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FUND FINANCE FRIDAY

Panel Recap: 'Hot Topics in Fund Finance'

February 18, 2022 | Issue No. 163

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The Thursday afternoon panel on “Hot Topics in Fund Finance” was chock full of interesting insight on the latest trends in our industry. Subjects included ESG, rated note feeders, continued LIBOR transition and the competition for talent in the market.

ESG

The last couple of years have seen an explosion of Environmental, Social and Governance (ESG) subscription lines, but early predictions of meteoric growth have recently been tempered to some extent.

LPs are putting pressure on sponsors to implement meaningful ESG in their fund investments. Banks are interested in participating in ESG deals to make sure that the obligations of the bank to make a profit and to do good in the world align with what’s happening in the global landscape.

The U.S. market is starting to evolve over time but hasn’t had the same kind of regulatory pressures as in Europe that have significantly moved the needle there. The European market has felt a huge rush of ESG regulations that, rather than serving as a deterrent, have been having a positive impact on increasing ESG activity. The legislation has included the taxonomy and low-carbon benchmark regulations, as well as sustainable finance disclosure statutes that have had a broad effect on ESG being factored into investment decision-making.

One key for ESG in fund finance is making sure that the credit facility tracks the risk that a bank is trying to address. To date, ESG credit facilities have typically been structured either using key performance indicators (KPIs) of the fund or using a use of proceeds approach (UoPs). But on the legal side, there is still no set market determination for how to govern this or standardization on what metrics will end up in the loan agreements. One observation from the panel was that it will be important to keep an eye on how our industry develops consistency of documentation.

The audience was polled by the panel on several ESG-related questions. In 2021, nearly 35% of audience members had firms with at least one ESG transaction, while just under 20% of audience participants were at firms with three or more ESG deals. For percentage of overall book of business, half of the audience responded that its fund finance portfolio comprised 5% ESG, while less than one-tenth of firms had portfolios of 10% or greater ESG. An overwhelming majority expected those percentages to be from 5-25% three years from now, with just under a quarter of audience members predicting that amount to be over 25%.

Rated Note Feeders

The use of rated note feeders has grown significantly in our market over the last few years. They are a tool to more easily permit insurance company LPs to participate in funds. Rather than providing an equity commitment like a traditional LP, the insurance company will be issued debt by purchasing notes from a feeder fund.

Insurance companies can use this structure to mitigate regulatory pressures that would otherwise diminish their opportunities for investing in private funds. Their regulators rate the risk of the investments held by insurance companies. Insurance companies have more favorable risk treatment for debt investments, especially debt investments that are rated by a ratings agency, than they do for equity commitments.

Insurance companies are starting to take notice of this technology, and GPs have begun to provide this approach as a solution for insurance companies to be LPs. The goal is to get the overall construct to function in a similar way to an LP that was committing in the more traditional approach via equity. The use of a rated note feeder tends to be more prevalent when there is a more concentrated borrowing base.

The panelists discussed issues of enforcement with requiring an LP to purchase notes in the event of a bankruptcy by the feeder. While European practitioners generally are less concerned that such enforcement may be estopped by a court, fund finance professionals on the U.S. side of the pond typically take the view that a lender would have diminished ability to enforce. To mitigate that risk, credit agreements will generally require the debt held by an LP to be converted to equity if there is any bankruptcy or insolvency of the fund.

LIBOR Transition

While we've all experienced the ocean of LIBOR transition amendments, panel members observed the interesting dynamic in the current state of play. The U.S. market still has a long lead time to when LIBOR truly falls away in mid-2023, yet banks are being required to shift to SOFR now to avoid risk of regulator-imposed penalties. Banks are assessing how to appropriately determine what is "new money" for purposes of when SOFR needs to be implemented. Funds sponsors want to ensure that their assets and liabilities match. If their underlying portfolio assets use a certain flavor of SOFR, GPs (especially for credit funds) desire that their credit facility liabilities match that same type of SOFR.

There is a sense that all parties may be waiting to see what the market evolves to on spread adjustments. Some market participants on both the lender and borrower side prefer new deals to have a flat margin, while other players would rather the loan documents separately list a spread adjustment for SOFR. When a credit adjustment spread is used, lenders and borrowers alike are negotiating over what those numbers should be.

On the Europe side, there was a much swifter move to the fallback rates. Given the end of 2021 deadline for non-USD LIBOR imposed by the UK benchmark regulatory supervisor, European credit facilities were forced to flip to the new benchmarks by December 31. Thus, LIBOR transition activity there has now largely been finalized.

Competition for Talent

Panelists noted that the fund finance space hasn't been immune to the Great Resignation. Competition for talent has therefore become rampant. Organizations are considering how flexibility and mobility add to recruitment and retention. At the same time, the pool of potential recruits may have widened because of the ability to have remote teams. Because there has been less emphasis on face time, firms are concerned that there is less relationship-building and mentorship. This can be especially challenging when bringing people in at the more junior levels. Our industry thrives on training new recruits, and many of the panelists expect their companies to focus on the education and coaching of their new professionals to fund finance.