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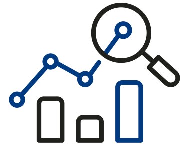
More than a fund company



LOAN FUNDS: A GROWING SOURCE OF FINANCE FOR EUROPE'S ECONOMY

Loan funds are increasingly popular with income investors and with corporate borrowers who struggle to access traditional sources of finance.

Banks remain the primary source of lending to European businesses, but getting loans approved can be tough. Since the global financial crisis, banks have a reduced appetite for corporate lending, reducing the number and types of business they are willing to finance.

At the same time, interest rates have been historically low (although that is changing slowly as inflation heats up). That has had a big impact on income investors, whose returns on traditional assets such as bonds have been weak. The rise of loan funds addresses both issues: it pools investors looking to boost their returns, while financing the growth of a wider range of businesses.

A loan fund for every appetite

Loan funds come in a variety of flavours, from lending to high-grade corporates to taking on the distressed debt of companies struggling to make repayments.

Many managers invest in corporate debt in the form of collateralised loan obligations (CLOs), where lenders pool or refinance multiple loans to companies and sell them in tranches that vary according to their risk and return. CLOs have fallen in and out of fashion over the years, but are a hot investment trend today, according to Fitch Ratings. European primary issuance of CLO securities reached a post-crisis high in 2021, with 94 issues totaling €38.5bn, a significant increase from 2019 (€29.9bn) and 2020 (€22.1bn).

Recently approved updates to Luxembourg's securitisation law, which notably authorises active management of securitisation vehicles for risks linked to bonds, loans or other debt instruments, as well as increasing investor protection, should make it more attractive to domicile CLO funds in the grand duchy. The changes should also boost the supply of securitised loans, by facilitating access for small and medium-sized businesses, and start-ups, to alternative financing under the European Crowdfunding Regulation.

Some investors like more control over the identity of the underlying borrowers, rather than buying into pools of assets.

Direct lending funds do as their names suggest. Fund managers pool investors' cash and lend it directly to businesses. This requires greater due diligence and expertise, as the fund's managers are acting like bank lending officers. They assess each company's current debt levels, cash flows and overall ability to repay, adjusting the terms and interest rates to the borrower's particular circumstances.

Thriving after lockdown

Not surprisingly, Covid-19 lockdowns have introduced an unprecedented element of uncertainty to the loan fund market. CLO activity dipped when entire business sectors were shut down and their revenues collapsed. There has been widespread reassessment of CLOs themselves and the risks they present to investors.

According to Fitch, reset and refinancing activity continued to hit new highs last year – but not necessarily, as might be suspected, reflecting a generalised worsening of borrowers' ability to repay. While more than one-third of European CLOs were re-evaluated or reset in 2021, with 100 transactions reset and 63 refinanced, the ratings of a majority of tranches reviewed in December were maintained or upgraded.

S&P Global Market Intelligence points out that volatility in the broader financial markets sparked by uncertainty over inflation is less of an issue for loan funds, whose assets are almost always floating rate based.

In Europe, loan funds come under the Alternative Investment Fund Managers Directive, and are mostly domiciled in Luxembourg or Dublin, the main jurisdictions specialising in funds sold in multiple EU markets. As alternative investment funds, access is generally restricted to professional and more sophisticated investors rather than the retail market. According to Preqin, direct lending funds dominate the sector, with assets of $138bn as of mid-2020.

Going green

There are two key themes that loan fund investors should be aware of: sustainability and regulatory developments, including a combination of the two.

ESG investment is accounting for an increasingly large share of European fund assets. Around one-third of European funds of all types are already classified under article 8 (displaying sustainability characteristics) or 9 (demonstrating a sustainability purpose) of the Sustainable Finance Disclosure Regulation, and their number could climb further this year.

The loan fund sector is somewhat late to the party, but no less eager to develop its ESG credentials – typically negative screening to avoid loans to 'bad' industries.

Yet, as in mainstream and other alternative sectors, there is growing awareness that negative screening is simply not enough. Investors are also wary of greenwashing: when sustainable claims do not match actions, or cannot be verified. The Sustainable Finance Disclosure Regulation is a good start. But there are gaps, particularly in the availability and credibility of data available to fund managers on the securities they invest in, and for investors to gauge the sustainability of the fund managers they trust their money to.

In private markets, data is even patchier and managers generally less experienced in all things ESG. The European Securities and Markets Authority is well aware of this and plans to make greenwashing a key priority in the next few years. Loan fund managers know that integrating ESG factors is complex, that they need effective processes, and that data vendors or their internal teams must move quickly to fill data gaps.

Liquidity and investor protection

The European Commission is also preparing reforms to the AIFMD regime itself. It has proposed restrictions on loan origination rules, requiring funds to keep a proportion of all the loans they make on their books rather than selling them on wholesale, and standardising the regulatory frameworks for private lending in place in EU member states.

Its aim is to provide better protection to investors and improve the management of risks to the financial system as a whole, although there is some concern within the industry about the implications of the changes the Commission has in mind.

How funds decide to manage their loan books in the long term could result in managers switching from open-ended to closed-ended structures, and placing restrictions on redemptions. The Commission is also concerned about liquidity, which should always be a consideration for loan fund investors. That is why EFA private asset services team has developed significant expertise in booking/keeping, audit support, tax, KYC and reporting for private lending assets.

Whatever the regulatory outlook, appetite appears undiminished. Recent loan fund launches have secured billions from investors, signaling that loan funds are likely to play an increasingly important role in financing the economy and its sustainability transition.

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