



FUND FINANCE FRIDAY

## **‘I’ll Be There for You’**

**December 9, 2022 | Issue No. 203**

### **Table of Contents:**

- **Fund Finance Credit Availability Still Locked In**
- **Fund Finance Credit Availability in 2023: Not Just Banks**
- **Are Loans Securities?**
- **Next Year on Fund Fanatics ...**
- **NAV Article in Deloitte Thought Leadership**

# Fund Finance Credit Availability Still Locked In

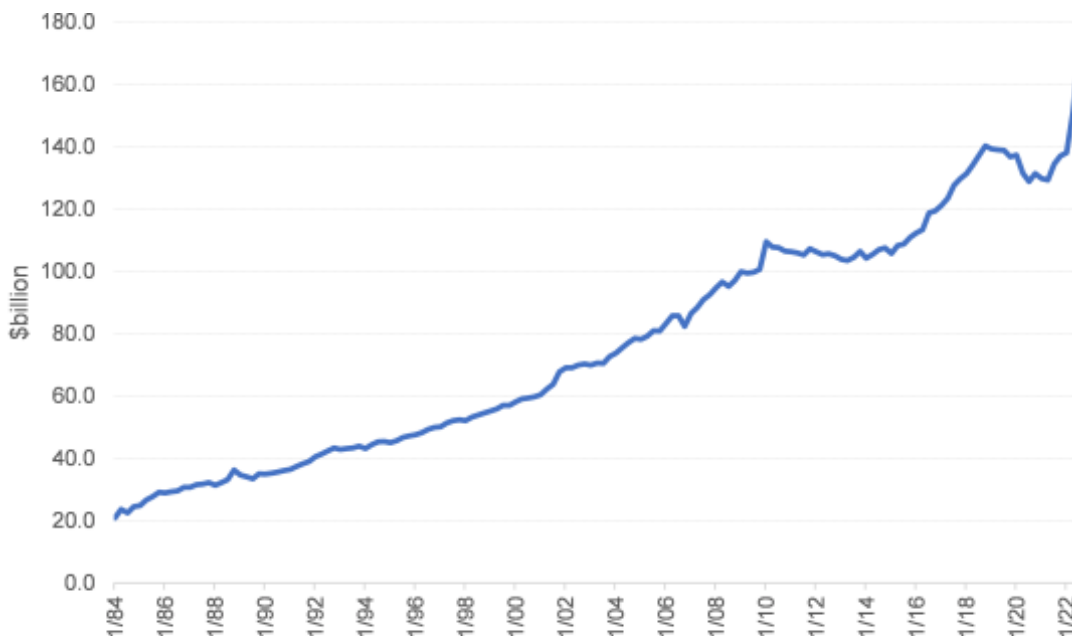
December 9, 2022 | Issue No. 203



**By Chris van Heerden**  
Director | Fund Finance

2022 has been a remarkable year for the banking industry. Yields on interest earning assets stayed well ahead of funding costs to drive record gains in net interest margins. The lift from higher rates, combined with broad based loan growth, translated to record net income.

## Exhibit 1: Quarterly Net Interest Income Powered Higher by NIM Expansion and Loan Growth

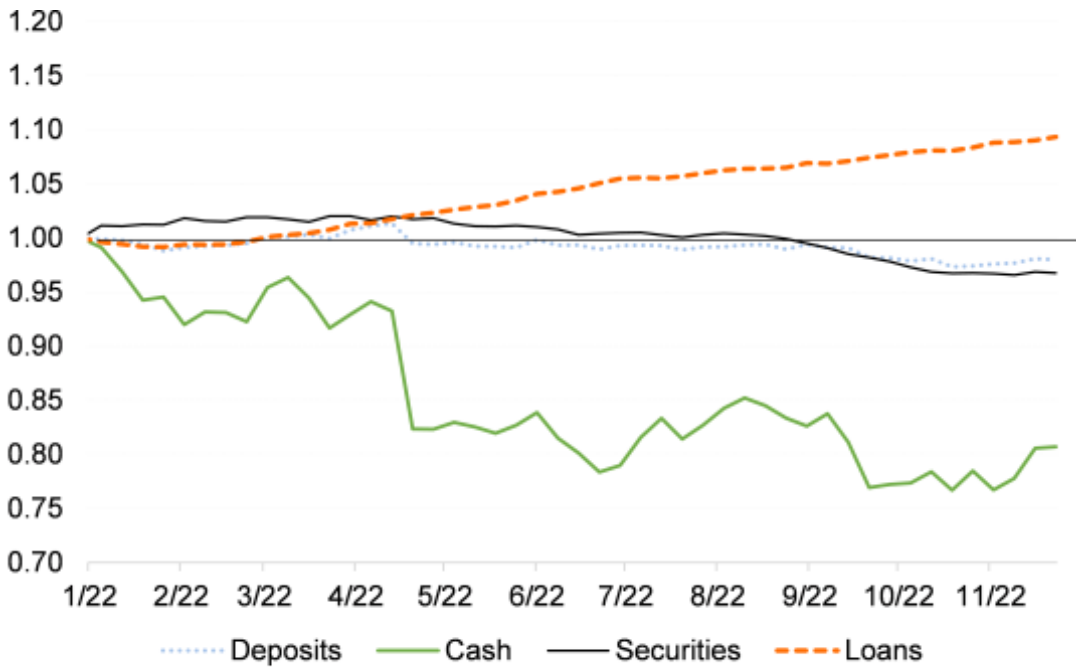


Quarterly net interest income for all FDIC insured institutions.

Source: Federal Deposit Insurance Corporation.

It certainly helped that, coming into the year, lending standards were still easing as the COVID brakes came off and demand for credit was still expanding across all major lending categories. That's not the setup for 2023.

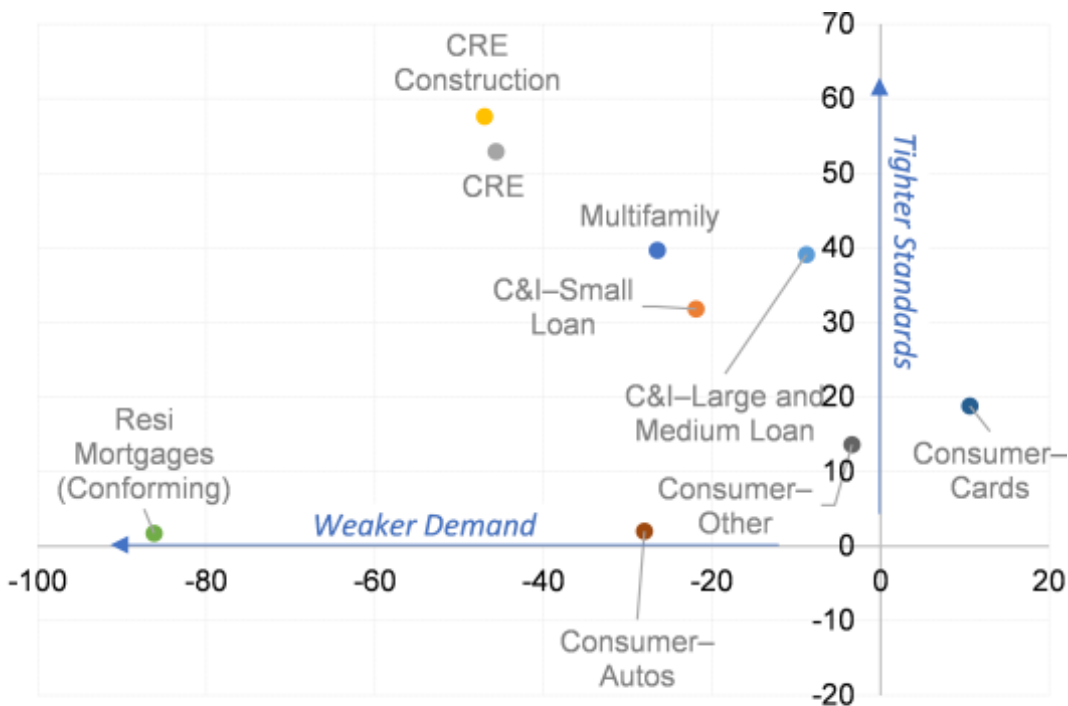
## Exhibit 2: Bank Balance Sheets – The Deposit Drain Showed Up in Cash and Securities



Source: Federal Reserve H.8 Assets and Liabilities of Commercial Banks in the United States.

With year-end approaching, the pace of the tightening in bank lending standards already looks recessionary, and loan demand is not far behind. (Credit cards are the lone exception where demand is still growing, which is probably not a positive economic indicator.) Loan growth is clearly going to be more difficult to come by in 2023.

### Exhibit 3: All Loan Products Ex-Cards Face Tougher Terms and Weaker Demand



Measures net share of banks reporting, not magnitude of change.

Source: Federal Reserve Senior Loan Officer Opinion Survey.

What does this mean for fund finance? For starters, lender interest in fund finance looks set to stay high even as fundraising decelerates. We're seeing this play out now with new lenders having recently entered the market and in ongoing discussions with several incumbents on their next phase of growth.

Our [October survey](#) of the heads of fund finance groups at banks showed that 64% of respondents expected fund finance commitments at their institution to grow in 2023. Along with that finding, a majority of participants anticipated utilization levels to decline as rates rise, and for pricing to continue to widen consistent with broader market trends.

Sustained lender engagement in 2023 should also continue to support price stability in fund finance as it has this year. While subscription facility margins are wider year to date, fund finance pricing has proven far less volatile in 2022 than in other credit products, a reflection of sustained lender commitment. While a softening economic outlook is likely to challenge bank performance in 2023, we think credit availability for fund finance is staying locked in.

# Fund Finance Credit Availability in 2023: Not Just Banks

December 9, 2022 | Issue No. 203



**By Chris van Heerden**  
Director | Fund Finance

As remarkable as the year has been for banks, 2022 will be remembered in part for the continued ascent of private credit. The scale and significance of these non-bank lenders became clear this summer when private credit funds stepped in to close a number of multi-billion unitranche loans as banks retreated from the leveraged loan market.

The growth path in private credit has been well documented. Preqin, for example, forecasts private credit AUM to more than double from \$1.21 trillion in late 2021 to \$2.69 trillion by 2026. To put that in context, private credit AUM grew from one-sixth the size of the U.S. ABS market at the end of the GFC to now nearly equaling the total size of that market. Of course, this is not a perfect comparison, but it illustrates that private credit has become a globally significant source of capital.

Given these trends, it's natural for fund finance market participants to think through the future significance of non-bank lenders to our market. To this point, it is important to highlight some differences between traditional direct lending and fund finance. For a corporate borrower, the attraction of a single-lender, bought deal is compelling, especially at this moment in markets. For one thing, borrowers, which are most often sponsors, can transact knowing that financing is locked in. That's been a challenge this year. Then, after origination, a single lender or small group can be much more responsive to a borrower's needs than a syndicate.

In fund finance, we don't have the same challenges. Execution works because of the relationship depth, pre-commitment credit approval, and an originate-to-hold business model. Our loans are not structured with the same price-flex mechanics as leveraged loans. And the majority of loans (91% by deal count in the first three quarters of 2022) in fund finance are bilateral. Add to that the pristine historic loan performance, and it becomes clear that we don't have the same problems for private credit to solve.

So, if private credit is to grow in fund finance – we think it will – the growth may be more about what challenges fund finance can solve for private credit lenders. Private credit funds are sitting on \$425 billion of dry powder based on PitchBook data. Sponsors get paid on deployed capital, so the clock is running on the committed capital while significant underwriting resources are already in place.

Average fund performance in 2022 also shows that private credit funds would benefit from broader diversification. Private credit returns softened in 2022 and generally tracked the broader loan market fairly closely. Fund finance exposure could reduce that correlation and help funds with both the deployment and the diversification challenge.

Answers, however, as we've [previously written](#), are unlikely to come from subscription lending. Even with one-month term SOFR up by 420 bps so far this year and subscription facility margins moving wider, unlevered returns don't quite pencil out. Aside from the hurdle return issue, there are also relative value considerations. Private credit funds are now able to hit double-digit returns in their core direct lending programs. Then, even if subscription pricing widened further, we think the LP borrowing base underwriting process will still fit best at banks. NAV lending is a more natural fit as loan margins align better with private credit cost of capital. Subordinated subscription debt could potentially be another avenue for growth in 2023, especially as the product evolves and in the event banks move to lower advance rates or sizes on new credit facilities.

Then there's the under-developed market for structured fund finance. Bank lenders have more incentives than ever to advance credit risk transfer solutions. Here, a private credit fund as a subordinated investor could gain exposure to a pool of high-quality subscription loans at a levered return.

Collateralized fund obligations may be another potential growth area where private credit funds can provide financing on a diversified basket of funds with the benefit of structural subordination and a credit rating. While the CFO market has been around since the early 2000s, LPs may be more motivated in 2023 to look for portfolio management tools, and CFOs can help free up liquidity.

So while we think bank credit availability is secure, we look forward to the evolution of fund finance in 2023 that may see more tapping into the vast and growing pool of private credit capital.

## Are Loans Securities?

December 9, 2022 | Issue No. 203



**By Leah Edelboim**  
Special Counsel | Fund Finance

We have been following a case that has been winding its way through New York federal courts for some time that players in the syndicated loan market have described as everything from “a potential game changer” to an “existential threat” to the syndicated loan market.

The case in question is *Kirschner v. JPMorgan Chase Bank, N.A.*, which is before the United States Court of Appeals for the Second Circuit. In this case, the Court will consider an appeal of a 2020 decision by the United States District Court for the Southern District of New York which held that the syndicated term loan in question was not a security. Significantly, this ruling indicated that because syndicated term loans are not securities, they are therefore not subject to securities laws and regulations.

The consequence of a determination that syndicated loans are securities would be significant. It would mean, among other things, that the syndicated loan market would have to comply with various state and federal securities laws. This would significantly change the cost of these transactions as well as the means by which syndication and loan trading take place. The Loan Syndications and Trading Association (LSTA) filed an amicus brief in this case in May of this year, which we covered [here](#). The LSTA argued in its brief, among other things, that beyond the increased cost, regulating syndicated loans as securities would fundamentally change other aspects of the syndicated loan market. Specifically, the LSTA pointed to the importance of a borrower’s ability to have veto rights and other control in determining which entities will hold its debt. The LSTA also noted the importance of quick access to funding on flexible terms specific to the borrower in question – something we know is at the heart of so many fund finance transactions – which would be greatly compromised within a securities regulatory regime. The LSTA brief also discusses potential negative impacts on the CLO market.

Those in favor of a change in regulation point to features such as nonbank lender participation in the market, the fact that the test to determine whether a loan is a security may be outdated, and the overall size of the syndicated loan market – at \$1.4 trillion – which could be a risk to the larger global financial system potentially warranting more stringent regulation.

Most experts believe that the Second Circuit will not overturn the decision issued in the lower court, but the issue in question is significant enough that market players should keep an eye on this one. Oral arguments will take place early next year. We will continue to watch as this case develops and update you here.

## Next Year on Fund Fanatics ...

December 9, 2022 | Issue No. 203

Scott Aleali and Jeff Maier posted a **Fund Fanatics highlight reel** of their 2022 interviews and are now looking for some engaging guests and topics for 2023. Contact Scott and Jeff with any suggestions and any comments.



## **NAV Article in Deloitte Thought Leadership**

December 9, 2022 | Issue No. 203

The Deloitte Private Debt Deal Tracker Autumn 2022 includes an article from Director Jamie Mehmood titled “The Evolution of NAV Financing against the Current Market Outlook.” To access the Tracker and Article, click [here](#).