

Fund Finance Insights

Fund Finance Ratings:
Behind the Scenes

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Introduction

The fund finance market has witnessed remarkable growth and evolution in recent years, becoming a crucial component of the broader financial ecosystem. As this market matures, the need for robust risk assessment and transparent frameworks has also increased. Fund finance ratings have been playing an increasing role in this context, offering a standardised approach to evaluating creditworthiness of various fund finance structures and helping to widen access to liquidity for the market. These ratings take into account different quantitative and qualitative factors specific to each structure.

In this paper, we explore the history of fund finance ratings and their role in the market. We also examine the key rating considerations for different fund finance structures, focusing on subscription facilities (**SFs**) and net asset value (**NAV**) facilities.

History of Fund Finance Ratings

Private and public ratings covering private market structures such as private equity collateralised fund obligations (**PE CFOs**) have existed since the early 2000s. On the other hand,

SF and NAV facilities were largely bank-provided products through most of their history so were unrated and relied on the credit assessment capability of individual lenders. As the investor base of these facilities expanded to institutional investors and as bank regulatory capital rules changed, the need for a more standardised and objective measure of credit risk emerged. In response to the demand for ratings, credit rating agencies (**CRAs**) have developed formal methodologies for SF and NAV facilities. This formalisation reflects the growing sophistication and scale of the fund finance market, as well as the drive for greater transparency and comparability for a wider range of market participants.

Role of Ratings

Fund finance ratings provide a tool for assessing the risk and creditworthiness of fund finance instruments. Ratings provide an independent evaluation of the likelihood of timely repayment. They offer a benchmark for comparing different products, enhancing market comparability and transparency. This increased clarity supports the ongoing growth of the market.

Ratings serve specific functions for various market participants. For lenders, ratings provide an external and consistent framework for assessing credit risk, informing pricing decisions. Ratings are also a tool that some banks use to optimise regulatory capital treatment as permitted by relevant authorities. Banking regulations impose minimum capital requirements based on risk-weighted asset ratios, which are determined in some cases by the credit quality of the assets. In certain jurisdictions, the use of external credit ratings is permitted, allowing highly rated exposures to apply lower capital reserves compared to lower-rated or unrated exposures.

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Ratings can increase interest from institutional investors looking to participate in fund finance lending, thereby broadening the lender pool and improving market liquidity. Insurance companies and pension funds may participate through a syndicate with lenders. These types of investors are from regulated industries and may require ratings (whether for external or internal purposes) to participate. The role of ratings in securitisation is further discussed in more detail in the SF section below.

For fund managers, ratings may be a consideration on a case-by-case basis to enhance access to liquidity and can help incentivise non-traditional lenders, such as insurance companies and pension funds, to participate in fund financing. For such non-traditional lenders, ratings can offer credit risk analysis to support and enhance their decision-making process, leading to more informed choices. Whilst fund finance ratings generally include an assessment of the qualitative aspects of the fund and the manager, it's important to note that these ratings apply specifically to the facilities, not to the fund or the fund manager themselves.

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The Ratings Process and Confidentiality

There are multiple CRAs active in rating fund finance products, including Fitch, KBRA, DBRS, Moody's, S&P Global and others. Rating agencies follow a structured process to ensure unbiased assessments and regulatory compliance. For example, at Fitch the process begins with discussions involving business or relationship management teams. This approach enables strict separation between the commercial and analytical teams. Once a rating engagement is initiated, the engaging party shares relevant information and documentation. The analytical team then reviews this information according to their criteria to formulate a rating recommendation. This recommendation is presented to the rating committee, which deliberates and makes the final rating decision.

CRAs issue both public and private fund finance ratings. Public ratings are widely available on the CRA websites, while private ratings are provided exclusively to the person who placed the rating order and can be shared only by this person to a limited number of parties.

A high duty of care is placed on the confidentiality of non-public information, such as Limited Partner (LP)-specific data, with strict compliance standards and operational processes to protect sensitive data. This commitment to confidentiality helps maintain trust and credibility in ratings.

SF: Credit Considerations

The subscription finance market has grown substantially in recent years, driven by the growth of private capital funds (including private equity, credit, real estate, and others) and the funds' wider adoption of subscription facilities (also sometimes called capital call facilities, or sub lines). SFs are lines of credit used by private capital funds primarily to manage liquidity and capital calls. They delay and reduce the number of capital calls, with the magnitude of the impact dependent on the terms of the facility. These facilities are backed by the capital commitments of LPs.

CRAs aim to determine the likelihood of timely repayment to the lender. They assess both quantitative and qualitative factors to determine the overall risk profile. Since the SFs are secured by LP commitments, the credit quality and diversification of the LP pool are key rating drivers. The Limited Partnership Agreement (LPA) and side letters that LPs sign are generally considered as part of the analysis, in particular to assess terms which could potentially reduce the LP's obligation and/or incentive to satisfy capital calls, or the manager or lender's ability to enforce such obligations. The level of overcollateralisation, indicated by the advance rate, which is the maximum permitted borrowing under the facility documentation, is also a key input. Fitch, for example, relies on the most conservative terms outlined in the facility agreement, rather than the current metrics, to mitigate negative credit migration as the facility progresses through the fund's lifecycle. The qualitative assessment usually considers the manager's capabilities, the fund's characteristics, and the structure. Rating caps may be introduced to reflect asymmetric risks such as manager weakness.

CRAs are engaging with the Loan Market Association (LMA) in the development of a LPA due diligence checklist for SFs to ensure that these key considerations in respect of LPAs and side letters are reflected in the upcoming LMA guidance.

Spotlight on SMAs

Separately Managed Accounts (**SMAs**) have gained popularity as investors seek customised investment solutions. SMAs present unique considerations within SF ratings due to their highly concentrated single-investor nature. This requires a granular assessment of the individual LP. The lack of diversification can pose heightened risk, and the potential for tailored documentation can offer unique structural considerations. Fitch's rating methodology for facilities backed by a single ultimate investor, for example, will link the rating of the facility to the LP's, with adjustments for structural and qualitative considerations.

Spotlight on SF Securitisation

The securitisation of SFs marks a significant development in the fund finance market, driven by demand for regulatory capital optimisation and growing appetite for SF exposure from institutional investors. An SF securitisation involves an SF seller, for example, a bank that has originated SFs, selling a pool of SF receivables to a bankruptcy remote vehicle. In turn, the trust or special purpose vehicle (**SPV**) issues securities backed by the SF receivables to third-party investors. While cash-funded SF securitisations are nascent, synthetic SF securitisations have been more widely utilised to date, whereby an originator keeps the pool of SF receivables on its balance sheet and effects a synthetic transfer of the accompanying credit risk through a derivative, risk-sharing, or other credit indemnity contract. Industry terminology is inconsistent, but cash or synthetic SF securitisations may also be referred to as "significant risk transfer" (**SRT**) or "credit risk

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Key risk considerations associated with securitising SFs include the revolving and short-term nature of typical SFs and the heterogeneous nature of individual SF attributes, as well as limited disclosures. Securitisation ratings could be constrained by insufficient credit enhancement, complex structures, or unrated or lower quality underlying SFs. The growth of SF securitisation underscores the increasing institutionalisation of fund finance and the role of ratings in facilitating market development.

NAV: Credit Considerations

NAV facilities are typically secured term loans to private capital funds. The facilities are secured by a fund's NAV – the value of underlying portfolio investments and the cash flows they generate. They can be secured by various asset types depending on the fund's strategy, including secondaries, buyout, infrastructure, credit, and real estate. NAV facilities require distinct credit considerations. Fitch's initial methodology focuses on NAV loans to secondaries

funds. These ratings assess facilities backed by the NAV and cash flow of funds or entities investing primarily in LP interests of alternative investment funds. Risks to the lenders include declines in the value of the portfolio assets, lower than anticipated distributions, the failure – through insolvency or otherwise – of the fund manager, and fraud.

CRAs may also issue ratings for NAV to credit or buyout funds, which require distinct credit considerations.

Methodologies for NAV loans are generally anchored by cash flow modelling. Key inputs may include assets and loan-specific structural features such as maturity, amortisation schedule, and loan-to-value (**LTV**) triggers. Covenants and structural protections, like borrowing base mechanisms and cash flow waterfalls, are also important for determining the credit strength of a NAV facility. Qualitative factors such as asset quality, additional sources of repayment and liquidity, fund and manager, and structure influence notching, guiding the overall credit evaluation.



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Looking ahead

The subscription finance and NAV markets are poised for continued growth, driven by the expansion and democratisation of private capital funds. As the industry matures, changes in regulation and the rising influence of non-bank lenders are expected to reshape the lending landscape, introducing new challenges and opportunities.

In response to these developments, rating agencies are adapting by refining their methodologies to address the complexities of new fund finance offerings. By enhancing their methodologies, rating agencies want to ensure that they can accurately assess the creditworthiness of these innovative financial products, providing valuable information to investors and other stakeholders and fostering confidence among market participants.

We invite readers to engage with the LMA, as well as CRAs, as the market continues to grow and evolve. Together we can ensure that the asset class continues to meet the growing demands of market participants and support efficiency, liquidity and transparency in the market.



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To learn more about the LMA’s work to support efficiency, liquidity and transparency in the fund finance market, please visit the LMA’s Fund Finance Microsite:

<https://www.lma.eu.com/fund-finance>

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