

CADWALDER

August Fund Finance Market Update

August 20, 2021 | Issue No. 140



By Michael Mascia
FFA Board Member

The fund finance markets have been quite consistent over the summer and new developments have been limited. But as we head back to school and close in on Labor Day, below are our recent observations of interest.

Transaction Volume. Our new matter volume year-to-date remains significantly elevated compared to 2020. Consistent with that, our team hours are also up meaningfully year-over-year as well. Unpacking the data a bit, however, July new matter volume was actually down. We opened 40 new fund finance matters globally, down from 58 in 2020. July 2020, of course, had been an all-out sprint for some lenders to support fund sponsors that could not find available lending capacity during the Q2 pullback, so monthly comparisons during the pandemic can be distorting. Consistent with both 2020 and back to 2019, I expect August data to ultimately show a respite; clients are out on vacation, and deal intensity has dialed down a good bit. We still show healthy prospective hours and LPA review counts (albeit more like flat to 2020), so we are gearing up for a post-Labor Day homestretch consistent with the last two years.

Credit Continuum. We have seen a number of traditional subscription lenders move ever so slightly down the credit continuum to both support clients and generate yield over the last six or so months. This is no concentrated-NAV push; but we have seen extended advance rates and some minor reliance on assets. It will be interesting to see if this trend expands as it furthers financing options available to funds later in the lifecycle at bank-lending cost of funds.

Regulatory Inquiries. I am receiving a number of calls from senior bankers preparing to respond to inquiries from regulators on their subscription facility portfolios – far more than in the past. Many of the questions are high-level around jurisdictional differences, country risk, enforcement process and related matters. If people are interested, I am going to lobby for a roundtable session at the FFA's Miami conference where senior bankers can discuss best practices for responding to regulators and compliance with directives.

LIBOR/SOFR Amendments. They are coming. Multiple banks are gearing up to tackle amendment projects across their portfolio.

Staffing Challenges and FFA U. Personnel vacancies and recruiting challenges continue to occupy senior banker and lawyer attention across the board. There are a lot of new bankers and lawyers joining fund finance teams. Please consider sending them to virtual [FFA University](#) on September 21st. We are working hard to get a solid day of training together for new people and have lined up a lot of very senior speakers. The full agenda should be available next week.

My girls went back to school this week: Victoria (6th grade) and Kristina (4th grade). Hope everyone has a great weekend.



SOFR: More Answers Make for More Questions

August 20, 2021 | Issue No. 140



By **Leah Edelboim**
Partner | Fund Finance

The market has received a lot of answers about benchmark replacement this year. We know for sure that LIBOR is going away. We also know that no new USD LIBOR loans should be originated after December 31st of this year. More recently, we now have more confidence in our LIBOR replacement as the Alternative Reference Rates Committee (“ARRC”) formally recommended forward-looking Secured Overnight Financing Rate (SOFR) term rates for syndicated and bilateral business loans and a number of other products.

Following this recommendation from the ARRC, the loan market has been off to the races to prepare for a SOFR-first world ... but not *that* fast: most players in the market are still originating LIBOR-based loans with a hardwired fallback.

In any case, shortly after the ARRC’s recommendation at the end of July, the Loan Syndications and Trading Association (“LSTA”) issued a SOFR Concept Credit Agreement. This form document is a term loan facility with Term SOFR as its benchmark rate of interest. This document is a wealth of information and guidance and even provides options for market participants to consider when crafting their own agreement.

One might think, “We have a benchmark and we have a form, so we must be ready to go all SOFR all the time,” but we are not quite there yet. First, the LSTA has been clear that this is a concept document and does not represent or set market practice. Instead, it is a tool for market participants to use in their transition planning. Moreover, efforts to draft a Term SOFR-based credit agreement have brought into sharp focus the differences between LIBOR and SOFR and have brought to the fore the question of how to originate new SOFR loans that are economically comparable to LIBOR-based loans. While SOFR is going to replace LIBOR, it is not completely comparable – SOFR is a risk-free rate while LIBOR includes a measure of bank credit risk. This being the case, SOFR tends to be lower than LIBOR as a general matter. In periods of market disruption, the difference is generally more pronounced.

The fact that the rates are not comparable isn’t news. The ARRC has recommended that credit agreements that fall back from LIBOR to SOFR include a spread adjustment to account for the fact that SOFR is generally lower than LIBOR. The ARRC-recommended spread adjustment was set on March 5, 2021, and it is the five-year historical median difference between LIBOR and SOFR. You can review all those changes [here](#).

The LSTA has explained that, ironically, the suggested spread adjustment – which is intended to be helpful and maintain the economics for parties switching from LIBOR to SOFR – might actually be causing some consternation. This has to do with the fact that we are in a historically low interest rate environment, and with interest rates hovering around zero, it makes the actual spot spread difference between LIBOR and SOFR significantly lower than the historical medians. For example, this month, the LIBOR-SOFR spread differential is around 9 basis points for 3-month LIBOR as compared with 3-month SOFR. The ARRC-recommended spread adjustment for 3-month SOFR loans is 26 basis points. Simply put, no borrower is going to be happy paying more than the actual market spread for its SOFR loans just because the recommended spread-adjustment is thought to be a historically accurate and fair rate.

According to the LSTA, there are several ways to bridge this gap and avoid a “cliff-effect,” which is where the rate that a borrower pays changes dramatically at benchmark transition. You can read all about it here in this thoughtful analysis by the [LSTA](#). Essentially, the first is a bit of a “do-nothing” approach and the expectation that general market forces will handle the issue because we are unlikely to stay in a zero interest rate environment indefinitely. As interest rates rise, the difference between LIBOR and SOFR is expected to widen, which would increase the spot spread adjustment. Another theory on the point where we could reach equilibrium is when LIBOR ceases to be available at the end of June 2023. At that point, billions of dollars’ worth of LIBOR-based loans (and trillions of dollars of assets, if you consider other financial products) with hardwired fallback language become SOFR-based deals and the spread adjustment baked into the fallback language will go along with it. It will mean that anything that doesn’t contemplate the relevant spread adjustment for a particular tenor will be “off market.” Another option would be to include step-up adjustments in a loan agreement that apply every time the rate resets – for example, at every quarterly reset. A set of spread step-ups would be an easy-to-incorporate provision and prevent the cliff-effect. There is a good deal of precedent in the market for this.

Bottom line: lots is coming together in the transition to SOFR, and the spread adjustment is the latest piece of the puzzle that market experts are working to put into place. Understanding that there is an economic difference between SOFR and LIBOR will set up market participants to address this issue head-on in their loan docs, with the understanding that further guidance is in the works.

FFA Announces 2022 Sponsorship Opportunities

August 20, 2021 | Issue No. 140



The Fund Finance Association released its 2022 sponsorship opportunities this week and opened registration for the 11th Annual Global Fund Finance Symposium in Miami from February 16-18, 2022. Sponsorship information is available [here](#) and registration info is available [here](#). The FFA tries hard to support and promote the fund finance industry with advocacy, education and information. The FFA does not charge membership fees and sustains itself via these conference sponsorships and ticket sales, all of which were challenging during the pandemic. Please consider supporting the FFA by participating in these events. Thank you!

PE News Highlights NAV

August 20, 2021 | Issue No. 140

PE News published a column by Sumit Chhabra of Acuity Knowledge Partners this week that highlighted the ways in which NAV financing is becoming increasingly relevant to funds. Specifically, a NAV facility can play a role in helping a fund hold on to winning assets longer – a growing trend, adding scope to invest more proactively later in the fund life, and a greater ability to ride out valuations in challenged assets. The article is available subject to subscription at [this link](#).

Fund Finance Hiring

August 20, 2021 | Issue No. 140

Fund Finance Hiring

NatWest Markets is hiring a Vice President in London to support the growth of its Fund Finance group, specifically focused on Subscription Line, Hybrid and GP financing. If interested, please refer to this [link](#).