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FUND FINANCE FRIDAY

Subscription Finance Loan Agreement Series, Part 12: The Use of Hedging through Borrowing Base/Security

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An increasingly common trend in subscription/capital call financing, reflecting the increasing appetite of funds in this area, is the utilisation of what is a fairly typical leverage or borrowing base in a subscription/capital call line to facilitate the provision of hedging (either for interest rates or for fx) on top of the standard subscription/capital call line.

In some respects, the terms on which this is done follow, as you would perhaps expect, similar principles to those adopted in the LMA documentation (in particular, the leveraged LMA facility and intercreditor). It is probably worth summarising these principles (although a detailed discussion of these often quite complex provisions is beyond the scope of this article):

- Under the LMA documentation (specifically, the LMA intercreditor documentation), hedging liabilities rank alongside and equal to any “senior” debt (and benefit from security, which is held for the benefit of both the other senior creditors and the hedge counterparties in common and on an equal basis).
- There are restrictions imposed on hedge counterparties on what payments can be made to them by the borrower/counterparty (usually by reference to those payments not being made after or triggering Events of Default under the senior credit facilities).
- There are also restrictions on the hedge counterparty taking enforcement action (in the sense of terminating or closing out a hedging transaction). While hedging liabilities generally rank alongside other “senior” debt (as per the above), security enforcement is left to the security agent and subject to the terms of the senior facilities, so the hedging counterparties usually have no separate and independent right to insist on security enforcement.

In applying these principles (and hedging generally) to a subscription/capital call finance, there are some additional issues that have to be considered (and a variety of approaches can be taken to documenting and solving these issues).

The first issue is that subscription/capital call lenders are working within specific leverage constraints in terms of the investors in the fund borrower. If any hedge provider is to be included equally alongside the other “senior” lenders, then the potential liabilities to that hedge counterparty need to be taken into account in assessing the leverage (or borrowing base) required to make both the other senior lenders and the hedge counterparty whole.

The hedging liabilities are usually defined by reference to the mark-to-market liabilities applicable to a hedge arrangement on any particular day and by reference to the liabilities on a termination or close-out of the hedging. In any case, anticipating the liability level is difficult to do since hedging liabilities (however they are assessed) can fluctuate significantly.

One way this is often addressed is to have a limit or cap on the amount of the overall leverage or borrowing base that can be allocated to hedging and to allocate that based on a reasonable assumption as to what the maximum liabilities could be. If the hedging liability goes above that pre-allocated amount, then it is effectively regarded as being outside the leverage and/or borrowing base coverage and also as being, in effect, unsecured.

The second (and potentially more difficult) issue arises where the fund's LPA contains a specific leverage limitation at subscription finance level. Because of the way hedging liabilities can fluctuate (and assuming that hedging is included in the LPA as "debt" which contributes to the leverage calculation), it's possible that a fluctuation in the hedging liabilities would cause an excess over the permitted leverage. That can "infect" not only the hedging but also the remainder of the subscription/capital call piece. The most common way to deal with this is simply to ensure that the hedging (alongside the capital call/subscription facility) includes a very significant "headroom," which, in most foreseeable circumstances, should be sufficient to ensure that the leverage restrictions are not breached.

Finally, including hedging arrangements and hedge counterparties (whether just within an allocation of a proportion of the available leverage or borrowing base or as part of the security) needs to be addressed carefully in documentation. If, as is sometimes the case, the (bank-side) hedge counterparty is the same entity as the lender under the subscription/capital call facilities, then the primary concern will be properly dealing with how the hedge liabilities are allocated and defined. In many cases, however, the hedge counterparty and lenders will not be the same. Particularly in a "multi-bank" subscription/capital call facility, they will almost certainly not be the same.

At that point, the documentation can go one of two ways. If the hedge counterparty is also a lender (but not the only lender) in the subscription/capital call line, then a number of the "intercreditor" and related provisions that need to be included where a hedge counterparty is a party can be included in the facility agreement itself, and it is possible to do without a separate intercreditor document. Even in such cases, however, and certainly in any case where the hedge counterparty is not part of any subscription/capital call facility, having a separate intercreditor agreement between the relevant parties should be considered.

As with any intercreditor arrangement (whether included within a subscription or capital call facility or outside it in a separate intercreditor), the senior lenders and the hedge counterparties will need to consider carefully which matters within the subscription facility and/or the hedging arrangements may concern them and, if so, to what extent they should have a say in those matters being resolved. It is worth noting that hedge counterparties in a subscription/capital call facility arrangement may actually look for more "general" protections here than is standard in the related leveraged LMA documentation.

The inclusion of hedging in capital call/subscription facilities is a relatively complex and developing area. We are watching these developments with interest, and as with some other aspects of current subscription/capital call finance, this may well be an area that we revisit as these developments take hold.