The Evolving Lender Landscape & Impacts on Balance Sheet Management[1]

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In describing the early days of the fund finance market, the panelists painted a picture of a small market dominated by a handful of large bank lenders pooling together in club deals to provide a novel product to pioneering fund sponsors who recognized the opportunities attendant in leveraging the uncalled capital commitments of investors in their funds. These lenders did not have centralized fund finance teams and were focused on the yield generated by any given credit facility rather than ongoing relationships with fund sponsors. In the years that followed, and especially following the global financial crisis, a flood of new lenders entered the space and the original product—the subscription line or capital call facility—has become nearly ubiquitous, and other products have been and continue to be developed to satisfy diverse capital and liquidity needs in a market that has exploded in size and scope. Against this backdrop, the panelists discussed the continued evolution of the market, the challenges faced by fund sponsors and lenders today, and the potential avenues for growth given the constraints faced by current market participants. Below are the key insights discussed by the panelists:

1) Defining Features of the Current Landscape.

- Over the last decade, the alternative asset class has exploded, with fund sponsors raising tremendous amounts of capital for their private investment vehicles. Subscription facilities have come to be expected, and demand for these facilities regularly outpaces supply.

- The increase in lenders in the space has, not surprisingly, brought with it an increase in competition amongst lenders and the development of additional credit products (e.g., NAV lines, GP co-invest lines, CFOs, etc.) to finance different pieces of the fund ecosystem at different times of a fund’s life. Lenders have developed centralized fund finance teams that focus on the overall relationship with their sponsor clients and ancillary business opportunities on both sides.

- It is difficult for lenders to offer all types of fund finance products and typically they will need to specialize. Sponsors know this and work to stay abreast of lenders’ specialties.

- While historically providers of capital in the fund finance market have been banks, challenges facing banks today have given rise to an increased interest by sponsors in seeking participation from non-bank lenders and other alternative sources of capital.

[1] The panelists were Steven J. Colombo, Managing Director at Goldman Sachs Asset Management, Missy Dolski, Global Head of Capital Markets at Värde Partners, Vicky Du, Global Head of Fund Finance at Standard Chartered, Steven Kahn, Senior Managing Director at Assured Guaranty, Michael Orphanides, Managing Director at BMO Capital Markets, and Laurie Lawler, Managing Director, Head of Capital Call Financing, and Deputy Head of FI Origination at Société Générale.

2) <u>Current Challenges Facing Banks & Impact on Fund Finance Market</u>.

- A tightening of the credit market has led to internal competition within banks for space on the balance sheet.

- Regulatory capital treatment and evolving bank regulations have also contributed to increased funding costs. Third party insurance can help with regulatory capital management and free up additional capital, but every institution's needs differ.

- Many banks are facing resource constraints, generally, and these constraints are contributing to longer timelines to get deals done. For example, fund finance teams in some financial institutions are not large enough to support deal flow and ongoing maintenance of existing deals, which is contributing to lenders being more selective, since they do not have capacity.

- Banks have competing priorities: abiding by capital requirements, managing balance sheets, and servicing existing clients. Consequently, fund finance teams must constantly prove internally that they can effectively distribute capital. Fund finance teams are also being asked to help generate interest in other bank products.

3) <u>Non-Bank Lenders and Alternative Sources of Capital (Fund Finance 3.0?)</u>.

- As discussed earlier in the panel, with the diminished supply of capital available from banks, there has been renewed interest in participation by non-bank lenders.

- Banks remain the dominant capital providers in the fund finance market, but it is early, and it was suggested that, as has been the case in other asset classes, non-banks (e.g., BDCs, insurance companies, private credit funds, and pension funds) will increasingly find ways to enter the market and drive borrowing costs down. Particularly, regulatory capital relief trades could be a factor as more sponsors get comfortable with how these transactions work.

- The panelists discussed the potential for a capital markets solution to help meet the financing demand (which they christened "Fund Finance 3.0") but the consensus among panelists seemed to be that there are many hurdles to overcome for any such solution to be realized.

- Among the challenges involved in making Fund Finance 3.0 a reality, the panelists discussed the difficulties of securitization in the context of bespoke, non-standardized documentation, the legal distinctions between securities and loans and the scope of disclosure that would need to be made in the securities context, and the economic reality that current pricing of most subscription facilities would not support securitization.

- The panelists considered whether having subscription credit facilities rated could help attract non-bank lenders to subscription credit facilities. The panelists agreed that subscription credit facilities should not be rated unless such a rating would improve pricing or improve sponsors' ability to raise more capital.

- The panelists noted that for a capital markets-based solution to become a reality in this space, it would require leadership from an existing lender or lenders who understand the scope of the product and how the various funding solutions are intended to work together.