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In Our Ratings Era: Top Lender Considerations for Subscription Facilities

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One of the best things about fund finance is that there is always something new and exciting happening in our space. New players come online, and new products and solutions solve issues that pave the way for fund borrowers to access capital and for lenders to get deals done. Often novelty is borne out of necessity, and that is very much the case with the increasing use of credit ratings in the subscription finance space. Here we will explain *why* we are seeing more credit ratings for sublines and issues that agents, lenders and fund borrowers should consider when negotiating a subline where the parties may ultimately seek a credit rating.

First, the basics, as most readers here know, subscription line facilities are credit facilities provided by a lender to a fund that are secured by the right to call and receive capital contributions from the fund's investors and the bank account into which those proceeds are deposited. The uncalled capital of the fund's investors also forms the borrowing base under a subline. This brings us to where, historically in fund finance, the place where credit ratings have played a role, which is as they relate to a fund's underlying investors. Investor credit ratings may impact the advance rate and/or concentration limit that are applicable to an investor's commitment in the credit agreement.

Second, why now? The increasing prevalence of credit ratings for subscription facilities is a result of a number of factors that exist in the broader lending environment and how the subscription market is impacted by those factors. On the one hand, we have the ever-growing demand for subscription lines of credit from private equity funds. Fundraising slowed last year but it ultimately ended up at a respectable $1.2 trillion globally for private funds. With a still-strong fund raising environment, demand for subscription lines is untempered. We estimate that the total subscription finance market is $900 billion in size globally.

On the other hand, there is a limited – albeit growing – supply of lenders in the subscription finance market. First, we had the FDIC receiverships of 2023, which significantly curtailed the availability of subline lending as it sidelined three very active originators. The market is still

bouncing back from that, as new lenders have come online and are doing deals but not yet at a volume that would replace what has been lost. Second, given regulatory capital requirements, the cost to a lender to enter into a subline transaction has increased. As a result, some major players in the market have had to scale back their exposure in the subline market, and other banks have exited the space. Looking forward, Basel III Endgame, in the form that it was proposed, could serve to reduce supply further by reducing overall RWA appetite. This is particularly significant for the GSIBs.

In the wake of this reduced supply pitted against ever-growing demand, two developments in the market have made credit ratings important. The first is that non-bank lenders, such as insurance companies, have entered the subscription lending space. Insurance companies receive favorable capital reserve requirements if they invest in debt instruments that have a credit rating. Typically unrated or non-investment grade ratings result in much higher capital requirements than investment-grade-rated investments. By obtaining a credit rating for a subscription facility, it makes the facility something that an insurer can invest in and therefore become a lender in the deal. The most common dynamic in the subscription space is for an insurer to come into a deal by way of a term loan tranche, as revolvers do not meet the investment needs of an insurer and are administratively burdensome.

We note that the European market is ahead of the U.S. market in terms of credit ratings for sublines. Insurers have been investing in sublines originated by European banks for some time (either directly or through subparticipations) and, as such, credit ratings are a more typical and prevalent feature of the subline market there. Also, in the European context, particularly with the impending changes to capital rules under Basel IV for certain lenders, having any instrument rated reduces the capital reserve requirements for the lender in respect of that transaction thereby freeing up a supply of capital to be deployed in other and additional transactions.

Finally, another reason why ratings are more relevant than ever has a bit to do with the fund finance market looking into the future. A lot of market players are thinking about whether sublines can be an investment product by way of a securitization. Ratings would play an important role there because, in a securitization, the credit rating provides an independent assessment of the underlying assets put into the securitization structure.

With these market factors, we think that it is reasonable to assume that any subscription credit facility could potentially seek a rating at some point during its lifetime. Each rating agency has an incredibly complex proprietary methodology that looks to quantitative and qualitative factors to make an ultimate rating determination. Quantitative factors include the credit ratings of the underlying investors (or lack thereof and therefore assume rating per the methodology) and the diversity of the investor base. Qualitative factors include the impact of investor documents like side letters and LPA provisions, the business and track records of the fund, and the terms of the subscription facility itself, which include everything from the covenant package to the size of the facility to identity of lender's counsel. Generally, the rating agency will aggregate the relevant quantitative factors and adjust that rating using qualitative factors and asymmetrical risks.

With all of this background in mind, we have put together a list of factors for lenders to consider when putting a subline in place, and outline how thinking through the terms of your credit

documentation at the term sheet stage of the deal can positively impact the credit rating that may be sought by the parties after the deal has closed. A number of these items are things that are already typical market practice and approach. The following are general terms to think about. Note that each methodology is different, and some may not consider all factors outlined below or give them the same weight in determining a credit rating. In no particular order, these factors – or, to all you Swifties out there, Easter eggs – that may garner a better credit rating for your facility are:

1. **Consider the Collateral** – The deal should have a well-considered and executed collateral package that is airtight and completely responsive to the fund's individual structure and the way that capital commitments flow though the structure. That's true of any deal. Robust exercise of remedies by the secured creditor and having a first priority security interest are important because the credit ratings process will look to how creditors will fare in a default scenario and any impediments to recovering on the collateral. To that end, separate collateral accounts for each fund entity without commingling is also important.

2. **Consider Your Covenants** – A stronger and more robust covenant package often translates to a more favorable rating. Items to consider include provisions that are found in both the affirmative and negative covenants, such as limitations on distributions to investors, limitations on additional indebtedness of the fund borrowers and negative pledges, among others.

3. **Consider Financial Covenants** – Financial covenants, such as a debt service coverage ratio or net asset valuations, minimum NAV measurement or ratios of debt to uncalled capital, can have a positive impact on a facility's rating. In general, the extent to which relevant financial metrics and triggers help to bring down leverage and preserve the value of the collateral in the subline can have a positive impact on a facility's rating.

4. **Consider the Deal** – Deal terms, like the facility size and the tenor, are also relevant. Facility size relative to uncalled capital and overall fund size can be particularly relevant.

5. **Consider the Investor Base** – A high-quality diversified investor base with a prevalence of rated investors will generally garner a higher credit rating.

6. **Consider the Fund Documents** – Standard and detailed diligence is key when it comes to analyzing the fund's documents. Most importantly, counsel should be looking to anything in the fund documents that would compromise an investor's obligation to fund a capital call, particularly one by the lender.

7. **Consider Confidentiality** – Few people really pay attention to the boilerplate at the back of the credit agreement, but it has never been more relevant. Allowing disclosure to ratings agencies in the current environment is an easy way to make sure that the facility can be shared with a ratings agency quickly and without a need for a facility amendment, if the parties determine that seeking a credit rating makes sense.

8. **Choose Cadwalader!** - This is a bonus point to consider, but we do note that some ratings criteria does consider counsel who prepared the financing documents; their expertise and experience level is relevant to the ratings analysis. It is important in any fund finance transaction for a lender to choose counsel with expertise in this subject area, given the many nuanced aspects of the fund documents, the credit documents, and market practice and the consequences they can have for an overall transaction.

In the U.S., the next round of bank capital rules are likely to cast a lingering shadow over subscription lending capacity for some time. A potential undersupply of capital would be ironic, given the outsized risk-adjusted returns available in subscription finance in a world where comparable products are testing post-GFC spread tights. Ratings may be a key piece to connecting the vast amounts of institutionally managed fixed income under a ratings mandate with the returns available in fund finance.