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A Primer on Capital Call Securitization

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Securitization has been a major focus in the fund finance industry as of late. Due to a confluence of factors, some of which are specific to fund finance, and some of which are features of the broader economic environment, it seems that fund finance has firmly entered its securitization era. To underscore the incredible amount of interest in the subject, just a few months ago, in June, Cadwalader was a lead sponsor to an extremely well-attended Securitization in Fund Finance conference held in New York. Then, most recently, there was major news in fund finance with the first broadly syndicated publicly rated securitization of sublines hitting the market. We are working on a number of these transactions here.

You, dear reader, may have noticed people discussing these transactions with great interest and predicting where the market may be headed, but what are they actually referring to and how do these deals work? Today, we break that down for you with this summary of 'why now?', a description of basic securitization structures, and some additional context you may not have considered.

Why now?

There are a number of factors driving interest in securitization in the fund finance market. It can largely be broken down to several factors – capital requirements of banks, demand for liquidity by sponsors, and growing demand from institutional investors who are looking to enter the fund finance market as investors. Traditional securitization market participants are also eager to facilitate financings for a nearly $1 trillion addressable market.

First, there are capital adequacy requirements. As you likely know, bank capital rules require banks to hold capital in a minimum amount, generally measured as a percentage of assets. The percentages vary by asset type, and are determined largely by the capital rules. Regulators require such capital in order to provide a cushion or buffer so that the bank can meet its obligations to depositors even if the loans it makes are not repaid or its investments drop in value. The idea is that banks having an adequate amount of capital are less likely to fail, seek a government bail-out, or trigger a larger systemic financial crisis. US capital rules are based predominantly on an international model developed by the Basel Committee on Banking Supervision, whose mandate is to enhance financial stability by improving the regulation, supervision, and risk management of banks.

In July 2023, US regulators – which include the Fed, the OCC, and the FDIC – proposed substantial changes, known informally as the Basel III "Endgame," intended to adapt US rules to the current model of the Basel Committee rules, known as Basel III. A number of the changes in this dense proposal are quite technical, but the key for most lenders in fund finance is that the effect is to increase the required capital that certain banks – and most significantly the largest banks - must hold against their risk-weighted assets (RWAs).

In response to both current and the proposed (and generally increased) capital requirements, banks with large fund finance businesses have sought to reduce the risk-weight of their subline portfolios. There are several ways that banks can do this and each of these options may be selected based on the unique features of any particular institution and the relevant transactions that will be covered. The tools here include (i) the use of credit ratings (for non-U.S banks), which we covered this spring **here** in FFF; (ii) the use of SRT/CRT, which we covered **here** in FFF; and (iii) the use of structured finance products such as securitizations (which may or may not be rated). We note that insurance products are a tool that certain non-US banks utilize, as these can provide capital relief in certain European and Asian countries. They may be used by domestic lenders for other purposes, such as relief from internal limits, but not for capital relief.

The second factor, which is demand for liquidity in the form of sublines and other fund finance products by sponsors, relates in part to the first factor of capital requirements. To the extent that a bank can get regulatory capital relief using the terms described above, it will have greater capacity to lend in other financing transactions. In addition, securitizing sublines will typically involve a sale of those sublines to a newly formed SPV—and will therefore result in cash infusion (i.e., liquidity) to the securitization issuer. An additional consideration for subline lenders who securitize (or sell to a third party who securitizes) may be to achieve some of the economic benefits of the securitization, which may include, among other things, lower cost of capital, larger investor base of buy-and-hold types, potential access to a fixed rate environment.

The third factor is the industry's general desire to create investment products for the insurance capital markets and other fixed income investors. For structuring banks and broker-dealers, the related capital markets transaction activity and fees are also appealing, and a great way to continue developing partnerships with affiliated lenders or even third parties (with such partnerships having become increasingly popular in the direct lending era). Securitization of sublines specifically creates a means for asset managers and insurance companies, among others, to invest in sublines which are historically an asset class that has low credit risk. For those of you who were asking us for 'insurance capital' to join subline lender syndicates, which we are already seeing outside the securitization context, this is your moment. Subline securitization bonds may also be appealing to certain fixed income investors who seek relatively short duration instruments compared to the general ABS market at an equivalent rating (e.g., AAA).

While all of this sounds super interesting and exciting, what do we even mean when we talk about deploying and leveraging structured finance technology in fund finance? As we like to do here in Fund Finance Friday, we are going to break down the basics for you and even give you a sense of the terms and issues that you may encounter as you wade into this subject.

<u>Traditional Securitizations</u>

Traditional securitization transactions are a category of structured finance transactions that generally involve the isolation of one or more assets from the bankruptcy and credit risk of the asset owner, which is typically the originator (for loan transactions) or an entity that purchased the asset following origination. This is most often accomplished by the securitizer forming a bankruptcy remote SPV that acquires the assets from a true third party on arm's length terms, or in a so-called "True Sale" transaction (i.e., without getting too technical, think about a sale among affiliates that is structured at arm's length). The assets in question can be anything from auto loans to credit card receivables to corporate loans to sublines or other revenue generating assets. To finance the acquisition of such assets, the SPV issues securities to investors (or borrows a structured loan from one or more lenders). The SPV then uses the cashflows from the securitized assets to make payments on such obligations. Recourse of the lender/investor is limited to recoveries on the securitized assets, in addition to some permitted recourse to the seller/sponsor/securitizer in the form of critical representations and warranties on the assets that are largely consistent with those of any sale transaction. In subline parlance, this could mean that if a securitizer didn't have title to a loan it sold to an SPV issuer, then it may have to buy that loan back at a hypothetical repurchase price of par plus accrued interest. Securitization is essentially an arbitrage transaction (relative to the interest cost if the unrated or below investment grade corporate parent were the borrower) because it allows lenders/investors to focus primarily on the credit risk of the securitized assets.

There are too many characteristics of these transactions to describe them all here, but we have assembled some basic information below and would be happy to discuss with any of you. We have also included a section to describe some of the differences between a traditional securitization and a credit risk transfer transaction (CRT), with which many of you are now familiar.

<u>The Details</u>

As with any sophisticated financing transaction there is a lot of jargon involved. The following is a short summary of the roles of the parties involved and the relevant documents that you will typically find in a traditional securitization.

The Parties

- The Originator – the originator originates the assets that it will securitize. There may be more than one originator in a securitization.
- The Issuer – a bankruptcy-remote entity (or group of entities) that is created specifically for the purpose of a particular securitization and is the issuer (and/or a co-guarantor) of the securities. Many of the negative covenants

and other provisions you might expect in a Credit Agreement appear directly in the issuer's organizational documents.

- The Servicer / Administrator / Manager – manages the securitized assets for an arm's length fee (even if affiliated).
- Back-up Servicer / Administrator / Manager – this party is present in some transactions to manage the assets in the event of the bankruptcy of the primary/initial Servicer / Administrator / Manager.
- The Trustee or Collateral Agent – this is the party that holds the security interest in the securitized assets on behalf of the investors. This party is typically a bank and may perform other roles in the deal such as acting as custodian, collateral manager, or account bank.
- The Initial Purchaser – this is the party who arranges the indirect sale of the Issuer's securities to the initial investors in the securitization. They typically play a meaningful role in the structuring and marketing of the securities. Note that private securitizations often feature a Placement Agent instead because those sales are direct issuance from issuer to investors, as are most structured loans.
- The Investors - these are the parties that invest in the securitization by purchasing issued securities (or loans).

The Main Legal Documents

- The Indenture – the Indenture is the document that sets forth the rights and obligations of the Issuer and related parties to the transaction and provides the terms of the securities that will be issued in the securitization. In a structured loan transaction, this would be a loan or credit agreement.
- The Offering Document – this is the document that makes important and legally required disclosures to investors. It describes the overall structure of the securitization deal, describes relevant risks, and the terms under which the securities are issued. This is not relevant in a private placement transaction where investors are required to do their own diligence.
- Note Purchase Agreement – this is the document under which conditions the investors (in a private securitization) or the Initial Purchaser agree to purchase the securities from the Issuer. There are limited conditions to purchase, but this sets forth important representation and warranty coverage as to material information, as well as setting forth issuance economics and indemnity coverage.
- The Sale Agreement – governs the terms of the asset transfer across the 'bankruptcy line'.
- The Servicing / Management / Administration Agreement – governs the terms of asset management.

Legal and Regulatory Considerations

- Securities Law – We have limited the scope of this primer to exempt, private securitization transactions, which we expect are most relevant to near-term fund finance transactions. Both the deal structure and the types of investors need to meet the requirements of a private transaction (e.g., for Rule 144A/Reg S transactions, investors would be restricted to QIBs or non-US persons).
- '40 Act – securitization issuers are generally not permitted to be investment companies.
- Bankruptcy – An important focus in a securitization is isolating the securitized pool of assets from the bankruptcy risk of the securitizer. Bankruptcy attorneys review every substantive aspect of a legal transaction and may insist on certain provisions that limit recourse to the securitizer, insist on arm's length conduct between affiliates, and generally prohibit any proposed transaction features that violate the notion that the benefits and burdens of the securitized assets have fully transferred to the SPV.
- Other Regulatory Requirements – There are a number of regulatory considerations (such as risk retention) in a traditional securitization transaction that arise from the Dodd-Frank Wall Street Reform and Consumer Protection Act and other rules that may be relevant to the particular assets being securitized.

How is a traditional securitization different from a CRT?

Many financial institutions have used CRT transactions to obtain capital relief in the last few years and in particular a number of our fund finance clients that are subline lenders have used this tool. A CRT is a term that refers to what is known as a "credit risk transfer." These are also known as SRTs, which stands for "significant risk transfer." Sometimes these transactions are also called "synthetic" securitizations." A CRT can take several different forms (bilateral CDS, SPV-issued credit-linked note or bank-issued credit-linked note), but in each structure a party typically assumes a first-loss portion of the credit risk associated with a pool of RWAs owned by a bank in exchange for periodic

premium payments from the bank. A key distinction from a traditional securitization is that the originating bank retains the RWAs on its balance sheet while transferring a portion of the credit risk associated with those RWAs "synthetically"—i.e., through a credit default swap or a credit-linked note—to one or more third parties. Some collateralized CRT structures may, like a traditional securitization transaction, result in a funding/liquidity benefit to the protection-buying bank (especially if the collateral is in the form of cash and is deposited with the bank that purchased protection).

Conclusion

As members of *the* original Wall Street law firm (232 years and counting), we are particularly excited about these developments in the fund finance market and proud to say that our securitization muscle matches the ones we flex in the largest and most experienced fund finance practice out there. We have been delighted to collaborate with our financial services and capital markets colleagues as we help our clients execute bespoke transactions that meet the needs of deal constituents at this exciting intersection of fund finance and securitization.

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