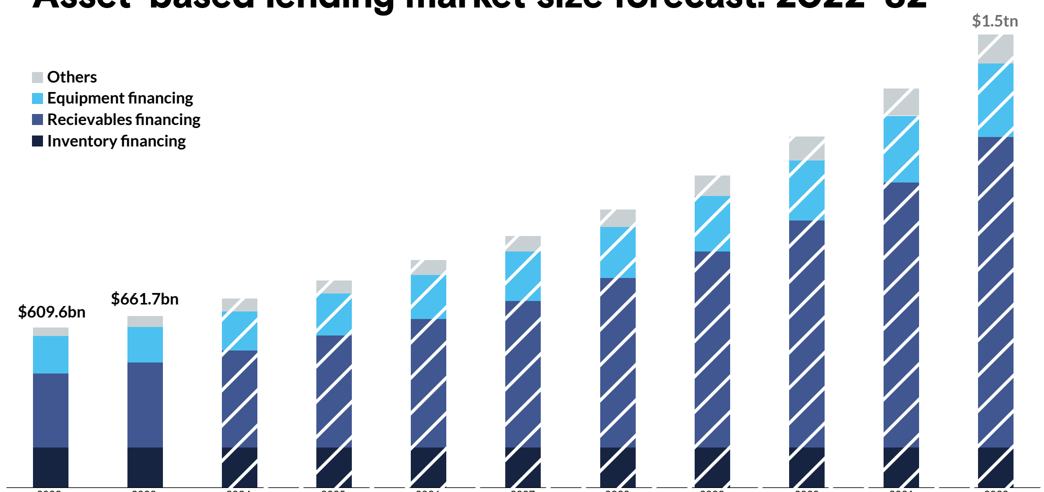
ABF: the new frontier for private credit in Europe

ABF is established in the US. It is now a focus for credit investors looking for private credit deployment opportunities in Europe that can offer attractive potential yields outside of traditional direct lending

By James Oussedik, John Goldfinch and Jon Burke

In the last 12 to 18 months, asset-backed finance (ABF) has been heralded as the next frontier for private credit in Europe, in the wake of bank retrenchment and evolving regulatory capital considerations. Already a well-established segment in the US, ABF has become a focus for global credit investors looking for private credit deployment opportunities in Europe outside of traditional direct lending, with attractive potential yields, offering diversification within portfolios, and downside protections. As a result, an increasing number of private fund sponsors are looking to create dedicated pools of capital to pursue ABF strategies in Europe.

Asset-based lending market size forecast: 2022-32



Source: Asset-based Lending Market Report, July 2024, Global Market Insights Inc. (https://www.gminsights.com/industry-analysis/asset-based-lending-market)

The first issue to consider when analysing a European ABF strategy is what, exactly, it is intended to cover at the asset level. The intended scope of the strategy and perimeter for investing will directly impact potential investor liquidity terms, fund leverage requirements, tax structuring, and regulatory posture. The range of investments covered within ABF is very broad: NPLs, RPLs, mortgages, receivables finance, consumer loans, plant and machinery finance, aircraft and locomotive rolling stock, to name a few.

When analysing types of investment return, income generation tends to be a key feature of most ABF portfolios along with the credit enhancement that comes from being able to isolate the cashflows generated by the relevant pool of assets. The extent and duration of income returns will influence certain investor-facing liquidity terms, including the ability to offer income distributing classes, redemption terms, and the extent of any gates, and the potential speed at which "run-off" interests may be paid out.

The inclusion of greater equity exposure is a common theme among alternative credit strategies, including ABF. The desire to potentially extend the limit on the equity bucket within a strategy's investment restrictions has increased during 2025, and may be viewed within the broader theme of the evolution of "private credit 2.0", which in some ways may be better labelled "private capital 2.0", characterised by an increased focus on the ability to provide hybrid solutions across the capital structure.

A larger equity bucket may facilitate taking greater equity exposures to lending platforms, either through creating such platforms, or providing the flexibility to hold majority ownership positions in existing platforms, potentially offering additional synergies with forward-funding arrangements and investment opportunities.

During the product development phase for a new ABF fund, there are various headline decisions which will need to be thought through, including from an investor preference perspective.

The key choice on structure will be to determine whether the fund will be structured as a traditional PE-style credit fund with a commitment/drawdown, cash-on-cash waterfall, and defined term, or as an evergreen fund, which may also include commitment/drawdown, or full capital subscriptions, but will typically provide for greater liquidity optionality for investors, with an open-ended term. There is now much more diversity in the market, led in large part by the preference of certain prospective institutional investors for evergreen products.

In the arena of evergreen funds, to the extent that the portfolio is likely to be comprised of private positions with income-generation, the general approach will be to utilise a liquidity toolkit which may include initial lock-ups, redemption fees, and run-off share classes, or "vintage" based investment periods with re-up mechanics between vintages. Considering income distributing classes may also be relevant, with investors pivoting to focusing on DPI as key a metric to evaluate fund investment performance, and liquidity optionality more generally being higher up the list of investor priorities. Incentive methodologies may vary between cash-on-cash waterfalls with carry distributions, and NAV/high-water mark incentive methodologies, which may also include an additional hurdle.

ABF funds will also need to consider during the product design phase the extent to which AIFMD II may apply. For an EU fund with an EU-based alternative investment fund manager, three particular aspects are of primary relevance:

- 5% retention requirement: loan originating funds (i.e. funds intending to hold 50% or more of NAV in originated loans) will be required to retain a 5% interest in the loans they originate, subject to certain exceptions;
- Leverage limits: an open-ended loan origination fund will be subject to a leverage limit of 175%, and a closed-end fund 300% – careful evaluation of what is incorporated into these limits will be required; and
- Open-ended funds: loan originating funds which are open-ended will have to include certain liquidity management tools.

Additionally, many European ABF investments may qualify as securitisations within scope of risk retention regulation. Depending on investor needs and the domicile of the fund, there may be a need to comply with those regulatory requirements, as detailed further below.

Tax structuring downstream to the investment-level will require specific attention, both to address potential leakage from credit investments, but also any equity investments which may require separate structuring solutions. Linked to this, the position on the tax treatment of incentive or carry amounts payable to the sponsor and its executives will need to be thought through up-front.

It tends to be the case that structures are market-tested in the US first and then port across to Europe being appropriately 'translated' by lawyers and other advisers in the route across the Atlantic. However, it is the case that jurisdictional differences do not translate to fundamentally differing ABF structures, which helps investors to approach both markets on a joined-up basis.

> **The ABF market permits a tailored approach that strikes a balance between the needs of sponsors and investors**

ABF investment structures can take many forms, often depending on the fund sponsor's existing relationships, investments and portfolio companies. Sponsors may have lending and other similar platforms in their portfolios, allowing an ABF fund to finance portfolios originated by such entities or acquire assets directly. As noted above, an ABF fund may also make equity investments in originating platforms, or create new platforms, to generate investment opportunities.

The typical strategy employed by ABF funds involves financing pools of cashflow generating assets – a form of direct lending. Usually, this strategy involves investing in notes issued in a securitisation or the making of a loan, in each case secured by a specified pool of assets acquired by a special-purpose entity formed solely for the related transaction. An ABF fund may also enter into a forward-flow arrangement with a lending platform: the fund will agree to purchase assets from such platform on an ongoing basis at a predetermined discount rate (i.e., a form of factoring). Assets acquired by an ABF fund directly are commonly also financed, whether via a securitisation sponsored by the fund or a credit facility provided by a bank (or possibly another ABF fund).

Where an ABF transaction involves the issuance of debt, it is important to take into account the presence of European 'institutional investors' which are subject to risk retention rules in the UK and Europe. Banks, pension funds, insurance companies, and certain fund investors must comply with these rules in respect of any investment that provides exposure to a 'securitisation' and this can add complexity for sponsors and investors alike. These rules apply irrespective of whether the investment is in the US or Europe; it is the jurisdiction of the investor which drives the analysis.[1]

ABF transactions are in the spotlight for treatment as 'securitisations' where there is any element of contractually tranched indebtedness, for example where a mezzanine tranche is introduced alongside senior indebtedness and/or 'equity' that is structured as subordinated notes (as opposed to shares or 'true' equity). This can be desirable for insurance company and bank investors, given the lower regulatory capital charges they incur as a result of being exposed to the underlying securitisation exposure, and many ABF transactions are deliberately structured so as to so qualify as such. The rules applicable to UK investors differ from those in the Eurozone in minor ways, but for all substantive purposes the regimes can be considered equivalent.

From a sponsor's perspective, three big questions need to be addressed to ensure such investors are able to satisfy themselves that they are investing in a structure that is compliant with the applicable risk retention rules. Whether or not pivoting to a securitisation solution is beneficial will depend on the improvement in debt pricing they are able to achieve as a consequence.

Firstly, the sponsor needs to identify an entity which is appropriately qualified to act as the 'risk retention provider'. Typically, this means identifying a party to the ABF transaction who will be the "originator" and has a close relationship with the assets that are ultimately supporting repayment of the securitised debt. In ABF structures this is usually relatively straightforward to achieve and involves less of the mental and legal gymnastics that certain other sections of the structured finance market are forced to grapple with.

Secondly, any such risk retention provider must acquire and retain (for the life of the transaction) a 'net economic interest' of 5%, which can represent a significant capital commitment given the size of recent transactions. This may be in the form of 5% of each contractual tranche of debt issued (known as a 'vertical strip') or, more usually in the ABF world, such of the first loss piece (often referred to as the equity) as is equal to 5% of the assets being securitised (this 'horizontal strip' is a fluctuating amount and needs to be monitored over the life of the transaction).

Thirdly, sponsors need to ensure that investors receive reporting on the underlying assets in a very prescriptive format, which can be administratively burdensome to produce and provide.

Many ABF transactions are deliberately structured so as not to qualify as securitisations to avoid having to address the above issues, whilst still being able to offer tranched exposure to the income streams generated by a diversified pool of underlying assets. The bespoke nature of the ABF market permits a tailored approach that strikes a good balance between the needs of sponsors and investors.

[1] Securitisations with a US nexus may also be subject to similar 'risk retention rules' applicable to sponsors of securitisations, as opposed to the rules adopted in the UK and Europe which apply to investors.