

Subscription Finance Facilities – the Allure to Securitise: A European Perspective

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Securitisation of subscription finance facilities is *en vogue* in fund finance. We have written previously on this topic, offering a [primer on capital call securitisations](#) and a [Q&A](#) regarding a first publicly rated cash capital call securitisation for *Fund Finance Friday* readers.

In this issue, we will dive deeper into the securitisation of subscription finance facilities and will consider some challenges that are inherent to this (new) asset class in the securitisation space.

Short tenors and the revolving nature – getting the eligibility criteria right

Subscription finance facilities are typically characterised by relatively short maturities and are generally structured as revolving credit facilities ("RCFs"). Although there are subscription finance facilities with term loans that could form the basis of a more straightforward securitisation process, the number of subscription finance facilities with both RCF and term loans is too limited to provide a meaningful (and a minimum) quantum of 'term loan' assets for a securitisation pool for the economics to work.

The characteristics of subscription finance facilities do not naturally lend themselves well to the duration and amortising nature of typical securitisation transactions.

A securitisation of subscription facilities (whether traditional or synthetic) structured with a revolving or a replenishing period that allowed for new assets to be added to the pool following the repayment or expiry of existing assets within the pool could provide a solution to this challenge. Once this period ends, the cash flows are allocated towards repaying the investors of the notes in the order of the priority of the payments (usually senior to junior notes but different waterfalls are routinely employed) in the case of cash securitisations. In a synthetic securitisation, replenishment periods allow for the size of the portfolio of assets referenced and the relative cost of credit protection purchased to be maintained for the duration of the replenishment period.

The intrinsically dynamic nature of RCFs in subscription finance securitisations results in a continually changing securitisation pool, and so it may prove challenging for rating agencies (and investors alike) to accurately monitor the associated risks, particularly where there is a migration of the risk of the underlying pool owing to changes in the composition of the pool. By way of example, if a 'higher quality' subscription finance facility that, say, has a highly rated limited partners base or reputable/experienced fund manager, is paid down within the securitisation pool, while a different 'lower-quality' facility with weaker credits or less experienced fund managers is drawn (and added to the pool during the replenishment period), then the overall quality and risk profile of the underlying assets/collateral in the securitised pool will have invariably changed. This can also impact the concentration and correlation risks of underlying limited partners and/or fund managers across the entire securitisation pool and, ultimately, affect negatively the ratings of the debt liabilities of the securitisation (or tranches in the case of synthetic securitisations).

In practice, these risks are normally mitigated (to a certain extent) by pre-set eligibility criteria and tests built into the securitisation and the associated transaction documentation that should ensure that only facilities meeting minimum standards are added. The eligibility criteria is usually applied to: (a) each individual facility; and (b) the securitisation pool as whole. This approach is typical also for other asset classes in the securitisation space.

In respect of individual facility criteria, these will likely include criteria regarding:

(i) the terms of the subscription finance facility, such as criteria on specific or minimum ratings of limited partners, the determination of the borrowing base, advance rates, facility maturity, currency denomination, governing law, etc.;

(ii) the debt receivables under the subscription finance facility, such as requirements on the loans being performing and not in arrears, the receivables being secured by the usual security package for subscription finance facilities (including first ranking security interests in favour of the originator over the limited partner capital call commitments and the bank accounts into which the capital commitments are paid) and other criteria, such as the free transferability of the receivables without notice to or consent of the fund or that interest under the receivable being current (and not being capable of being capitalised); and

(iii) the underlying fund documents, such as that the terms of the fund documents permit the fund to borrow and give guarantees/cross-guarantees, that they contain customary terms in respect of limited partner defaults, the inclusion of provisions waiving set-off, defence and counterclaim rights by investors as well as criteria on the general partners/fund managers (for instance, a minimum AUM or them being included on a white list of approved managers/sponsors) and other criteria.

The eligibility criteria is also customarily applied on the securitisation pool as a whole. Such criteria will typically deal with, among other things, diversity and concentration limits, maximum limits on the loan amount of any subscription finance facility in the overall securitised pool, on facilities that are managed by the same sponsor (typically on a look-through basis), limited partner contributions (again evaluated using a look-through approach) and limitations with respect to predefined and eligible investment strategies.

The list, and in particular the calibration of eligibility criteria, will be determined by the needs of each securitisation transaction (including any requirements of any relevant rating agencies), and whilst it may be tempting to set strict criteria to achieve a desired rating (with potentially lower levels of credit enhancement), this is a balancing act. The eligibility criteria must be sufficiently accommodating to allow the originators or the issuer SPVs to source suitable collateral on their balance sheet or to originate collateral in short order for the purposes of replenishing the securitisation pool during the revolving period.

An overly prescriptive regime would result in a much quicker amortisation of the securitisation structure (which may be further exacerbated by the customary clean-up calls (allowing the originator to collapse the entire structure where the size of the portfolio drops below a threshold percentage of the initial size)), leaving investors with a degree of reinvestment risk.

Finally, in connection with the RCF nature of a typical subscription finance facility, in instances where the utilization of revolvers falls below anticipated levels used in cash flow modelling for the securitisation, there may be inadequate cash flows within the cash securitisation to cover the interest payments on the issued securitisation debt. Such risks can be addressed by the usual techniques used in the securitisation space, such as the use of higher attachment points/credit enhancement on the rated debt (senior or mezzanine tranches usually sold to investors on a cash securitisation), robust overcollateralisation maintenance requirements and the inclusion of amortisation triggers in the securitisation structure (which broadly work to switch off the replenishment period for investors to be repaid as quickly as possible whilst there is sufficient credit enhancement in the structure supported by the first loss piece). Conversely, if the draws on revolvers under various subscription finance facilities exceed modelled assumptions, the issuer SPV may face liquidity challenges in fulfilling its obligations. A possible means to solve for this scenario, in the case of cash securitisations, would include the use of liquidity reserves.

Documentation risks – impact on the ratings and credit enhancement

Another challenge for securitising sublines arises from documentation risks. There are three levels of documentation that will need to be considered in assessing the risks of a securitisation of subscription facilities.

Firstly, there are the fund documents that will include various contractual arrangements to ensure that the borrowing is permitted, that any guaranteeing/cross-guaranteeing and granting of related security is permitted, and that generally speaking, the finance parties are adequately protected. This includes having well established (and clean) provisions

around the right to call capital, waivers of rights of set-off, defence and counterclaim by investors, the ability to call recallables, the existence of overcall provisions, as well as other customary provisions typically expected by lenders in the fund finance market.

In principle, the ability of the lenders to be repaid under the subscription finance facilities is highly dependent on the terms of the fund documents. In the securitisation context, rating agencies will likely need to perform a loan-by-loan level analysis on the subscription finance facilities included in the securitisation. The analysis and risk modelling then should look into the borrowing base of each facility and limited partners (for things like their ratings or, in the absence of ratings, other parameters such as their creditworthiness, industry, country or region of the limited partners and other qualitative factors) and the general partners (in particular, their track record in the management of funds and their AUM among other things). Importantly, the analysis should also closely scrutinise the fund documents to identify risks. Absence of, or a material deviation from some of the key provisions in the fund documents may necessitate the running of additional stress tests to the borrowing base of the affected subscription finance facility(ies) in the securitised pool or even the exclusion of those underlying assets from the securitisation. Overall, this may result in a lower rating for the securitisations involving subscription finance facilities or the need for additional credit enhancement on rated tranches. All of this, however, may negatively affect the economics of the securitisation, including pricing of the transaction.

In addition to the fund documents, the terms of the individual subscription finance facility agreements can also substantially affect the underlying collateral. Similarly to the above, to arrive at a rating, rating agencies (and ultimately investors) will need to get comfortable that those facilities are extended on robust standard terms and supported by market standard legal opinions.

Lastly, an analysis of the transaction documentation of the securitisation structure will be required. The evaluation of the legal structure of a securitisation will include a review of the transaction documents and legal opinions. For cash securitisations, such analysis will also focus on the securitisation SPV, its corporate structure, bankruptcy remoteness, the 'true sale', tax issues and security interests. In the case of synthetic securitisations, given that the originator keeps the receivables on its balance sheet, the scope of documentation and parties is inherently narrower and the review of documentation here will be less onerous.

The qualitative analysis of underlying documentation in respect of subscription finance facilities may need to be more intense compared to other asset classes. Such analysis will likely need to focus on factors that are susceptible to significantly influence the repayment of the subscription finance facilities and ultimately the creditworthiness of the overall securitisation. Accordingly, the rating of subscription finance facilities and ultimately of the securitisations of this asset class will depend on the 'quality' of legal documentation at various levels underpinning this securitisation.

Conclusion

The securitisation of subscription finance facilities is nascent. Many issues (including those above) will need to be considered by market participants for best practices to emerge as more fund finance participants are poised to utilise securitisation as a tool. After all, subscription finance facilities should qualify as good candidates for securitisations given their relatively simple and standardised structures, and importantly their stellar credit track record. Specifically, defaults and losses on subscription finance facilities have historically been very rare, and the only known cases are associated with fraud or technical payment defaults arising out of administrative issues rather than fundamental credit defaults on the facilities.

Cadwalader will be hosting the **Capital Call Securitization Conference** in conjunction with Fitch Ratings in our New York office on Thursday, April 3 from 1:30 PM to 6:30 PM. Learn more [here](#).