Term Loan Market Update

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About a year ago, we published "**Term Loan Solutions in Fund Finance**," which ended up being a popular article on *Fund Finance Friday*. Since then we have seen lenders, sponsors, law firms and rating agencies become more interested in understanding a possible term loan component for certain fund finance facilities. Fund finance credit facilities that are secured by uncalled capital commitments of investors ("Sublines") have historically consisted of revolving loan facilities that were often broadly syndicated. In contrast, fund finance credit facilities secured by portfolio-level assets ("NAV") have historically consisted of term loan facilities, sometimes with a small revolving loan component, but were often bilateral or club deals (that is, not broadly syndicated). Interestingly, as the NAV market matures and syndication becomes more common in NAV, the Subline market matures and term loans become more common in Sublines. This has led to a coincidence where both the Subline market and the NAV market are negotiating issues regarding term tranche lenders and revolving tranche lenders, but for inverted reasons: The Subline market because term loans are relatively new and the NAV market because syndication is relatively new.

Cadwalader is lucky to have market-leading Subline and NAV practices for bank and non-bank lenders. We have worked on several amendments adding term loans to existing Subline facilities since the publication of the first article and we are regularly working on NAV facilities where syndication is increasingly common. So we thought a market update on term loan features in fund finance could be of interest. Here is what we have learned.

New Developments in Sublines

In the context of Sublines, the main payoff of adding a term loan tranche to existing facilities is to attract non-bank lenders, which adds facility capacity for bank lenders and sponsors. The term loan tranche would provide a fully funded term loan as of the closing of the term tranche amendment (or original closing), addressing the need for meaningful non-bank lending in the current market. We have provided guidance on several issues when adding a term loan,

including separate tranches, shared collateral, right-sizing the commitment and tenor, ratings, payments, rates and pricing, and addressing divergent lender interests.

The term loan should be fully drawn within a few business days of closing and would not be able to be re-borrowed. We would recommend that the term loan have its own separate tranche, with a single first priority lien securing the obligations of both the term loan and revolver lenders *pari passu*, since this would avoid the need for an intercreditor agreement between the term loan and revolving loan lenders. In hybrid Subline/NAV facilities, there may be a business case for a term loan to have a junior lien on the Subline collateral in addition to its own senior lien on the NAV collateral, but the parties should consider the additional time and expense of multiple liens and an intercreditor agreement. In the most cost-effective case of shared collateral in a Subline, the collateral would consist of the uncalled capital commitments of the investors, with a single administrative agent administering the collateral pool for both tranches. Parties should consider the relationship among the term loan commitment, revolver commitment, and the size of the collateral pool when right-sizing the commitment.

The tenor of the term loan should align with the revolver for ease of administration, though this ultimately depends on the preferences of the borrower and lenders. The maturity date of the term loan could be extended to accommodate possible non-bank lender preferences for longer terms, but this would require parties to give thought to whether the administrative agent is willing to serve in an agent role if the facility is term loan only later in the life of the facility. Term loan lenders would need to negotiate either an amortized repayment schedule or a bullet payment for the principal at maturity. Mandatory prepayments should be aligned with the parties expectations, and we have seen prepayment penalties in the context of some fixed rate term loans or no prepayment penalties in the context of some floating rate term loans for early repayment. In addition, we have seen a focus on the Required Lender definition for approval of various voting matters in the credit agreement (e.g., collateral management and amendments), with a focus on a bifurcated definition based on the available borrowing base to balance the interests of the term loan lenders with the revolving lenders when there is no meaningful ability for the borrowers to advance on the revolving commitments. As expected, we have also seen each facility receive a rating from a nationally recognized statistical rating organization ("NRSRO") as a condition for closing the term loan. Agents and sponsors will need to be prepared to field questions from the NRSRO, with guidance on what is important and emphasizing the strong historical performance of Subline collateral over time. The NRSRO will have an important role to play, and the agent should coordinate the engagement of an NRSRO (which is typically hired by the sponsor) alongside marketing efforts to identify and close a term loan lender, most typically an insurance company over the transactions we have seen.

A NAV Perspective

Parties to NAV facilities may face similar issues when syndicating facilities with term and revolving loans that were previously bilateral or club deals. This is because the potential divergences of interest between revolving and term loan lenders is not an issue in bilateral transactions with a sole lender. Historically, NAV facilities are primarily term loans used to finance a specific portfolio, which may be accompanied by a small revolving loan tranche for working capital purposes or to capitalize interest on the term loan. The NAV market is just starting to come to terms with some of the issues presented by term loan lenders and revolving loan lenders having potentially divergent interests in a syndicated context, but there will be

some important issues in the NAV market that may be less important in the Subline market. For instance, parties to NAV facilities will need to consider their expectations regarding credit support and collateral pools (with revolvers in NAV often being backed by a parent guarantee) and a payment waterfall that syncs with the expectations of the parties on repayment in a default and end of maturity scenarios.

Capital Relief Trades as Supplements or Alternatives to Term Loans for Balance Sheet Management

Term loans are valuable for Sublines because they free up balance sheet availability, which is under increasing regulatory pressure. When a non-bank term loan lender replaces a revolving commitment of a bank lender, we can regard this as a tool of balance sheet management for the bank. What's more, as non-bank term loans increase, this will free-up bank balance sheet in the aggregate for the fund finance market. Under bank capital rules, every bank is required to hold a minimum amount of capital to mitigate the risk associated with possible losses. These regulations will in many cases become more stringent as a result of the implementation of the Basel III Endgame and bite especially hard in a rising rate environment where fixed rate securities must be sold or marked down. Even without the dual challenge of higher rates and regulatory pressure, holding the necessary capital on a bank's balance sheet can be expensive. One solution to this issue is a capital relief trade ("CRT"), which we have covered in depth in a previous *Fund Finance Friday* **article** and is a pre-eminent practice at Cadwalader. A CRT allows a bank to use their capital reserves most efficiently by converting loans or other risk-weighted assets into "securitization exposures." A CRT has three main requirements: (1) a bank transfers the credit risk to a third party, (2) the transfer must be on a tranched basis and (3) the investors acquiring the first-loss tranche of credit risk do so on a collateralized or funded basis (unless the investor is itself a bank or a sovereign). Thus, a bank can tranche a first-loss credit risk to a third party while retaining a senior tranche of the credit risk and substantially lower the regulatory capital required to be held against such specific credit risk. In light of increasing regulatory requirements, CRTs provide banks with an additional tool to increase balance sheet availability

Conclusion

With the interest rate cycle at its crest and the regulatory environment tightening under the Basel III "endgame," 2024 is a great year to consider term loans as a way of increasing borrowing capacity and freeing up balance sheet. Administrative agents and sponsors can be proactive in identifying use cases for adding term loans, depending on the structure and investment needs of the fund. The administrative agent in particular will be key in identifying and marketing to non-bank lenders who are interested in term loan lending, which is an example of the importance of deep relationships between sponsors and their administrative agents. Finally, all lenders can consider the use of capital relief trades, or CRTs, to free up additional balance sheet for the fund finance market in a tightening regulatory environment.