

Introduction

The landscape of fund finance is shifting. One of the most significant trends over the past few years is the growing presence of institutional investors participating as non-bank lenders in fund finance facilities. These institutional investors are a welcome source of additional capital and, collectively, they are driving innovation in the asset class.

Institutional capital is, however, a broad term which covers a wide range of different investor types. Each investor will have its own specific motivations for investing in fund finance. Appetite for risk and return will vary, and different investors will be targeting different structures and terms to access the asset class. This latest Insights paper summarises some practical documentation and structuring considerations for lenders and borrowers. It is not intended to be comprehensive and parties should always seek appropriate legal, tax, and regulatory advice for their own specific facts and circumstances.

Institutional investors in fund finance

Whilst institutional investors will have different motivations for becoming fund finance lenders,

fund finance products are generally valued as offering relative stability in times of market volatility. This makes them an attractive, diversified source of reliable returns. Subscription facilities have demonstrated strong credit fundamentals and historically low default rates, while NAV loans can provide exposure to higher-risk, longer-tenor assets, allowing investors to tailor their risk/return profile. Compared with traditional fixed-income instruments, such as shorterdated government bonds, fund finance has been seen as offering compelling yields without materially impacting credit risk.

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Practical structuring considerations

Fund finance (in particular. subscription facilities) is an operationally intensive asset class. All parties should ensure there is a clear understanding of the operational capability of the nonbank lender from the outset, as this will determine which types of fund finance loans the non-bank lender can invest in. Large and established private credit funds or asset managers are likely to benefit from in-house operations and treasury functions that closely resemble a bank set-up. Other lenders, whilst sophisticated and experienced investors, may have very limited operational capabilities.

Loan structure

Whilst it may be assumed that only term loans are attractive to institutional investors, some of these investors are able to participate in revolving credit facilities (RCFs) and could be a useful source of additional liquidity for RCFs.

That said, there are certain types of investors who prefer a term loan structure with highly predictable cashflows and limited operational activity. Others, such as European insurance firms who

may be investing under the Solvency II 'Matching Adjustment' framework (which modifies the discount rate used to value certain insurance liabilities), may only be able to invest in term loans.

It is worth highlighting that not all term loans are the same and a careful review of loan documentation is required. Factors to consider include:

- Can interest be rolledup/capitalised?
- Are prepayments permitted?
- Is it fixed or floating rate funding?
- Is it an amortising loan or a bullet repayment at maturity?
- What are the lender voting arrangements and does the loan documentation contain "replacement lender" / "yank" clauses which can remove and replace a lender if they do not vote in favour of amendments and waivers?

Beyond the RCF vs term loan discussion, institutional investors in term loans may have additional structuring requirements, such as a defined non-call period and make whole payments so that the fund finance loan documentation can comply with any relevant qualifying matching adjustment rules.

It is important that the exact requirements of the both the borrower and the investor should be fully understood from the outset.



Funding timescales

Fund finance lenders are expected to be agile and flexible. It is important to understand how the institutional investor manages its liquidity and what notice periods are required for funding. Some institutional investors may themselves need to call capital from their investors; others may have immediate, same day, access to capital.

Parties should carefully review the funding requirements and timescales within the loan documentation to ensure they are able to meet these without introducing additional funding risk to the borrower or agent. Factors to consider include:

- Funding currency: Can the investor only fund in single currency or does it have access to multiple currencies? Are they able to invest in multicurrency facilities and do they have access to the optional currencies within the timescales typically required by the loan documentation?
- Jurisdiction: Fund finance is a global asset class and loan transactions may require lenders working together across multiple jurisdictions and time zones. Investors should consider the impact of time zones and different banking days/public holidays across the market (for example, in terms of payment processing and servicing).
- Tenor: Just as there are a wide range of different types of institutional investors participating in fund finance, there are many different use cases for fund finance within an institutional investor's credit portfolio. Some investors are allocating to subscription facilities as an alternative to public credit. Others, attracted by the strong risk-adjusted returns, short tenor and low default history of the asset class, may

invest into subscription facilities as part of an enhanced cash portfolio (rather than allocating from their traditional private credit bucket). The use case in the investor portfolio will drive their appetite for tenor, e.g. can they only invest for a maximum of 12 months or are they looking for a longer multi-year exposure?

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Investment entry point and diligence requirements

Institutional investors participate in fund finance facilities at various entry points. Many investors will join a transaction from the outset at primary issuance, whilst others (due to regulatory or structuring reasons) may only be permitted to invest in seasoned loans, buying exposure in the secondary market. Also, some investors may wish to be a named lender whilst others may need to join a transaction as a sub-participant, sitting behind a bank lender. Borrowers will also have a view here. The entry point will determine the appropriate type of documentation and diligence required (e.g., via transfer or by sub-participation agreement) and this will impact transaction costs for the institutional lender.

In Europe, if there is an agent bank (rather than a third party agent), it is commonplace for the agent bank to appoint lender counsel on behalf of all lenders in the syndicate at primary issuance. Named lenders at primary issuance would expect to have reliance on legal due diligence



and legal opinions. This has the benefit of streamlining execution and reducing legal costs for the borrower (other loan markets, such as the US, may operate differently).

Bank lenders looking to syndicate risk after primary issuance, should consider negotiating the extension of reliance to any investor joining the transaction within a specified timescale, and should consider whether this includes any subparticipants.

The level of diligence and information available to lenders can vary depending on the sensitivity and confidentiality of the information in question. As a result, approaches may differ across transactions, reflecting the nature of the information and parties involved. The scope and nature of the information provided should be taken into account when assessing the transaction, and the extent to which this information can be shared with any investors participating in a fund finance loan via a pooled or structured vehicle.

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Ratings

The publication of ratings methodologies for fund finance, both for NAV and subscription facilities, has been key to unlocking institutional investor access to this asset class. See the earlier Insights piece on Fund Finance Ratings: Behind the Scenes for more detail.

Ratings have become synonymous with institutional investors as lenders and it is often assumed that they automatically require an External Credit Assessment Institution (ECAI) rating in order to invest into fund finance. Whilst this is true for some types of institutional investors participating as lenders (for example, US insurance firms), it is not for all. Many institutional investors are able to participate in unrated fund finance facilities, or can make use of internal credit ratings.

When considering the relevance of ratings, there are some additional questions to consider, including:

- Does the institutional investor lender require a public rating, or is a private rating letter sufficient?
- Is borrower consent required?
- Does the institutional investor lender require a minimum rating and should ratings triggers be documented?
- Who is responsible for arranging the external rating and does the investor have any restrictions on which ECAIs are to be used?
- Is the entire loan facility being rated or just the institutional investor lender's exposure?

External ratings and ongoing ratings surveillance are an additional transaction expense. As rating methodologies in fund finance continue to evolve, approaches may vary among ECAIs, which can influence how ratings are determined. A discussion about ratings requirements should occur at the earliest opportunity, to either ensure that these can be obtained within the required timescale, or to avoid any unnecessary transaction costs for the borrower and institutional investor lender.



Withholding tax and grossup obligations

Loan documentation often requires a lender to represent whether it is a "Qualifying Lender". The definition of a 'Qualifying Lender' is carefully negotiated. It will vary between loan documentation as it depends on the specific jurisdictions and parties involved in the lending arrangement. A 'Qualifying Lender' will likely include lenders who are resident in a jurisdiction with a double tax treaty with the borrower's country or who otherwise qualify for domestic exemptions from withholding tax. This representation will clarify the specific tax status of an institutional investor lender and it is important for parties to review the relevant definitions to guard against any unexpected tax liabilities. Borrowers will wish to limit withholding tax liabilities and gross-up costs and lenders will want to ensure they receive full interest payments without unexpected tax deductions.



Transferability

Fund finance loan documentation will typically contain transferability provisions setting out the conditions under which a lender can transfer its rights and obligations to another lender. Such provisions allow a borrower to control the type of entity that holds their debt and allows lenders to manage their exposure.

However, these provisions are typically drafted with bank lenders in mind and should therefore be a key area of focus for non-bank lenders. Institutional investors participating as lenders should carefully review existing transferability language, including any restricted transferee/non-permitted lender list. For example, a private credit borrower may wish to prohibit transfers to another credit manager that follows a similar investment strategy or may

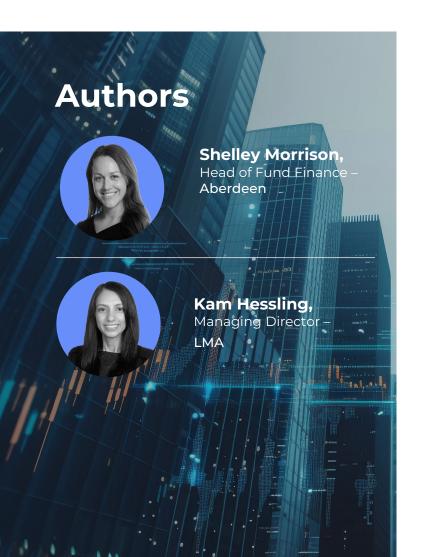
require consent for such transfer. Institutional investor lenders should review the transfer provisions to check whether the provisions allow them to transfer debt to affiliates (such as another part of the balance sheet). Otherwise, consent to join the lending syndicate should be sought from the borrower at the outset.

Looking ahead

The role of institutional investors as lenders in fund finance is set to increase further, bringing continued innovation to the market. In order to maintain effective efficiency, liquidity and transparency, it is important to understand the impact of such innovation on structuring and documentation.

We invite readers to engage with the LMA and industry associations to promote greater understanding of the role of institutional investor lenders and contribute to the efficient evolution of the market. 66

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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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