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Comfort Letters

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In the evolving fund finance market, lenders are constantly assessing ways to mitigate risk and enhance credit support in order to provide for the smooth operation of subscription-based credit facilities. One such credit enhancement that is experiencing a resurgence in this space is the parent comfort letter – a type of credit support in the form of an affirmation letter from an investor's parent entity that provides lenders with additional assurances about such investor's financial backing without creating direct recourse to the Parent. The question begs: Why would a lender accept a non-binding Comfort Letter over a stronger contractual obligation from the Parent?

In this article, we'll explore how Comfort Letters impact fund finance facilities and distinguish them from other forms of credit enhancement tools.

When underwriting a Facility, a lender will conduct a thorough analysis of a fund borrower's investor base to determine the creditworthiness of the investors that are eligible to participate in the borrowing base and identify any potential enforceability issues to their obligations to fund capital calls. During the course of this analysis, a lender may uncover an investor that is an intermediate entity (*e.g.*, a subsidiary or special purpose vehicle) through which a much more financially robust Parent is actually back stopping and pulling the strings. While the investor has committed capital to the fund borrower, its standalone financials do not meet the lender's credit criteria for full inclusion in the borrowing base. However, if the Parent has a strong credit rating and significant financial resources that can help enhance the creditworthiness of the investor, lenders are more likely to include the capital commitment, thereby increasing the borrowing base and improving the fund's borrowing capabilities under the Facility.

There are various forms of credit support documentation that a Parent can provide to lenders to help strengthen the credit profile of an investor and provide assurances that the investor will be able to meet its obligations under the fund borrower's governing documents (*i.e.*, the limited partnership agreement, subscription agreements and side letters). You can read a more in-depth overview of the common types of credit support provided in fund finance transactions **here**. However, rather than tying itself to a legally binding document such as a guaranty, equity commitment letter or keepwell agreement ("Binding Agreement") which have legal and business implications for the Parent, the non-binding nature of the Comfort Letter has been a useful bridge to connect the Parent's financial support of the intermediate investor entity. A Binding Agreement creates contractual privity between a lender and the Parent and imposes a direct legal obligation on the Parent to step in if the investor fails to fund capital calls. While preferable for a lender, entering into a Binding Agreement exposes the Parent to financial liabilities, regulatory implications and potential legal enforcement actions that would likely deter the investor, and ultimately the Parent, from participating in the Facility. Given these considerations, lenders may decide to make the strategic decision to accept a Comfort Letter in lieu of the Binding Agreements.

A Comfort Letter allows the Parent to acknowledge and support the investor's capital commitment without formally assuming financial, regulatory and legal risks. It signals to a lender that the Parent stands behind the investor and will provide financial support but stops just short of a legal commitment. Typically, a Comfort Letter will acknowledge the following: (i) that the Parent is aware of and supports the investor's capital commitment in the fund borrower; (ii) that the investor is financially backed by the well-capitalized Parent; and (iii) that the Parent intends to ensure that the investor will meet its capital commitment obligations to the fund borrower. By issuing a Comfort Letter to a lender, the Parent is taking on a reputational risk to its market position, and, as a result, it is incentivized to ensure that the investor meets its capital commitment obligations to the fund borrower. The credibility of the investor community is of the utmost importance to develop and sustain strategic partnerships with fund managers and to the fund finance ecosystem, which is rooted in the strong and trustworthy relationships developed by its many market participants.

As funds continue to raise capital from diverse investors, including intermediaries of larger institutions, lenders must cast a wide net and evaluate not just the investor’s creditworthiness but also the Parent providing the ultimate source of repayment. In today’s market, where institutional investors and their intermediary vehicles are major players, Comfort Letters have become a valuable tool to balance credit concerns with investor flexibility.