

Fund Finance Friday



Fund Finance in a Rising Rate Environment: Bank Survey and Observations

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Everyone is talking monetary policy as though they have been watching the Federal Reserve closely for years. Some people are even claiming to have had lunch with Paul Volcker in the '80s. Inflation and rising rates are a frequent topic among private equity professionals these days. Everyone seems to be auditioning for a CNBC segment (if CNBC is reading this, my professional email is in my bio).

We all have seen incredible growth in the fund finance product over the last several years. With the rapid increase in interest rates in the United States and elsewhere, it's prudent to ask what is the future of the fund finance product in a rising rate environment. To help gain some insight, Cadwalader sent out a client survey to our bank clients, "The Cadwalader Fund Finance Decision Maker Survey." Here is what we have found.

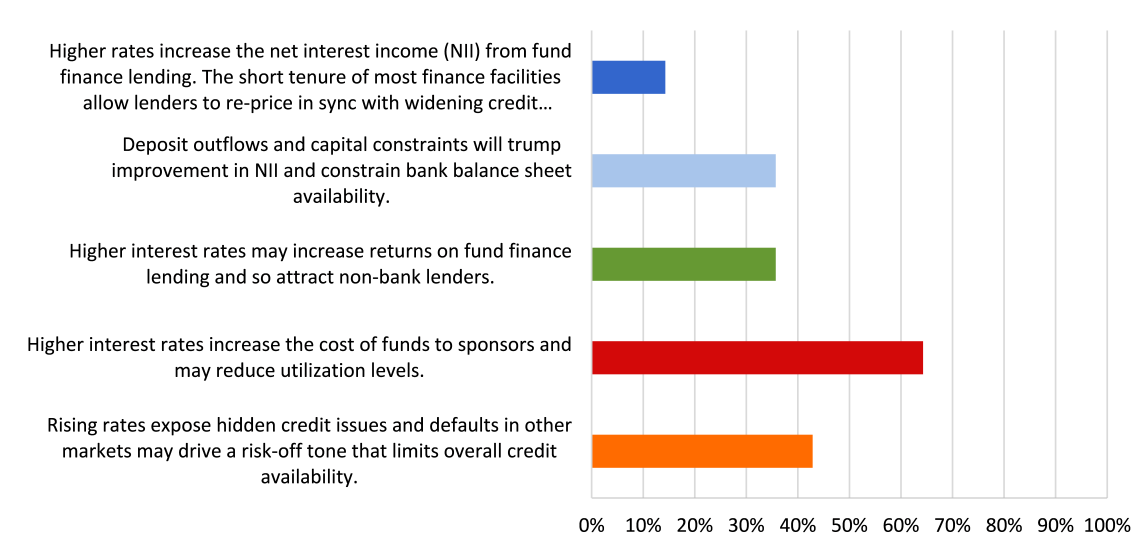
Among respondents, 21% of banks predicted that their allocation to fund finance will be meaningfully higher in 2023, with 43% as somewhat higher. Another 21% forecasted unchanged outstanding commitments and 14% anticipate somewhat lower commitments. That means that out of our respondents, 86% are holding steady or increasing their exposure in 2023.

On the whole, these results point to a greater growth orientation among lenders than we would have anticipated. We see two qualifiers to the raw data:

First, a survey by count of respondents doesn't correspond to total commitments – it is possible, and even likely, that a larger number of smaller and medium-sized players are "risk on" whereas other banks may be facing a more challenging balance sheet environment. If correct, we could see a further extension of an in-place trend in the fund finance market whereby the top lenders' market share recedes as the lender base diversifies.

Second, we surveyed group heads, a sample that is probably oriented towards growth, whereas the realized outcome for commitments may be dependent on macro variables and balance sheet constraints outside the control of fund finance decision makers. Even with these qualifiers, we see the result as expressing a strong growth signal that runs counter to some market sentiment conversations we've had recently.

Exhibit 1: Higher Interest Rates Expected to Show Up in Lower Utilization



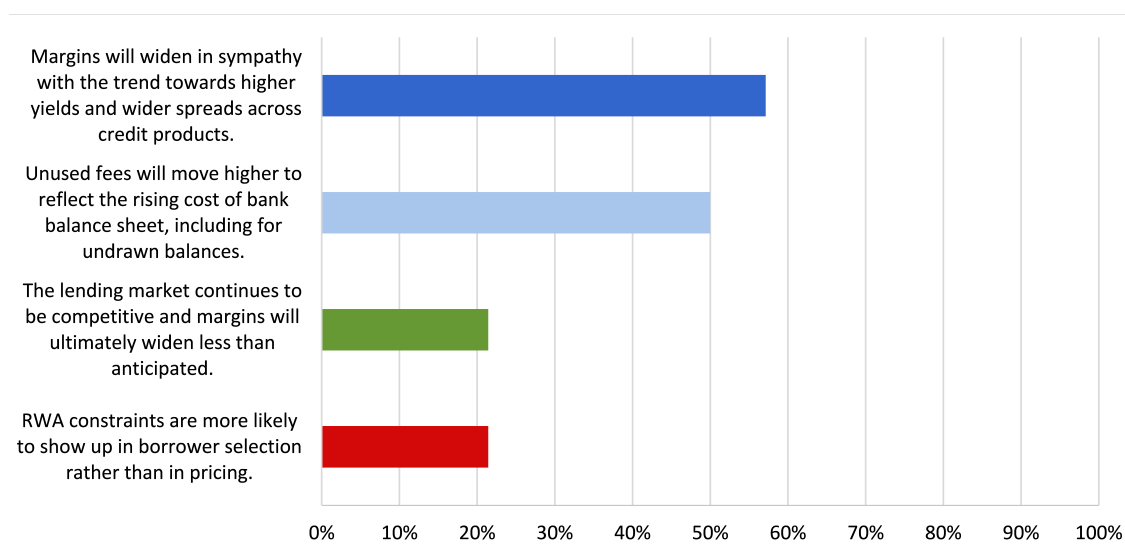
Note: Summarizes percentage of respondents that selected each option.

Source: Cadwalader, Wickersham & Taft LLP

In assessing the likely effects of higher interest rates, respondents zeroed in on utilization levels (Exhibit 1). According to our survey, 64% of respondents expect utilization levels to decline as borrowers face a higher cost of funds. This is also something we have heard anecdotally and have solved for by, for example, setting unused fees higher at a 30 bps/35 bps toggle rather than the traditional 20 bps/25 bps. There's also been some discussion of minimum usage requirements and offsetting lower utilization through higher fees. A more straightforward solution might simply be smaller facility sizes – fundraising trends and general partner behavior in reaction to rising rates may drive this as a natural solution that solves for lower utilization rates.

There is also a standout in terms of disagreement: only 14% of respondents thought higher rates would attract more bank capital, given subscription facilities are a floating-rate product with a short loan term that allows for frequent revisiting of margins. While moving capital to new floating-rate loans in a rising rate environment makes intuitive economic sense, most banks don't think this is significant to the outlook for 2023.

Exhibit 2: Margin and Unused Fees Expectations Point Higher



Note: Summarizes percentage of respondents that selected each option.

Source: Cadwalader, Wickersham & Taft LLP

We also asked for any general thoughts on the direction of margins and unused fees. As rates increase and liquidity tightens, a little more than half of respondents agree that margins will increase with higher yields and wider spreads across other credit products. We read this as a general expectation for further possible widening, extending what has already been a trend to higher margins in recent months. Consistent with the discussion on utilization levels, half of respondents thought unused fees would move higher.

The takeaway is that banks remain bullish on the product generally, subject to significant balance sheet headwinds that are independent of the true health and demand for the product. This implies that increasing interest rates do not make the product less attractive but will instead affect utilization rates. Utilization rates are likely to reflect a higher cost of

funds to borrowers, and behavioral changes at funds as fund finance facility pricing approaches the 8% pref return (the cost of LP capital). Our editorial comment on this would be that the treasury product characteristics of subscription facilities – the immediate access to funds, the operational efficiencies, multi-currency availability, etc. – will also come into play and may buffer some of the anticipated decline in utilization.

One might think that when restricted supply (via internal cost of funds increasing and balance sheet pressure) meets continued healthy demand, we would see new non-bank entrants into the market. Indeed, 35% of respondents saw some possibility of increased non-bank lending as interest rates rise. That may very well happen, but also query whether sponsors are comfortable with a private credit fund as its lender. We could very well see new insurance companies and even LPs enter the space as liquidity providers, but the ability to execute remains key. Agent banks with a demonstrated track record of executing facilities will remain in strong demand.

While rising rates are key variables in our outlook for 2023, the pro-cyclical nature of regulatory pressure is also critical. Many key players in the fund finance market are global systemically important banks (GSIBs) who are facing increasing GSIB surcharges (that is, additional capital buffer they are required to hold in addition to the baseline required capital reserves). Rising capital requirements are an added constraint that comes in the context of potential fair value depreciation in securities portfolios and potentially higher and earlier loss provisioning in other products under the current expected credit loss (CECL) framework – all pointing to a tightening in balance sheet availability and more sensitivity to adding risk weighted assets (RWA).

In such an environment, we would expect banks with RWA pressures to pursue three strategies. First, we expect to see an emphasis on core sponsor relationships. Second, banks are likely to pursue capital relief trades to help manage their RWA proactively (see our discussion of Cadwalader's capabilities in this area [here](#)). Third, we expect a continued re-evaluation of all facets of deal economics, as is apparent from the survey responses.

Of course, banks are just half of the market equation. Perhaps in a future article, we could solicit general partners and CFOs. *Fund Finance Friday* would look forward to presenting other perspectives. Any takers?