New Suppliers of Capital in Fund Finance[1]

By Lindsey Hughes and Justin Keller

Large, traditional banks have historically served as the main suppliers of capital in the fund finance market. While these banks continue to dominate the space, particularly with respect to subscription facilities, as demand for capital continues to outpace supply, market participants are increasingly looking to the potential for non-banks—business development companies, private credit funds, insurance companies and pension funds, for example—to step into the gap. This panel focused on these alternative suppliers of capital—their place in the current landscape, their limitations and potential for growth, and the challenges these new lenders are predicted to face as they increasingly seek to participate in the market. What follows is a high-level summary of some the key points discussed by the panelists.

1) Evolution of the Market and Current Landscape. Regulatory capital requirements and a slowdown in the growth of deposits have contributed to a reduction in available capital within traditional banks, causing traditional lenders to pull back and forcing banks to be more selective in deploying capital, which has exacerbated the already high demand from borrowers and makes the potential for non-bank lenders' involvement ever more attractive. The panelists suggested that subscription facilities, however, will likely continue to be largely the domain of traditional bank lenders. In the near term, new banks, especially smaller, regional banks, will continue to enter the market and grow their capabilities, and established non-U.S. banks will likely continue to grow their market share. Non-bank lenders have had limited appetite for participation in subscription facilities due to typically lower pricing, but there has been increased participation by non-banks in other liquidity solutions in the space, including NAV and GP lines and collateralized fund obligations.

2) Buffet of Choice. The uptick in additional banks and non-bank lenders entering the market has created a "buffet of choice" for sponsors. Lenders' competition for market share is resulting in an evolution of product offerings and the need for greater flexibility from credit providers, with sponsors able to entertain different options in line with their respective strategies. This buffet of choice will continue to drive an increased diversity of credit products, flexibility, and competitive pricing.

3) Flexibility. While many of the non-bank lenders and smaller banks entering the space may have the ability to be more flexible and creative in structuring certain aspects of a facility than the larger banks that have traditionally supplied capital to the fund finance market, they will have operational challenges to overcome. For example, non-banks are likely to demonstrate greater flexibility with respect to features like facility tenors, advance rates, and concentration limits but may struggle to provide optionality with respect to certain operational features like availability of alternative currencies, letters of credit, same-day funding, and other borrowing mechanics.

4) Role of Ratings in an Evolving Market. The panelists emphasized the importance of ratings as a factor in increasing the availability of capital in the fund finance space. In addition to generally validating the market and helping to prove its strength to regulators, ratings permit better capital treatment for banks subject to

[1] The panelists were Ana Arsov, Managing Director, Global Co-Head, Banking at Moody's Investor Services, Mike Durnin, Principal at Ares Management, Greg Fayvilevich, Head of Global, Funds Group at Fitch Ratings, Ron Franklin, Partner at Proskauer, Marc Silva, Global Head, Private Equity Subscription & Partner Finance at UBS, and Sherri Snelson, Partner at White & Case.

such regulations (thereby freeing up capital), and they enhance the marketability of these facilities to a broader segment of participants (which increases the pool of potential lenders).

5) Regulatory Challenges. Regulations continue to pose a challenge to increasing the availability of capital in the fund finance market, for both banks and non-banks alike. The risk-based capital treatment for subscription facilities, for instance, remains more conservative than it likely needs to be based on the product's track record, which includes only a few instances of fraud and very limited investor defaults. However, the dearth of material defaults and lack of loan loss history cuts both ways. Bank regulators remain focused on prudential and systemic risk and continue to scrutinize G-SIBs' exposure to leveraged finance, and without this loan loss history, it is difficult to know the potential scope of loss or the systemic implications thereof, which leads to more conservative accounting treatment. With respect to non-bank lenders, the NAIC continues to scrutinize insurance companies' involvement in rated-note feeders, collateralized fund obligations and other structures aimed to deliver regulatory capital relief to these companies. The panelists expressed hope that as regulators' views become more settled, the increased certainty will result in a more robust market.

6) Securitization. During the question-and-answer period, the panelists noted that securitization could provide another potential source of capital in the fund finance market, but it faces significant challenges in the near term. Specifically, the bespoke nature and variability across facilities, lack of ratings, and low pricing are a few of the immediately salient practical barriers to development in this area. There would need to be significant resources dedicated to developing the model in this context and getting participants comfortable with the added complexity.

7) Predictions for the Future. The panelists acknowledged that the industry would continue to face certain headwinds in 2023, including rising interest rates and both geopolitical and economic uncertainty; however, across the board, the panelists expressed general optimism for the future of fund finance and the alternative asset class generally. The consensus seemed to be an expectation that while the fund finance market may not see much additional growth compared to recent years, it is unlikely that we will see a significant withdrawal of lenders in the space. Rather, near-term challenges will cause lenders to place an even greater emphasis on maintaining relationships with sponsors.

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