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Questions and Answers on Capital Call Securitization – An Idea Whose Time Is Now

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Securitization of sublines continues to be the hottest of hot topics in fund finance. Whether it could be done, how to do it, and how to overcome certain real and perceived challenges were topics of countless articles and conversations among practitioners and their clients for quite some time, but that all changed in 2024 when we truly saw the dawn of the securitization era for fund finance. We at Cadwalader have been working on a number of transactions that sit at this intersection of securitization and fund finance this year. Earlier this quarter, the market sat up and took notice when the first broadly syndicated, publicly rated securitization of sublines hit the market with the Capital Street Master Trust Series 2024-1 transaction.

An important topic of conversation with our clients has been how structured products play into the capital call market and how to best structure these bespoke solutions to meet the needs and business prerogatives of each client. As we usher in the era of securitizing sublines, new ideas and possibilities abound.

In this week's *Fund Finance Friday*, we follow up our **primer on capital call securitization** piece with an overview of some of the different approaches that can come into play in a securitization of subscription facilities.

The key here is that structured products have a number of different, *ahem*, structures that can be utilized and each one has its own particular advantages and can meet different needs. To that end, we believe it is time to start the discussion on the shape of things to come, and by shape we mean the variety of different structures that parties can use in their securitization deals.

Q: What type of structure did the Capital Street deal use?

A: The first broadly syndicated, publicly rated securitization of sublines was a first-of-its-kind deal but the securitization technology was not novel. The deal utilized a securitization structure that is a methodology that is typically followed in credit card receivables securitizations. Those deals pool the assets and look at the relevant assets solely as a pool and not at all on an individual basis.

Q: Are there any drawbacks to this structure?

A: While it is a structure the market knows well, it begs the question as to whether it is the best structure for a subline securitization, which is essentially a pool of loans. Some market participants may be better off considering a structure that relies on CLO methodology, which, rather than treating this pool of loans as a collective pool, would instead allow for a more bespoke and individual loan evaluation in assembling the structure. The ratings approach for this structure would likely follow a CLO methodology as there is no separate "non-CLO" ratings methodology. We do note that a CLO would require an additional layer of structure to address revolving loan mechanics, which we discuss below.

Q: What type of structure should a lender put in place if it is trying to manage its balance sheet?

A: There are several different types of securitization structures, which can be deployed based on the needs of the applicable parties. Key to these transactions is understanding the needs and motivations of the parties to a securitization so that the structure can adequately address them. We start here with a structure that is intended to help a bank manage its balance sheet in structuring the deal. One type of structure that does that is with respect to a specific loan being originated (*i.e.,* making that loan itself qualify for securitization capital treatment). To put this structure in place requires a bankruptcy remote, special purpose borrower that was formed solely for the purpose of acquiring capital call rights and incurring indebtedness secured by them.

Q: Are there any drawbacks to this structure?

A: This structure works well if you are starting from scratch. However, if a bank has an existing pool of capital call loans that have been structured as recourse debt of the fund, this structure may not work because it would require amending and updating to a securitization structure that could be cost and/or credit prohibitive.

Q: How do you solve for this?

A: If that is the case, a better approach would be to take this pool of loans and sell them into a bankruptcy remote, special purpose borrower (equitized by a third party) that finances the capital call loans as a pool (which financing could be in the form of a bank warehouse product or a capital markets securitization). In both cases any involved financing bank could then qualify for securitization capital treatment, which decreases capital hold requirements and might allow for additional pricing flexibility.

Q: What about a CLO structure?

A: CLOs have a few attractive advantages to consider. First, the reinvestment period provides the issuer significant time to benefit from the financing structure. In addition, the CLO market is now well conditioned to reprice liabilities, so the cost of funds can be reduced opportunistically. This is different from the master trust and it is an advantage in an emerging asset class because pricing could improve over time at lower attachment points.

Q: What are the potential drawbacks or concerns regarding a CLO structure?

A: One feature that differentiates subscription facilities from the collateral normally found in CLOs is that sublines are usually 100% revolving loan facilities. Unless a subline is structured to include sizable term tranches, Capital Call CLOs will need to manage significant daily funding activity within their portfolio. That means access to liquidity will be paramount to maintaining their rating. Over the years, CLOs have solved this issue with various mechanics including cash collateralization of unfunded amounts, bank-provided swingline loans and even revolving notes issued to entities with high short-term ratings. All of these approaches have their advantages and work in certain circumstances but one of their drawbacks is that they make the transaction more expensive. The most efficient long-term approach could ultimately mirror the syndicated lending market where revolving and term exposures are split into tranches and sold separately.

Q: Is there anything else that readers should keep in mind as it relates to these different structures and approaches?

A: One additional note about nomenclature for these types of facilities: when we talk about a "securitization," it is the issuance of tranched indebtedness backed by a pool of receivables. It does not require the issuance of ABS securities (which is beneficial for U.S. risk retention; unfortunately EU/UK risk retention is another story for a future article), and the indebtedness can (and often is) evidenced by loans or repurchase agreements. These loans can serve as warehouses for future securities issuances but often do not and exist as stand-alone financings.

Looking Forward

Whatever structure the market selects, there are a number of issues that will need to be addressed in order to transform the product from a novelty to a flow product that can be scaled. The challenges to securitizing sublines have not gone away; rather, the market has shown that they can be overcome and deals can be done. These factors include duration, velocity of capital calls, replenishment and reinvestment, and ratings criteria. Each deal will have to consider these factors (and others!) in determining the right structure for that particular transaction.

As we move into this era of securitization of sublines, solutions in the form of structured products abound. The key to the success of any deal is balancing the business and other objectives of the parties against the reality of the relevant underlying capital call loans and other considerations that will vary deal to deal. The good news here is that the options are plentiful and many bespoke solutions exist. We are excited to brainstorm with our clients and provide solutions as they navigate this intersection of securitization and fund finance.