THE EVOLUTION OF ALTERNATIVE FUNDS IN LUXEMBOURG

The Alternative Investment Fund Managers Directive (AIFMD), which grants a European passport to managers of alternative funds, came into effect in 2013. Rapid implementation of the Directive helped Luxembourg to further develop its role as a well-regulated hub for the global alternative investment industry, building on its success and experience in UCITS funds.

Over the last decade Luxembourg has become a prime location for Alternative Investment Funds (AIFs) in particular private equity, venture capital, hedge and real estate funds.

The Grand Duchy's international approach towards fund management has created a business environment flexible enough to support all structures, designed to facilitate a range of alternative investment strategies, spanning the full liquidity spectrum. The industry also benefits from a wealth of well-established service providers in back and middle office functions, and third party AIFM services, with the ability to tailor solutions to the size and complexity of each asset manager so overall a really attractive fund jurisdiction.

MARKET GROWTH

The number of private equity funds in Luxembourg with + €1 billion in assets has more than doubled in the past 18 months, with the average size of each fund increasing by 50% since 2018, according to a survey by ALFI and Deloitte. The Grand Duchy now accounts for 15% of European AIF's, with a 12.4% share of European Alternative AuM.

A survey by ALFI and KPMG showed a 14.5% climb in AuM in Luxembourg private debt funds, to a total of over €56 billion, representing an impressive 40% increase over the last two years.

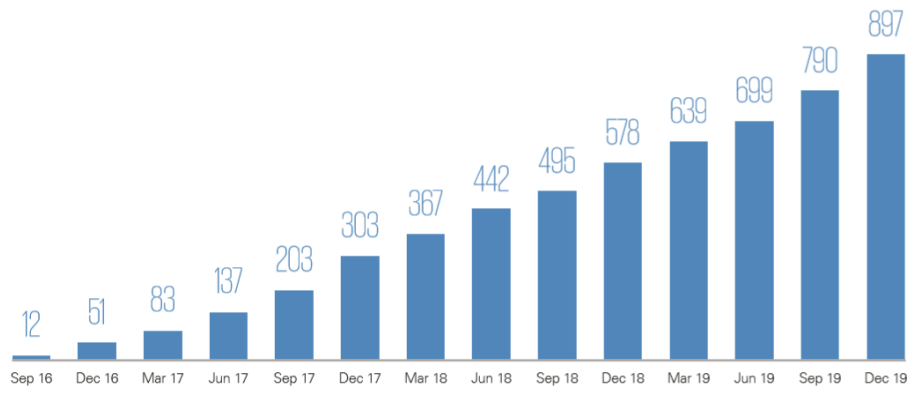
Direct lending strategies almost doubled to 32% of the private loan market. High yield bond strategies remained stable at 22% whilst senior loans dropped from 35% in 2018 to 22% in 2019. It is anticipated that one of the major effects of the COVID 19 epidemic will be the impact on global banking and consequently an increased demand in alternative sources of funding, whether debt or equity.

FUND TOOLBOX

Recent industry reports confirm the excellent acceptance of the Reserved Alternative Investment Fund (RAIF) structure, which was introduced by Luxembourg in 2016 with enhanced time to market being a primary objective. It has turned out to be a clear success, now accounting for four out of every five new funds launched.

The RAIF is a unique multipurpose alternative fund structure, which can be launched quickly as the fund is supervised by an AIFM rather than being fully regulated. Notably, more than 900 RAIFs have been established since its launch. The number of launches of RAIFs focused on property alone more than doubled in 2019 and has continued on this trajectory in 2020, despite the adverse conditions presented by the COVID 19 pandemic. RAIF structures represented more than 51% of all Luxembourg PE at end 2019.

Number of RAIFs from July 2016 (inception of the RAIF Law) to December 2019



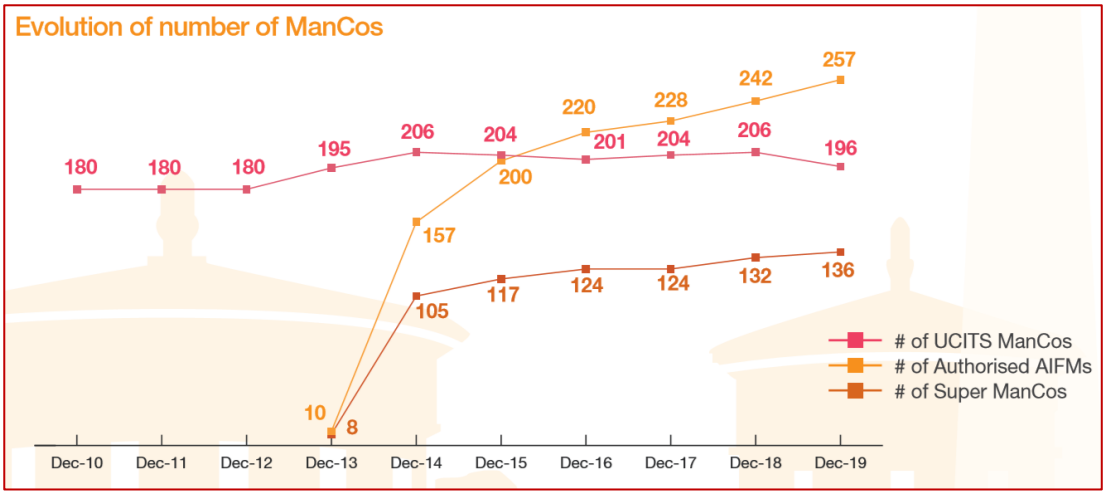
Sources: Luxembourg Business Registers (lbr.lu); general information; list of RAIFs

ALTERNATIVE INVESTMENT FUND MANAGER (AIFM)

The role played by the AIFM in supervising and supporting the AIF should not be overlooked. In parallel to the growth in number of AIF's, Luxembourg now has more than 250 licensed AIFM's, more than half of which offer third party AIFM solutions.

After the introduction of the AIFMD in 2013, the complexity and cost of complying with financial regulation increased sharply. This is when third party AIFM's emerged, offering not just to assist with increasingly challenging regulatory compliance, but the complete control of almost all aspects of day-to-day activities of the investment manager, including portfolio management, while also allowing the fund to benefit from its European marketing and distribution passport. Effectively, the AIFM can 'host' a fund under its own AIFMD license, leading to the description of them acting as a 'regulatory umbrella' for funds unable or unwilling to invest in compliance and operations departments of their own.

Luxembourg now has more than 400 authorised Management Companies, with approximately 65% of these being AIFMs.



(Source: PWC 2020)

INFLUENCERS OF CHANGE

The global financial industry is currently facing an era of unprecedented change and alternative asset classes will no doubt be presented with challenges and opportunities as a result. The long-term impact of COVID 19, Brexit, sustainable investment and the move towards services tailored to online, easy-to-use platforms are just some of the major expected influencers of change. All of this is driving a shift in the operating models of the underlying sectors and industries, while at the same time influencing the composition of portfolios developed by asset managers and asset owners alike.

COVID 19

As the COVID 19 pandemic continues to create turbulence in global financial markets and propels investors into a race for liquidity, we are seeing investment funds grappling with some of the issues they had confronted during the global financial crisis, such as defaults on capital calls from high net-worth or private investors or tactical defaults and GP led restructuring. It's also creating severe political, social, and economic uncertainty that is translating into significant public market volatility worldwide. While the impact on alternative assets is less observable to date, it is likely to be as significant as that for public markets.

What is clear is for private markets the 2016 - 2019 vintages will likely be mostly impacted as they have the largest unrealized portfolios, leading to hold periods being extended as managers wait for market recovery. Earlier vintages should be less impacted as their returns should be baked in or realised at this stage. Co-investment transaction levels are expected to mirror the expected drop in private market transactions due to the increased uncertainty and the need for GPs to focus on navigating their existing portfolio companies through challenging market conditions.

BREXIT

Brexit will require managers to identify and map out the areas of their business that have cross-border connections both in and outside of Europe, and to set out detailed current types of their arrangements.

What is certain is that impacts will be felt in cross-border investment management and distribution functions. While it is now clear that regulations will allow for investment management functions to be fully delegated, cross-border marketing and distribution still poses serious concerns, as UK based firms will no longer have access to the EU passporting regime.

Without this, distribution of funds is subject to the relevant national private placement regime (NPPR) applicable in the given target Member State. The NPPR varies from Member State and some do not allow for any NPPR. As a result, managers of AIFs currently sold under the Passport have decided that reliance on NPPRs will not be appropriate in future. Such managers are establishing or engaging with EU AIFMs or EU AIFs to ensure continued access to the passport.

SUSTAINABLE INVESTMENT

A growing number of large institutional investors today are incorporating ESG metrics into their capital allocation and stewardship criteria. This shift toward sustainable finance has profound implications for investors and companies. Luxembourg is the first European country to launch a Sustainability Bond Framework. This innovative framework, which meets the highest market standards, is also the first in the world to fully comply with the new recommendations of the European taxonomy for green financing.

Living up to its reputation as a first-mover, Luxembourg has also incorporated eligibility criteria that are already fully in line with the recommendations of the final report of the Technical Expert Group on the Taxonomy of the European Union. In the same spirit, the framework has been designed to comply with the draft European Green Bonds Standard.

All these initiatives ensure Luxembourg contributes to the positive development of the sustainable fund market.

LEADING LUXEMBOURG

It’s difficult to determine exactly what asset managers might be looking for in response to these major changes in the global financial markets however it is very likely that investors will demand what leading factors Luxembourg has always offered and fine-tuned over the past three decades being:

- framework of long-term stability
- transparency
- commitment to serving an international fund industry
- proven track record in responsiveness to market demands
- willingness and ability to change

With a proven focus on providing expertise and structure to service the industry, Luxembourg is set to play a material role in the stabilisation of the European funds industry in a post Brexit, post COVID 19 and pro ESG era.

JTC LUXEMBOURG

JTC opened its offices in Luxembourg in 2009 and we have subsequently built our capabilities to offer full end-to-end servicing to the regulated and non-regulated fund sectors and are perfectly positioned to support Luxembourg's financial industry as it evolves to meet changes and new investor demands.

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