Underwriting Considerations in Today's Market[1]

By Emma Russell and CJ Donald

The Underwriting Considerations in Today's Market panel covered questions relating to how lenders and fund sponsors are reacting to changes in the market following bank failures and what trends they expect to see going forward. Specifically, the panel discussed the following questions:

- **How can banks balance the current regulatory environment with lender desires to service existing clients and acquire portfolios?** At the outset, the panelists discussed how, due to the regulatory environment, banks are facing higher capital requirements. The increased buffers have constrained the amount of capital banks can deploy, compared to previous years. Lenders are also focused on comprehensive operational risk, as opposed to strictly focusing on a borrower's credit profile. So, lenders currently desire strategic client relationships that will be mutually beneficial. For example, most lenders will prioritize deals with existing clients who use other products offered by that lender.

- **How do lenders and fund sponsors collaborate given the current credit environment?** Lenders have proactively met with sponsors to forecast future needs and assess whether availability can be reduced for older vintages. Sponsors must also understand the short-term and long-term needs of their lenders. For example, some lenders leave syndicates because of a borrower's failure to meet internal requirements to provide other banking business. Other lenders might leave a syndicate because they only want to be the lead arranger or because they have left the syndications market altogether. To be successful borrowers, sponsors must understand existing and potential lenders, and work to identify the proper fit.

- **Have underwriting teams changed practices in light of the credit environment and regional banking crisis?** Banks have increased the amount of pre-close and post-close work to make sure clients are monitored appropriately. Specifically, banks are focused on the accuracy of the borrowing base (approval of new investors, recognition of transfers, etc.) and ongoing reporting. Further, for NAV facilities, quality of the general partner is of paramount importance. It is important for banks to understand a general partner's risk profile, borrowing intentions, and past fund performance. Banks also want to understand whether the general partners are business savvy. These questions help underwriters determine whether they can trust the general partner. For lines of credit, underwriters focus more on each limited partner's willingness to timely contribute capital. For rated note feeders, banks focus on the capacity of the feeder to service the debt.

[1] The panelists were Gregg Scheuing, Director of Alternative Funds Lending (Bank of New York Mellon), Mike Elwell, Director of Private Equity Banking Group (Citizens Bank), Mark Egger, Executive Director at J.P. Morgan, Alex Phillips, Managing Director at PNC Bank, Evelyn Pellicone, CFO of Crestview Partners, and Thierry Grunspan, Director at S&P Global Ratings.

Sponsors have also changed their operations given the current environment. Previously, sponsors used to appoint one individual to manage the bank relationship. Now, fund sponsors have enhanced their teams to include legal, fund administration personnel, and accountants. Fund sponsors have developed routine and checklist-based processes to increase communication so the funds can avoid foot faults.

- **What current trends are impacting lenders and sponsors?** Lenders are expanding the definitions of events of default, including fund defaults based on fund performance metrics. NAV facilities and hybrid facilities continue to gain popularity because sponsors generally have capital constraints. Banks have not yet fully invested in growing the NAV market because they are still building out their expertise in the space but, as banks continue to grow their portfolio analytics departments, expect NAV facilities to increase in popularity.

- **What future trends will impact underwriting?**

  - ***New SEC Rules.*** The Securities and Exchange Commission recently updated guidance with respect to the regulation of private fund advisors. The new rules and amendments are designed to protect private fund investors by increasing transparency, competition, and efficiency in the private funds market. Certain portions of these rules relate to or are relevant to fund finance market participants, including new mandated investor disclosure of fund performance metrics without impact of a subscription line.

  - ***Subscription Lines.*** Sponsors will still use subscription lines of credit. However, some limited partners are pushing back on the use of subscription lines because of higher interest rates than we have seen in recent memory. Accordingly, sponsors will increasingly use subscription lines for short-term administration convenience rather than longer term investment management.

  - **Regulatory cost of capital.** Capital requirements will force banks, especially regional banks, to monitor credit more intensely, administer it with more precision, and continue to learn more about the limited partners.