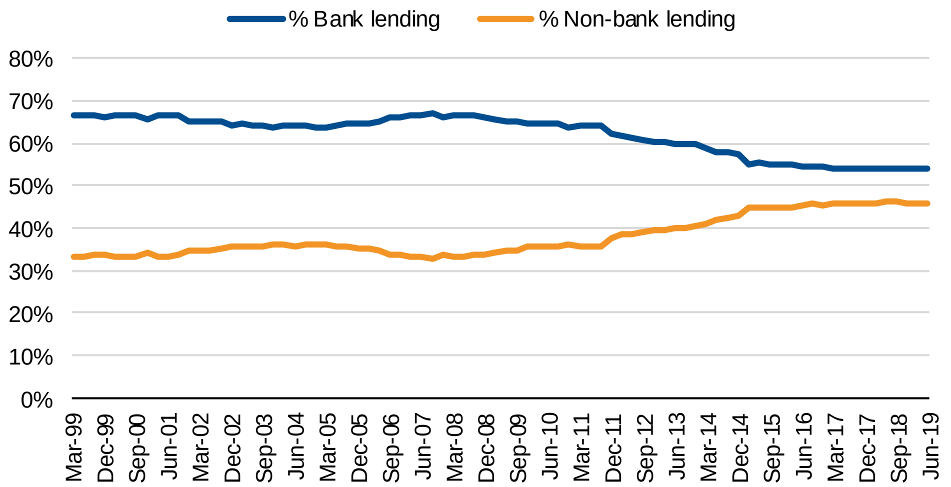
Direct lending funds risk assessment

Direct lending funds have become an important part of Europe's financial ecosystem in recent years, providing financing to middle-market companies and other borrower segments. These funds share similarities with leveraged loan CLOs, the more traditional way to gain exposure to a diversified high-yield credit portfolio. However, analysing the risk of direct lending funds requires a specific approach given the large discretion given to managers to build highly non-granular investment portfolios.

Figure 1: Evolution of bank and non-bank shares of total lending in the Euro area



Source: Financial Stability Board

Since the Global Financial Crisis (GFC), banks no longer dominate the European corporate lending landscape. Figure 1 shows the increasing share of total credit granted by the non-bank sectors, reaching 45% of total lending in the euro area as of Q2 2019 compared to 33% in Q1 2008. The emergence of private debt funds has helped to fuel this disintermediation process. The funds provide tailor-made solutions to corporate borrowers that are unable to find appealing conditions in traditional banking because of size, leverage constraints or special structuring needs.

Direct lending funds and leveraged-loan CLOs might appear as comparable investments to investors at first glance. But beyond an exposure to a portfolio of corporate debt managed by an asset manager with a strong background in corporate debt, the risk profiles of the investment options are very different. End-investors in direct lending funds are all exposed to the same portfolio risk, as opposed to CLO investors, who are exposed to different risk profiles via tranching.

Thanks to this alignment of interest with investors, direct lending fund managers have high flexibility in building and replenishing the asset portfolio. Direct lending funds typically have longer ramp-up and re-investment periods, broader eligibility criteria and less stringent concentration limits than CLOs. In Europe, fundraising for senior direct lending funds is now on a par with CLO issuance , which reached EUR 30bn.

An increasing number of direct lending funds are raising debt financing directly or indirectly via securitisation of their shares. Assessing the credit risk of this debt requires an in-depth analysis of the strategy and of the manager, given the generally lenient rules shaping the investment profile.

Analysts

Benoit Vasseur
+49 69 6677389 40
b.vasseur@scoperatings.com

Sebastian Dietzsch
+49 30 278 91 252
s.dietzsch@scoperatings.com

Mirac Ugur
+49 69 6677389 73
m.ugur@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

Assessing leveraged loan CLO managers demands a multi-faceted analytical approach, August 2019

Addressing credit risk for online lending platforms, January 2019

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

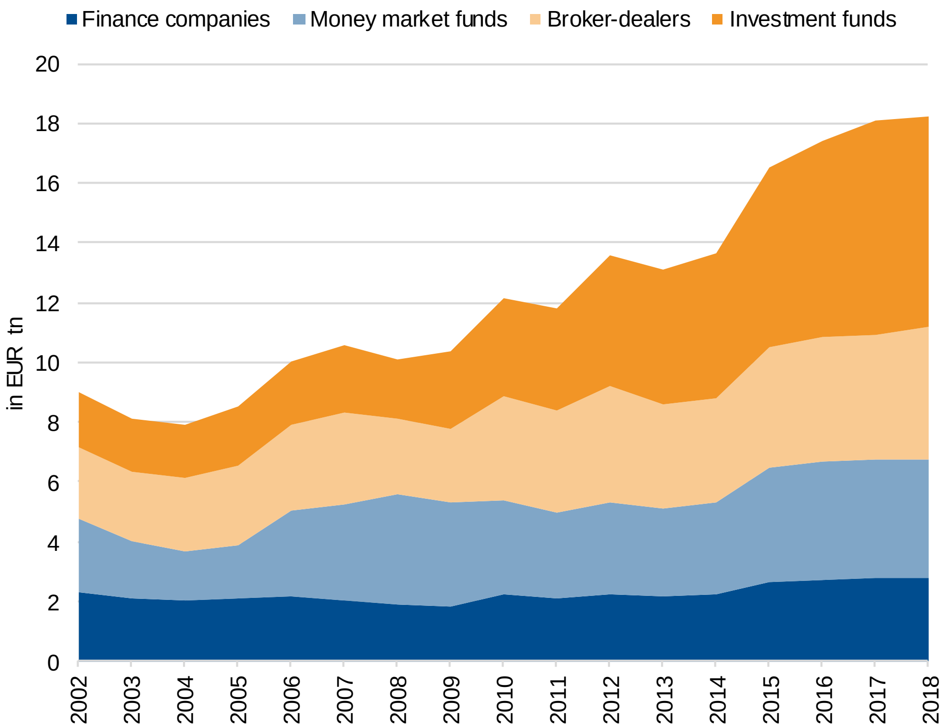
info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Over the last two decades, private debt has become a substitute for traditional bank-provided financing across global financial markets. Consolidation in the banking sector, tighter banking regulations and significant economic growth in the middle market help explain the growth of non-bank lending. This growth mainly stems from investment funds, as illustrated by Figure 2. Investment funds globally held about EUR 7trn of credit assets in 2018 compared to 2trn in 2008.

Investment funds are the main driver of private credit growth

Figure 2: Investment funds are the main driver of private credit growth[1]



Source: Financial Stability Board

Direct lenders connect SME to investors

Direct lenders filled the under-serviced middle market space, connecting small and medium-sized enterprises (SMEs) to institutional investors, fuelling the recent expansion of private debt as an asset class.

The consolidation of regional banks into larger banks with national reach has reduced the appetite to lend to smaller borrowers. Changes in the scale and the employment of the banking industry have pushed banks to focus on bigger clients with possibly larger fee-generation possibilities. The GFC also played a big role in this consolidation process, as stressed banks were merged while regulation introduced more stringent capital requirements. This led banks to significantly tighten their underwriting standards[2]. Nonetheless, middle-market funding needs have remained large as these companies continued to perform strongly[3], as evidenced by Figure 3 showing the failure rate of mid-sized companies trending lower in major European countries since the GFC.

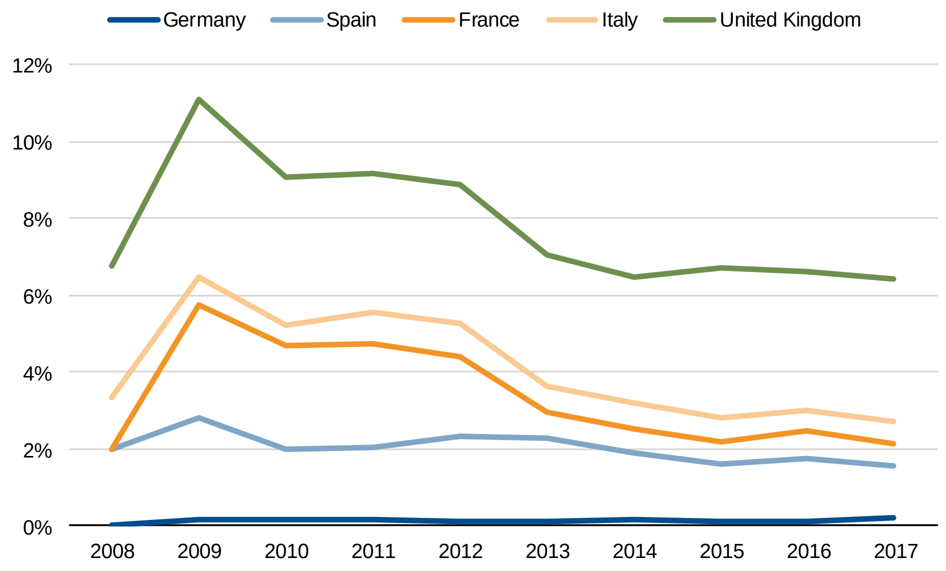
[1] This series is for euro area countries in addition to 21 other major countries including US and China.

[2] Even though European SMEs do not see access to finance as a big problem, they are still cautious about tightening collateral and other requirements in terms and conditions of bank loans. - *Survey on the Access to Finance of Enterprises (SAFE)*, European Central Bank

[3] Small and medium-sized enterprises (SMEs) accounted for 56.4% of the value added generated by the European non-financial sector in 2018 and it has grown 20% since 2008. SMEs have accounted for 50% of the total increase in non-financial sector value added. - *Annual Report on European SMEs 2018/2019*, European Commission

European SMEs show downward trending failure rates

Figure 3: Failure rate of European SMEs is trending low



Source: Eurostat[4]

The European private debt market has grown steadily in recent years but has not reached a mature state as in the US[5]. Demand for private debt funds is strong as they offer higher yields (see Figure 6) compared to other European asset classes, especially with low interest rates persisting.

1.1 Private debt as an asset class

Private debt includes any debt extended to companies by non-bank entities. Besides direct corporate lending, private debt can finance different types of activities, including infrastructure and real estate, mostly in the form of senior or mezzanine secured debt. While some strategies, such as distressed debt, focus on secondary market opportunities, the main driver of the expansion in the private debt space is direct lending.

Institutional investors such as pension funds, insurance companies and other fund managers typically lend to SME borrowers through a direct lending fund. Direct lending is a form of transaction where a lending source provides loans to corporate borrowers without an intermediary. The borrowers are usually SMEs, which use this debt not only for business activities but also for acquisition financing. Direct lenders include private equity and venture capital firms, hedge funds, CLO managers on behalf of certain vehicles, online lending platforms[6] and business development companies.

Direct lenders target SME with stabilised cash-flows

Private debt lending also entails different types of borrowers compared to traditional bank lending. The rigid cost structures and rather mechanistic lending approaches of commercial banks cannot compete in this market. Firms that borrow from non-bank lenders are typically younger, spend more on R&D and, outside the direct lending sector, are more likely to have negative EBITDA. Direct lending targets, however, are generally SMEs with stabilised cash-flows and proper business models. Private debt lenders initially tend to adopt a more relationship-based approach with a strong emphasis on the security package and assets of the borrower.

[4] This series is for companies with 10 or more employees.
[5] Bank loans and credit lines are by far the most relevant financing source for European SMEs. – *SAFE*, European Central Bank
[6] For more analytical considerations on online debt platforms, see this link: Addressing credit risk for online lending platforms

Direct lending focuses more on ex-ante alignment of incentives rather than ex-post monitoring. This is reflected in discipline through shorter maturities and different types of covenants such as restrictions on executive compensation or on a borrower's ability to change material contracts without lender consent, in addition to the traditional restrictions based on financial ratios. Other instruments include structured equity components, more interaction with the management of the company and high pre-payment penalties, since direct lenders plan to hold exposures to maturity.

Private debt lenders offer tailor-made solutions

Borrower-focused, tailor-made lending gives private debt lenders a competitive advantage relative to banks. Private debt lenders are able to impose higher spreads for tailor-made solutions through the focus on borrowers that cannot find appealing terms in traditional banking. Besides higher funding costs faced by non-bank lenders compared to banks with cheap deposits, the costs of obtaining credit relevant information drive the generally higher spreads.

1.2 Current European direct lending

Direct lending market continues to grow

According to Deloitte[7], the size of Europe's leveraged loan market has doubled in less than five years, now standing at EUR 201bn. Direct lending deployment also increased, from EUR 16.7bn in 2016 to EUR 38.1bn in 2018, following the same trend and corresponding to a 29% annual growth rate. More than 60% of European direct lending transactions are M&A-related.

Close sponsor involvement partially offsets the generally weaker credit profile of direct lending transactions. The majority of the deals involve a private equity sponsor that engages in a closer relationship with the transaction parties and may provide additional equity support for a loan. Geographically, most deals in post-GFC Europe took place in the UK, followed by France and Germany. According to Preqin, EUR 25.6bn was raised in private debt funds in 2017 compared to EUR 19.1bn in 2018. Private debt fundraising also picked up pace in 2019 after the slowdown in 2018.

1.3 Spiritual brother – leveraged loan CLOs

Direct lending funds have features in common with leveraged loan CLOs, stemming from the targeted credit quality of the portfolio and the overlap in fund managers. Beyond these two elements, the two products diverge, in particular with respect to the investment universe. Leveraged loan CLOs focus on the liquid broadly syndicated LBO market with significant public information, whereas direct lending funds target the non-public, less liquid SME LBO and refinancing markets. The two products might compete on a limited share of the private debt market, i.e. private debt to large SMEs, but generally only if CLOs are unable to find sufficient standard collateral.

[7] Deloitte alternative lender deal tracker Autumn 2019

Figure 4: Direct lending funds vs. leveraged loan CLOs

	Direct lending funds	Leveraged loan CLOs
Investors	Pension funds, insurance companies, sovereign wealth funds, asset managers	Broad range of institutional investors, including banks, insurance companies, asset managers and hedge funds, as many risk profiles are offered via tranching
Credit quality of asset portfolio	CCC – BB	CCC – BB
Assets	Wide range of SME loans, generally with a LBO or high-yield background, but private	Liquid broadly-syndicated loans to large caps, often in a LBO context SME LBO loans to a lesser extent
Return sources	Asset return includes illiquidity premium, which compensates for the larger effort to gather credit information Standard margin above reference 550+ bp	Asset return (standard margin above reference 350bp to 600bp) plus a complexity premium on the liabilities side
Asset-/Portfolio manager	Asset manager with significant expertise in credit origination, portfolio management and credit management	CLO manager with significant expertise in credit selection, portfolio management and credit management
Management flexibility	Generally high enabling the manager to implement credit views via overweight	Constrained by a tight set of rules ensuring preservation of collateral quality and minimum diversification
Conflict of interest management	Easy: investor group with homogeneous risk/return interests	Complex: different investor groups with heterogeneous risk/return interests
Regulatory framework	AIF rule book, which focuses on reporting and transparency Different regulatory capital charges, depending on internal approach (look-through, etc)	Securitisation regulatory rules apply, among others for risk retention and regulatory capital charges
Liquidity of instrument	Generally limited tradability of the fund shares or the repackaged debt	Liquid secondary market available for both assets and liabilities
Asset management costs and structure	Significant information advantage of the asset manager regarding the assets justifies senior ranking asset management fees of up to 1.0%; Performance fee for the asset manager, depending on total return to investors	High level of public information improves the assets' liquidity, which reduces senior costs to 0.1% to 0.15%; Performance fee for the asset manager, depending on equity returns

2 Asset characteristics of private debt funds

Private debt funds offer flexible asset management

Private debt funds generally start as empty shells that normally progress through three periods: the investment period (portfolio ramp-up), the re-investment period (portfolio management) and the divestment period (liquidation/amortisation). During these phases, an asset manager allocates committed funds in the private debt space according to a generally flexible set of conditions (the investment criteria), and with a significant degree of discretion that reflects its quality, investment style and expertise (asset manager impact).

2.1 Action on behalf of the fund – the asset manager

A private debt fund employs an asset manager to invest investors' money in private debt assets, both during the ramp-up period and the re-investment period. The manager's objective is to create a portfolio of private debt assets that is superior to the average private debt market (

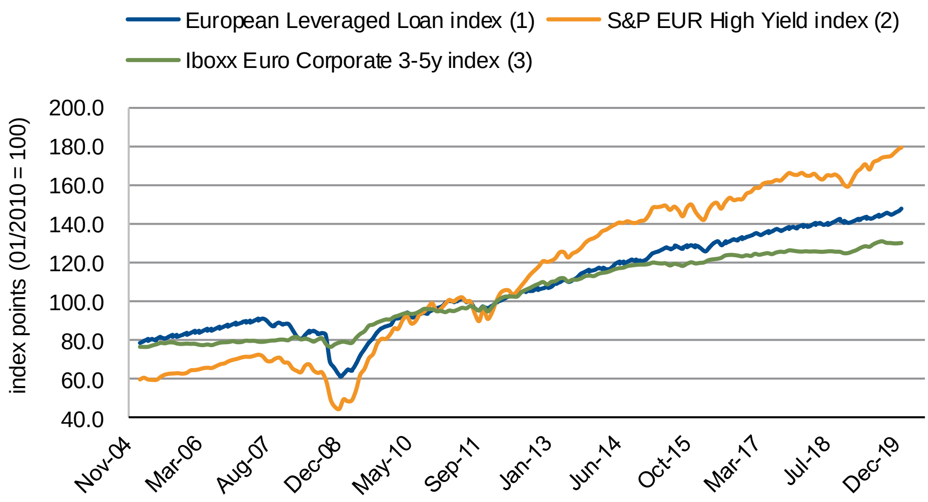
Strategy specific benchmarks allow to show portfolio management benefit

Figure 5), in terms of risk and return[8], net of management fees.

[8] Generally measured in a sharp ratio that is higher than an appropriate market benchmark.

Strategy specific benchmarks allow to show portfolio management benefit

Figure 5: Selected European debt performance benchmarks[9]



Source: Scope Ratings and Bloomberg

The over-arching similarity between successful private debt managers is the superior ability to execute a credit investment strategy, which requires both excellent market access and a superior fundamental credit intelligence.

Market access is a key feature

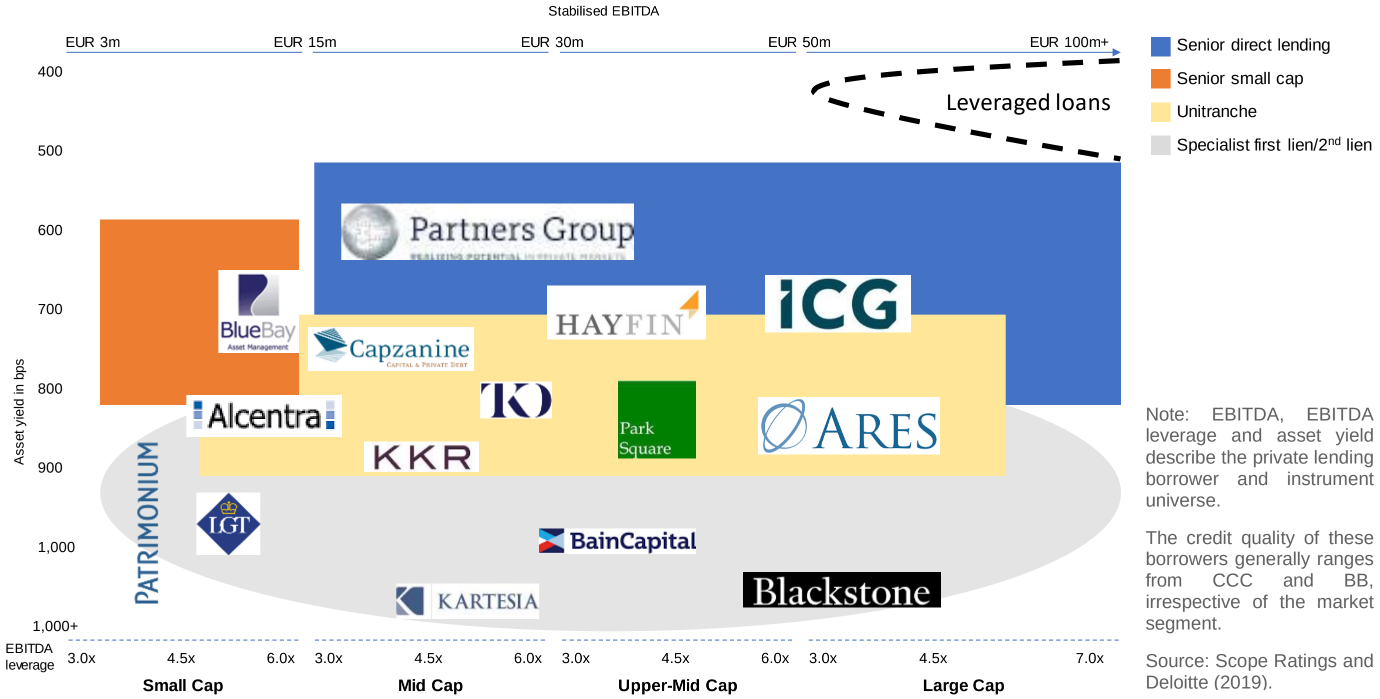
Given the private nature of target investments, market access is fundamental to the implementation of any investment strategy. Scope qualitatively assesses market access through an evaluation of the manager's private debt transaction-related sponsor and borrower network. Additionally, we consider its integration into the financial markets as an institutional investor, including its relationships with investment banks, brokers and other asset managers. The quality of the operational set-up in terms of proficient traders, hardware, software and back-up systems also feeds into this assessment.

Wide range of strategies and management styles

The credit investment strategy lays the path for the portfolio building and usually distinguishes asset managers from each other, as a function of their size, area of operations and risk appetite. As shown in Figure 6, the continuum in private debt ranges from boutique managers that often focus on niches, i.e. targeting small corporates and smaller investment lots, to large global asset managers, which generally also have a CLO management background. The latter focus more on larger corporates within the SME universe with larger investments, such as unitranche transactions.

[9] Over the last eight years, European leveraged loan have showed a much better Sharpe ratio than European high-yield or investment grade debt (2.0 vs 1.2) thanks to a much lower realised volatility.

Figure 6: Sample asset managers in European senior direct lending[10]



Note: EBITDA, EBITDA leverage and asset yield describe the private lending borrower and instrument universe.

The credit quality of these borrowers generally ranges from CCC and BB, irrespective of the market segment.

Source: Scope Ratings and Deloitte (2019).

Exclusive access to borrower information is a source of alpha

Despite the presence of many sophisticated and successful smaller asset managers, investors tend to favour larger managers, because of credit investigation capacity, investment sourcing and capital commitments. In particular, the larger managers have the resources to attract and keep talent in-house, and therefore maintain a higher diversity of opinions. For instance: anticipating market trends goes hand-to-hand with fundamental analysis, as illustrated by the downturns in the construction sector right before the GFC or the financial distress experienced by oil-and-gas companies more recently. In addition, the ability to generate exclusive borrower information has proven to be a major source of excess performance in the illiquid market of private debt.

Larger managers can cope with large borrowers' financing needs

The manager's size also plays an important role in terms of funding capacity. Privately-arranged unitranche financings, which have broken the EUR 1bn mark[11], cannot be assumed by one fund alone, due to concentration constraints. The ability of multiple funds and accounts under management allows these large investments to be split into pieces in-house, addressing the demands of borrowers with large financing needs that value the flexibility and privacy of this market.

A strong legal and compliance framework, together with a good understanding of the manager's incentives and remuneration complete Scope's assessment of the asset manager. We consider how much the fund manager is allowed to deviate from the expected strategy within the investment criteria (see Figure 7). For instance, trading systems which allow transaction criteria to be implemented with hard exclusion rules, limit the manager's flexibility and ensure a high level of investment compliance.

The alignment of interest with investors, either through co-investment or subordinated remuneration also improves our understanding of the manager's use of available flexibility.

[10] The list is not exhaustive. Some managers have assets under management for several of the strategies listed in the graph
[11] Bloomberg (03/2019): www.bloomberg.com/news/articles/2019-03-06/who-needs-a-bank-why-direct-lending-is-surging-quicktake-q-a.

2.2 The portfolio framework – investment criteria and portfolio profile

Managers and investors have aligned interests in debt funds

The investment criteria of debt funds are normally more flexible than comparable structures such as CLOs, allowing more discretionary decisions by asset managers and higher concentrations. This is mainly driven by the symmetry of interest between investors and with the asset manager. Debt fund investors are all on the same level, sharing the same interests with respect to risks and returns of the fund. Tranched products, however, face high interest asymmetry between the different stakeholder groups from the top to the bottom of the capital stack, which generally results in much more detailed/narrow investment criteria.

Investment criteria depend on the fund's strategy

Regulatory constraints and investors' requirements will define additional investment boundaries for the asset manager. The investment criteria act as minimum requirements the fully invested portfolio must comply with. However, there may be deviations with respect to portfolio profile criteria, such as concentration limits, which generally only apply for the fully-ramped portfolio. The asset manager accepts these as an obligation, where non-compliance may lead to a mandate withdrawal and even to legal litigation in case wilful misconduct can be proven.

Investment criteria for private debt funds steer portfolio management

Criteria can be defined as applicable to single investments (eligibility criteria), the entire portfolio (portfolio profile criteria) or both. Investment criteria for private debt funds generally touch on the following areas:

Figure 7: Typical investment criteria for private debt funds

Item	Specification
Obligor type	Company type, project type, generally characterised by key metrics
Debt type	Seniority, security, under stress
Expected return	Either in the form of a minimum coupon and/or a portfolio target return
Credit quality	Minimum rating requirement, and/or credit relevant metrics such as EBITDA and leverage
Amortisation profile	Bullet and/or amortising, driving cash-flow projection and reinvestment need
Maturity	Depending on the fund exit strategy: • No final liquidation maximum investment maturity that allows a contractual amortisation within the debt fund's lifespan, including a tail-period to address potential debt work-outs • Final asset sale no maturity limits required
Concentration	Single name Region Industry Other

The fund's investment criteria alongside similar existing transactions run by a specific manager are the largest drivers of Scope's asset portfolio assumptions. More tangible elements, such as a static portfolio or a homogeneous balance sheet from which the manager selects the assets, reduce the uncertainty of the portfolio risk profile.

2.3 Three portfolio life periods – ramp-up, reinvestment, divestment

The life periods of a private debt fund come with certain risks for the investors, but also certain mitigants.

2.3.1 Ramp-up period

Ramp-up period generally exceeds one year

At the beginning of a private debt fund project, there is no portfolio and the asset manager employs its abilities to deploy the collected investor capital in an optimal way, in line with the investment criteria. We analyse the asset manager's investment strategy and the path pursued to reach the target portfolio, accounting for historic performance in similar strategies. The required ramp-up period depends on the manager's opinion about market access and the investment pipeline, but also on fund strategy[12]. We view positively whether the ramp-up plan for the portfolio respects target portfolio covenants at all times[13], as it limits the risk of being stuck with a non-compliant portfolio should the investment market shut down during the investment period. Liability costs during this period can be met from collected coupons. Otherwise, well-sized reserves also help to ensure the liquidity of the fund.

Defaults and losses during the ramp-up period can happen, but should be commensurate with the credit profile outlined by the investment criteria. Moreover, potential excess funds from coupon and acquisition discounts may help par-value preservation.

2.3.2 Re-investment period

Active management lasts usually between two to four years

Once the target portfolio is reached, the re-investment phase starts. The asset manager re-invests portfolio repayments and collected coupons, to the extent they are not required to meet certain fund liabilities. During this period, a clearly defined waterfall helps identify the funds available for re-investment. Excess funds can be used to either create over-collateralisation, or pay extra dividends to investors, above standard periodic distributions.

At this point, the fund should have a portfolio that is 100% compliant with the investment and portfolio criteria. The repayment of investments will be redeployed, in line with investment criteria. If no replacement can be found, the investors may demand repayment of their investment in order to avoid negative carry on non-deployed cash.

2.3.3 Portfolio amortisation period

The portfolio amortises naturally or via sale

Once the two to four years of active portfolio management are over, the portfolio will amortise, either i) actively through asset sales, ii) passively through amortisation, or iii) a combination of both. The investor preference may favour one of the three options, in terms of:

- time to repayment, i.e. the investor considers how quickly they can re-invest the funds into a new actively managed product;
- profitability, i.e. the investor considers the remaining portfolio yield and sale costs;
- market conditions at the time of divestment, i.e. the investor considers market value discounts, re-investment options;
- credit loss potential, i.e. the investor considers the potential portfolio losses from credit events, accounting for idiosyncratic information but also market and industry trends; and
- asset manager quality, i.e. the investor considers the asset manager's secondary market access as a seller, but also its capability in an asset workout scenario.

Very often, we have seen cases where option iii) is preferred. Following the re-investment period, the asset manager has a certain period of time, generally assumed to be the

[12] Some debt investment strategies show more opportunities than others and may shut down from time to time. In particular the distressed debt market may not be open to everyone, given the sensitivity of information involved, and a volume highly dependent on the business cycle.
[13] Leaving concentration covenants aside.

expected life of the product plus two years where amortisation may happen, but with a focus on opportunistic sales.

The other two cases are extreme in the sense that option i) may only need a tail period sized sufficiently for the asset manager to arrange the orderly sale of the entire portfolio; without buffers; this could be just a few weeks. Option ii) may go as far as the longest asset maturity plus an additional period to allow for an orderly work-out of potentially late defaults.

From a credit risk point of view, keeping both option ii) and option iii) available would be preferable, as it allows sufficient buffers to let the assets amortise, in case of high market-value discounts. In addition, the option for an opportunistic sale can be valuable in the case of credit-impaired assets. Option i) and option iii) introduce a market risk component, as the manager might find an adverse market environment when a too short tail period forces asset sales at distressed prices, that are not reflective of credit risk.

2.4 Key risk drivers of direct lending

Figure 8 outlines selected key risks that investors in direct lending funds are exposed to and highlights which information Scope uses to conduct its assessment.

Figure 8: Key risk drivers of direct lending funds

Risk	Information used and main questions to answer
Default risk	**Track record of investments:** - how successful is the manager at avoiding defaults and impairments in the light of the targeted strategies? **Internal rating or scoring model:** - how does the manager assess credit quality and differentiate risk profiles? - how forward-looking are such assessments? - how did these measures perform historically?
Recovery risk	**Historical performance:** - what levels of recovery were achieved for impaired/defaulted credits? **Origination practices:** - what types of covenants are included in the loan documentation? - what is the level of control of the manager in a restructuring situation? **Recovery strategy:** - how would the manager typically work out distressed assets? - is there in-house expertise to handle complex restructurings?
Reinvestment risk	**Origination strategy:** - what is the manager strategy if tightening spreads limit investment opportunities? How was it handled in previous strategies? - what is the deal pipeline and expected market volumes? **Positioning and market access:** - what are the steps taken to ensure relevance and access to borrowers in a market with increased competition?
Market risk	**Historical price / spread time series:** - should the strategy rely on the sale of assets prior to maturity, what is the expected price discount taking into account illiquidity and possible market stresses? **Exposure to FX and interest rate moves:** - what are the hedging agreements and strategy in place? - if any residual exposure is left, how can it evolve given origination strategy?
Asset manager risk	**Historical track record in ramping up funds and meeting investment criteria:** - has the manager achieved to commit the capital according to the envisaged timeline? - do the managed portfolio offer more diversification than the investment criteria? **Evolution of AuM and financial performance:** - is the manager well positioned to invest in the coming years in people, technology and infrastructure? - can the fundraising strategy compromise origination strategy? **Track record and stability of the investment team:** - is there key person risk? **Alignment of interest:** - has the manager also made his own capital contributions to the fund? - what is the fee structure in comparison to market practices for the envisaged strategy? - at asset level, are the borrowers owned by a private equity sponsor?

3 Debt financing of private debt fund structures

Funds increasingly raise financing in the form of debt

Traditionally, funds issue shares with equity-type properties to raise the financing needed to grant loans to selected corporate borrowers. Recent regulations, however, incentivise institutional market participants to invest in rated debt products. This is particularly the case for insurance companies looking for long-duration investments matching their liability profiles[14]. As a result, we see an increasing number of funds raising debt financing directly or indirectly via securitisation of their shares. Luxembourg-domiciled entities issue most of these debt instruments in Europe, as Luxembourg offers comprehensive and flexible frameworks[15] for securitisation and fund activities.

3.1 Type of issuer

Most of the Luxembourg transactions are executed through securitisation vehicles, governed by the Securitisation Law of 22 March 2004, or investment funds, depending on the fund manager structure and requirements of end investors.

3.1.1 Securitisation vehicles

Securitisation vehicles or SIF/RAIF are common structures

Luxembourg securitisation vehicles can take the form of a company or a fund. A securitisation company needs to meet minimal capital requirements (e.g. EUR 31,000 for a *société anonyme*) and can be set up as an orphan structure, with the shareholders being a charitable trust. The company's board of directors can create segregated compartments if the articles of association of the vehicle allow. The compartments do not affect each other as assets are ring-fenced. If assets in one compartment under-perform, the creditors of this compartment may suffer losses without recourse to the other compartments' assets.

A securitisation fund is incorporated as a *fonds commun de placement* (FCP) or a fiduciary estate and is managed by a management company incorporated in Luxembourg. No capital is required at fund level. Similar to the compartments in a securitisation company, a securitisation fund can be split into various sub-funds, which can be treated as separate entities with full segregation of assets, independent creditors and possible various priorities of payments.

3.1.2 Specialised and reserved alternative investment funds

Figure 9 summarises the main characteristics of securitisation vehicles, specialised investment funds (SIF) and reserved alternative investment funds (RAIF).

SIFs and RAIFs are incorporated as FCP or SICAV and have a minimum capital requirement of EUR 1.25m to be reached within 12 months of incorporation. SIFs are supervised by the Commission de Surveillance du Secteur Financier (CSSF) and most qualify as alternative investment funds (AIF) requiring an authorised alternative investment manager (AIFM). RAIF are not supervised by the CSSF and all qualify as AIF, requiring an authorised AIFM. Both SIF and RAIF can be structured in separate and independent sub-funds giving the same flexibility as securitisation funds.

[14] For instance: Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) in effect since 1 January 2016, Rundschreiben 11/2017 (VA) published by the BaFin

[15] Governing laws include the Law of 22 March 2004 ('Securitisation Law'), the Law of 13 February 2007 ('SIF Law') and the Law of 23 July 2016 ('RAIF Law')

Figure 9: Different types of issuing vehicles

	Securitisation Vehicle	SIF	RAIF
Legal Form	Securitisation company or securitisation fund	FCP or SICAV/SICAF	FCP or SICAV/SICAF
Sub-funds or compartments	Possible	Possible	Possible
Supervision	No supervision by the CSSF unless repeated issues to the public	Supervised by the CSSF	Not supervised by the CSSF
AIF	Do not qualify	Mostly qualify	Qualify
AIFM	No	Yes	Yes
Investment type	No restriction	No restriction	No restriction
Investor type	No restriction	Institutional, professional investors or HNWI	Institutional, professional investors or HNWI

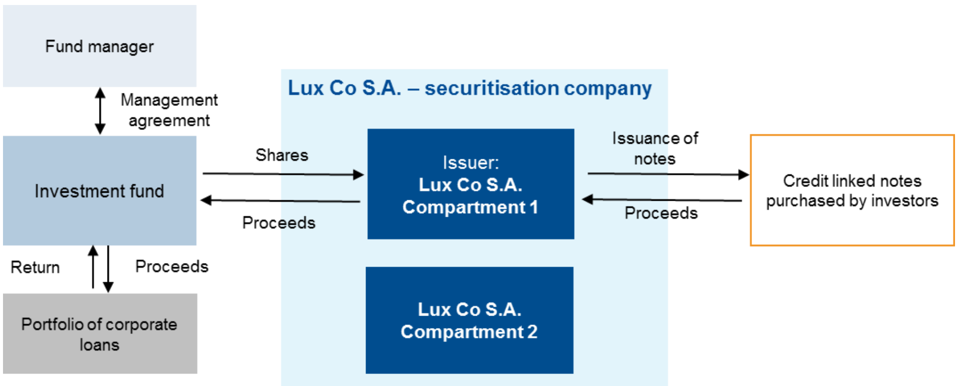
3.2 Structure overview

Issued debt is a pass-through of the fund's strategy

The issuer's assets consist of the portfolio of loans originated by the fund manager or shares issued by the fund owning the portfolio of loans. To finance the purchase of the assets and the set-up costs of the structure, the vehicle will usually issue credit-linked notes under a single class of debt, without subordinated tranches to absorb first losses. However, it may be the case that the notional debt is lower than the funds' net asset value, or that the expected fund interest proceeds exceed the structure's liability costs. In that case, the rights to this 'implicit' equity are attached to the debt instrument i.e. excess funds from the portfolio also flow to debt investors. The next two figures illustrate common structures involving a securitisation company and a specialised investment fund.

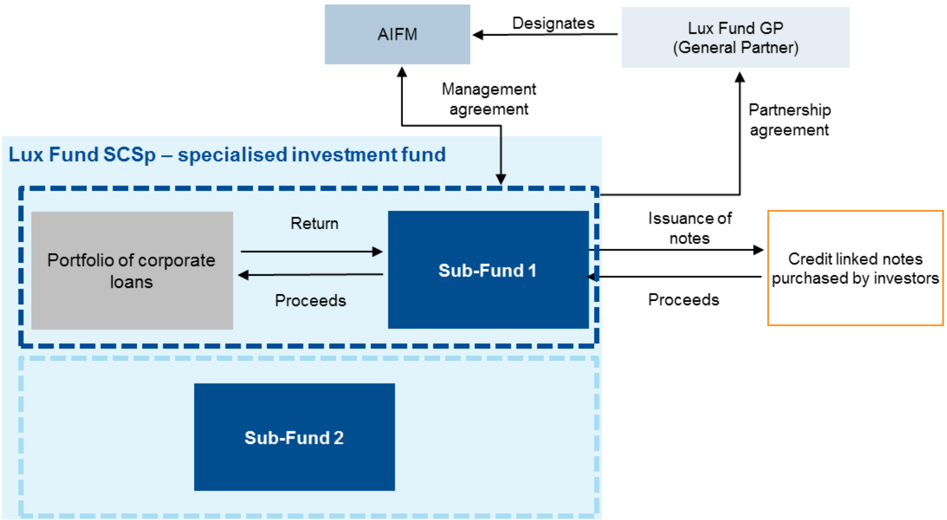
Securitisation company owning fund shares

Figure 10: Case of a securitisation company owning fund shares



Specialised investment fund

Figure 11: Case of a specialised investment fund



Due to the pass-through nature of these securitisations, investors in the credit-linked notes in both cases highlighted above have a similar risk and return profile that mirrors a direct investment in the fund's shares. However, the credit-linked notes receive preferential treatment regarding capital charges under certain regulatory frameworks, such as Solvency II if they can achieve an investment-grade rating from an external credit assessment institution.

3.3 Profile of the debt financing

Excess funds can be used to repay debt principal

The issued debt usually promises regular interest payments at defined interest payment dates and the redemption of full principal at maturity date. It also generally pays a variable coupon depending on the performance of the underlying fund's shares or assets, similar to the excess spread paid to equity investors in other structured finance transactions. The failure to pay variable coupons does not trigger a default of the issued debt. Alternatively, certain structures use some of these excess funds to amortise the principal early. Scope's credit analysis focuses on the expected loss associated with the payments contractually promised by a debt instrument on a particular payment date or by its legal maturity.

Liquidity risk is mitigated by low or deferrable coupons

Structures in which the interest due under the terms of the credit-linked notes is deferrable, and/or much lower than the annual net return expected from the fund's shares or portfolio of assets, show limited liquidity risk[16]. Similarly, specific expenses such as management fees may also be deferrable in certain structures. Additionally, pre-funded reserves, replenishment of which ranks senior in the waterfall provide similar liquidity risk mitigation, if sized reasonably.

Long investment periods may trigger market risk at maturity

Market risk can be present in structures where the legal final maturity of the financing instrument is earlier than the scheduled maturity of the fund's assets[17]. This may be the case for structures with long re-investment periods, or investments in long-dated assets. Should it be necessary for the issuer to sell fund shares or for the fund to sell underlying assets in order to generate the required cash flow at maturity to redeem the debt, the notes will be exposed to market-value risk upon liquidation of the fund's shares or assets. We incorporate this risk by applying market-value decline assumptions appropriate to the

[16] Liquidity risk means that the volatility in the generation and distribution of the fund returns may lead to a shortfall of cash available for interest payments by the issuer of the credit linked notes.
[17] See option i) and option iii) in section 2.3.3.

characteristics of the asset portfolio to be liquidated. Mechanics favouring early amortisation of the notes mitigate the impact of such risk as the outstanding notes' principal at maturity is reduced. Any currency mis-match between assets and issued debt also exposes investors to market risk. Fund managers often employ hedging agreements such as forwards or options to mitigate foreign exchange risk.

3.4 Building credit enhancement

There are multiple ways to create credit enhancement

The repackaging of private debt funds is generally only attractive to institutional investors if the credit-linked notes achieve an investment-grade rating. Considering the non-investment grade profile of private debt fund portfolios, the rated instruments need credit enhancement. They normally benefit from over-collateralisation, either in the form of excess spread, additional refundable reserves, or a lower instrument notional compared to the fund's net asset value. Figure 12 summarises some of the mechanics in structures we have seen.

Figure 12: Mechanics of credit enhancement building

Way of building credit enhancement	Mechanics

Over-collateralisation	• Obtained when asset value exceeds remaining principal liability due
	• Ways to create over-collateralisation at inception includes:
	  ○ purchase the assets at a discount
	  ○ issue the debt at a premium

Cash reserve account	• Can be used to fund expenses and cover portfolio losses • Usually funded at inception of the transaction
Excess spread	• Corresponds to interest payments on assets net of senior fees, expenses and interest payments due under the notes • Can be substantial as interest due is usually set well below expected asset yields • If used to pay down the notes or invest in new assets, over-collateralisation is improved • If paid as a variable coupon, does not create credit enhancement • Can be used to replenish the cash reserve account

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com