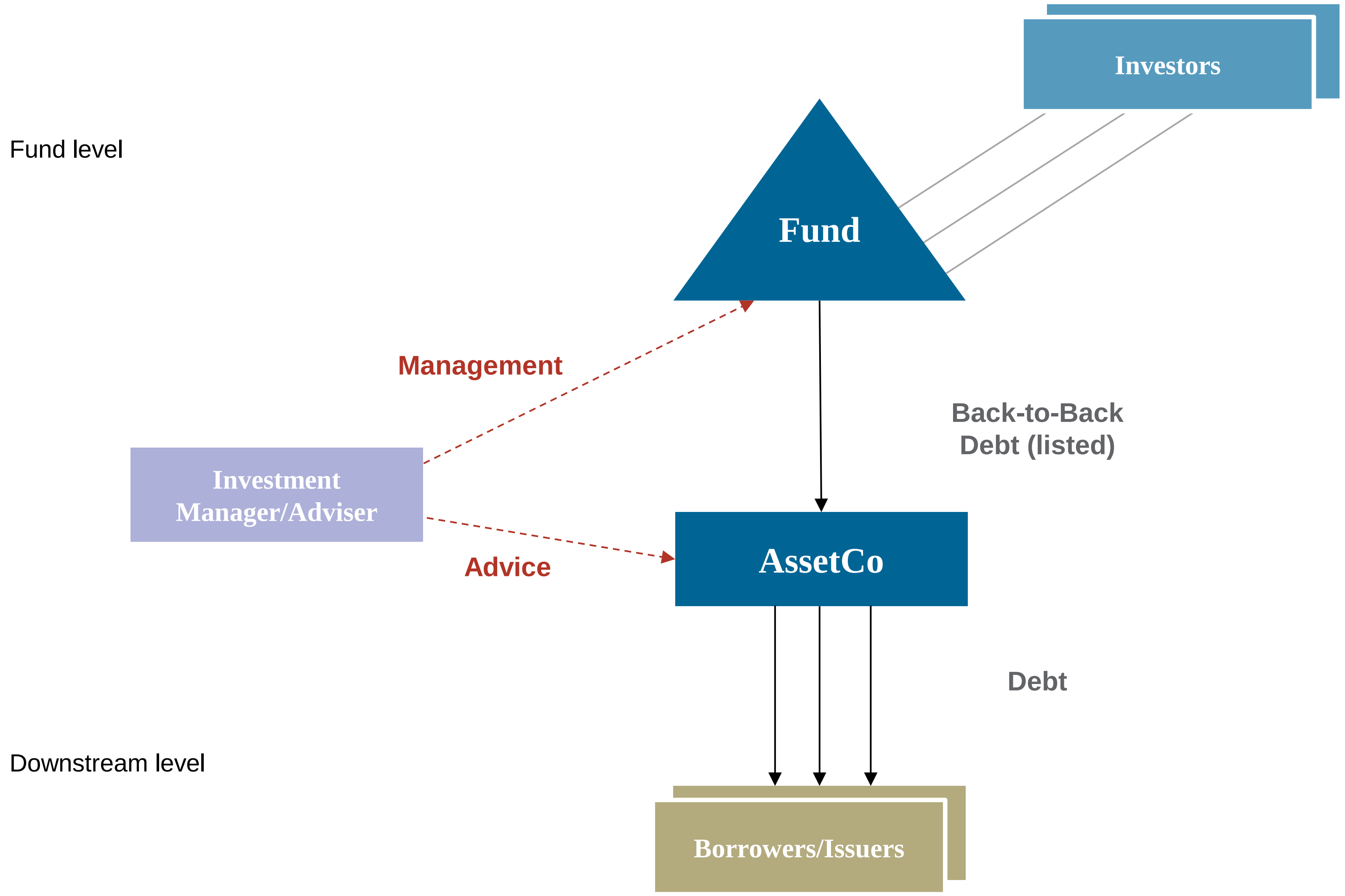
V. Cross-border lending activity

- No EU harmonisation
- Potential structuring options
  - Interposition of local vehicle (AIF or securitisation vehicle)
  - Banking fronting entity
  - Dedicated SPV
- Introduction of a EU asset passport (eg ELTIF)?



3. Debt funds – the tax perspective

Debt Fund: Luxembourg Platform



Tax – structuring objectives

Basic aim is to minimise tax leakage

Potential sources of leakage:

- direct taxes in fund and holding vehicles
- withholding tax on cashflows up the structure (interest) – UK, Spain, Italy, Belgium, etc.
- VAT on management fees

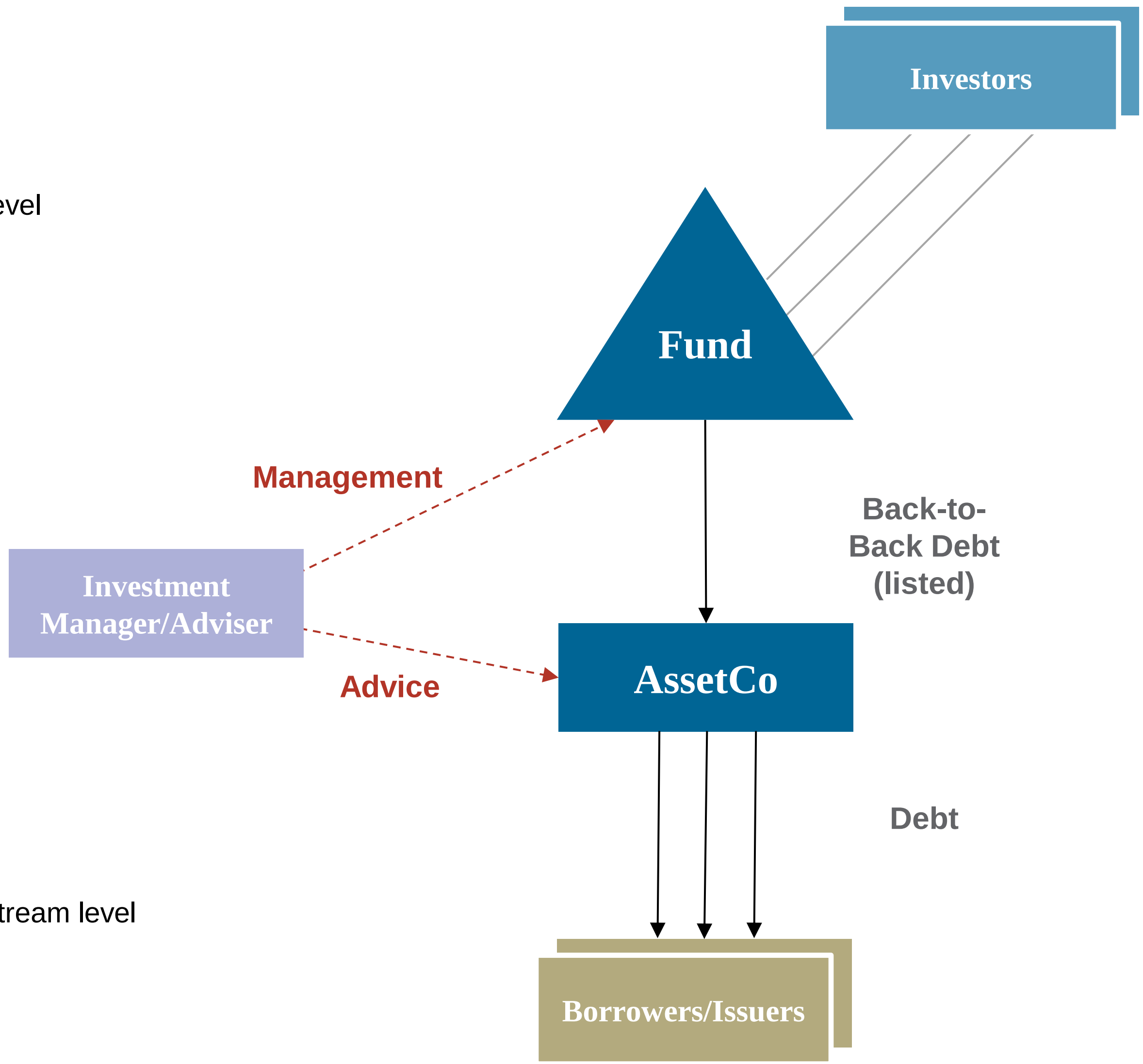
Minimize compliance burden for investors

- avoiding creation of an unintended tax presence for investors

Avoid "dry" tax charges for investors

Debt Fund: Luxembourg Platform

Fund level



Downstream level

Structuring options

- Fund (SIF, RAIF, SCS/SCSp - AIF)
- AssetCo (LuxCo vs. Lux Securitisation Co)

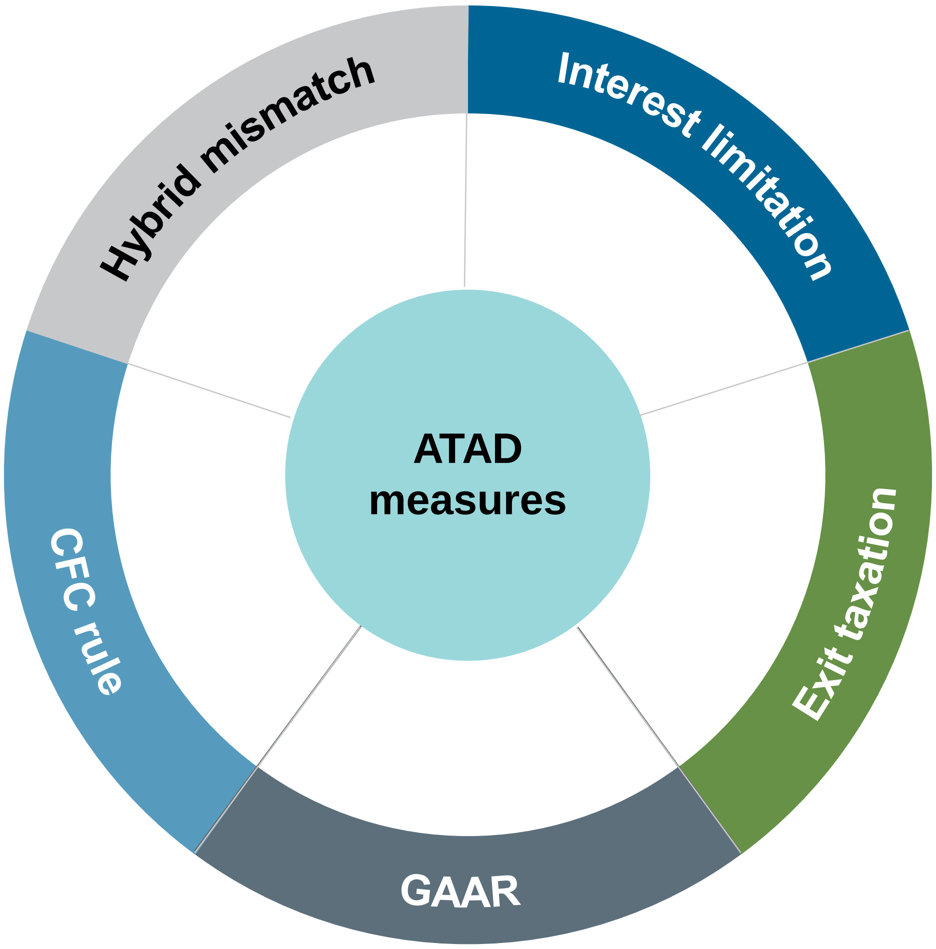
Tax Considerations

- Availability of treaty benefits to avoid withholding tax
- Tax residence/permanent establishment issues for Luxco
- VAT on fees
- Transfer pricing

OECD BEPS project – Overview

1	15 actions covering virtually all traditional international tax issues
2	Final BEPS Reports released in October 2015
3	Implementation of action points by – National laws: Measures may potentially be implemented/interpreted differently in various jurisdictions – Changes to tax treaties by way of multilateral instrument (action point 15)
4	Already measures labelled as BEPS measures by many countries (e.g. French interest deduction ceiling rules)
5	EU level: Parent-Subsidiary Directive, Anti-tax avoidance directive

Anti-tax Avoidance Directive (ATAD)



BEPS Action 6 – Treaty abuse

Progress on the non-CIV discussion

2015 Final Report on Action 6 on non-CIVs:

« OECD recognises the economic importance of these funds and the need to ensure that treaty benefits be granted where appropriate »

24 March 2016

Consultation paper on treaty access for non-CIVs published - work in progress

6 January 2017

Discussion draft with examples

Implementation of BEPS Action 6 (treaty abuse)

- ✓ Change to preamble: tax treaties may not be used to achieve double non-taxation
- ✓ In addition, choice to adopt either of:
  - ✓ PPT only;
  - ✓ PPT + simplified/detailed LOB; or
  - ✓ detailed LOB + other anti-conduit measures
- ✓ Multilateral Instrument does not include detailed LOB
- ✓ PPT: A treaty benefit must be denied where:
  - ✓ one of the principal purposes of an arrangement is to secure a benefit under a treaty; and
  - ✓ granting such benefit would be contrary to the object and purpose of the relevant provisions of the treaty
- ✓ Strong preference for PPT in Europe

BEPS Action 6 – Treaty abuse

The CIV/non-CIV distinction in OECD materials

CIVs	✓ Widely held, diversified portfolio, regulated (UCITS) ✓ Conclusion in 2010 Report on treaty access by CIVs ✓ Less concerns about treaty abuse by CIVs (individual tax planning not possible, as widely held)

NON-CIVs	✓ Alternative investment funds (AIF), including private equity funds
	✓ Concerns from governments that non-CIV funds are used to
	    ✓ provide treaty benefits to investors which they could not have obtained themselves
	    ✓ defer recognition at investor level of income on which treaty benefits have been granted

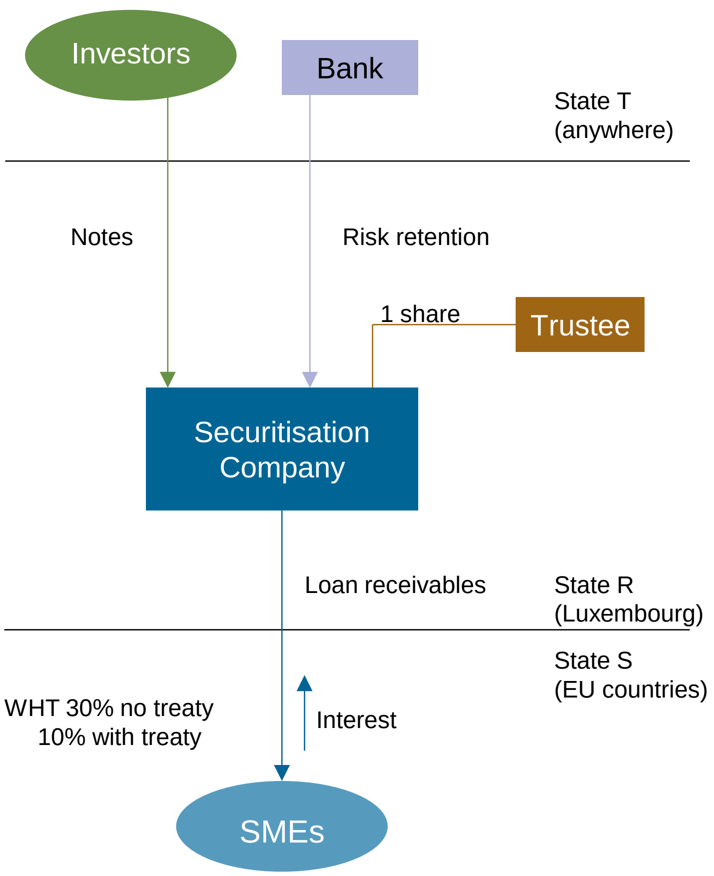
OECD examples: Securitisation company (1/2)

Scenario

- ✓ Bank sets up SeCo and transfers portfolio of loan receivables
- ✓ SeCo fully debt financed
- ✓ Notes listed and held through a clearing system
- ✓ Widely held by third party investors
- ✓ Bank retains small portion of notes to comply with regulatory requirements

Drivers for SeCo in State R

- ✓ Robust securitisation framework and legislation
- ✓ Skilled and experienced personnel and support services
- ✓ Extensive tax treaty network



Securitisation company (2/2)

Specific circumstances

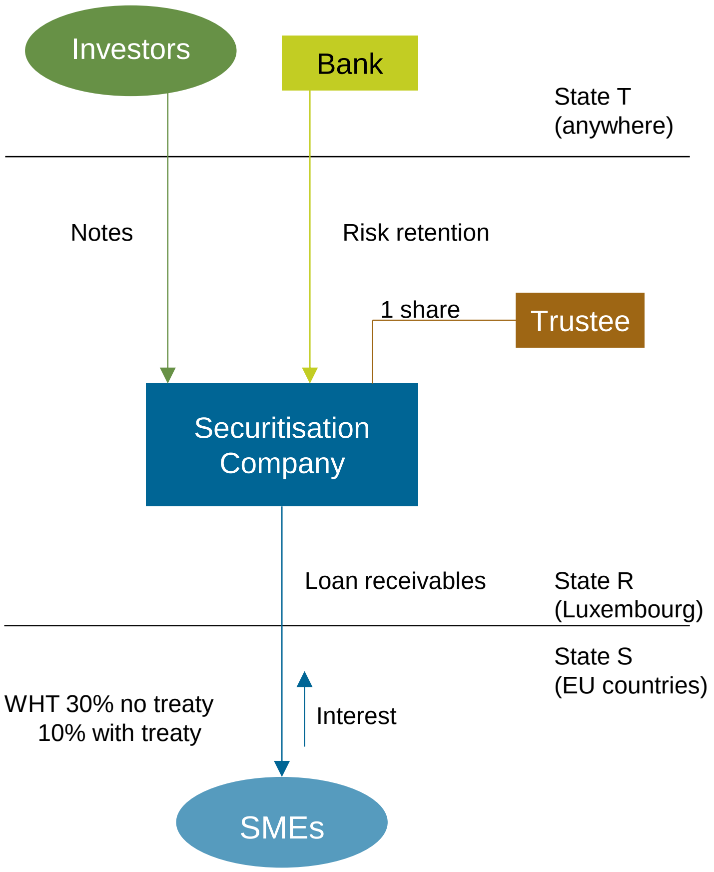
- ✓ Investors' decision to invest not driven by specific underlying investment
- ✓ SeCo's investment strategy not driven by investor tax position

Tax benefit sought

Reduced WHT on interest under State S/State R tax treaty

Same benefit available under State S/State T tax treaty !

Result: Not reasonable to deny treaty access



Questions?

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