

CADWALADER

# 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.

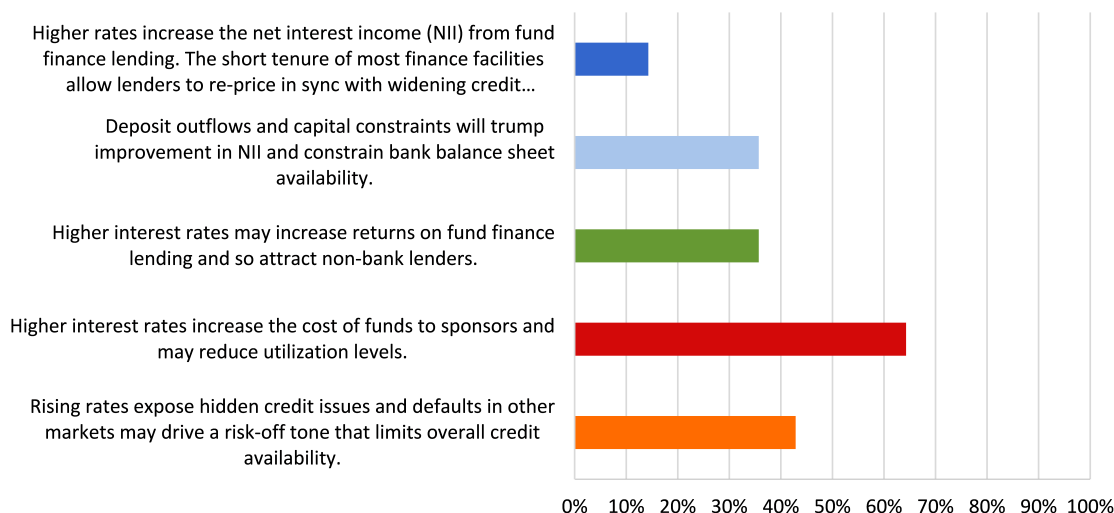
Among respondents, 21% of banks predicted that their allocation to fund finance will be meaningfully higher in 2023, with 43% as somewhat higher. Another 21% forecasted unchanged outstanding commitments and 14% anticipate somewhat lower commitments. That means that out of our respondents, 86% are holding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

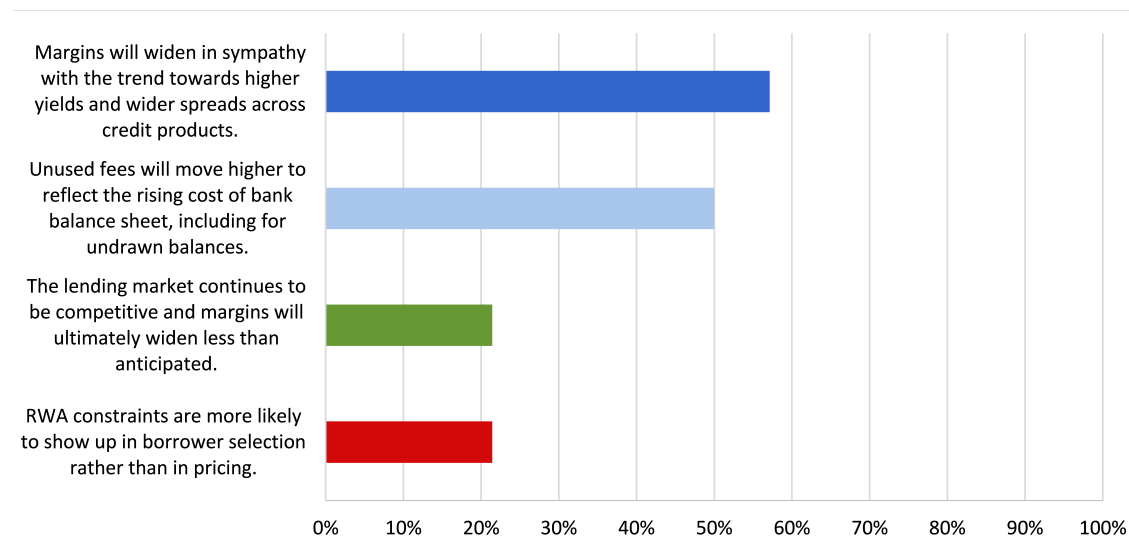
Source: Cadwalader, Wickersham & Taft LLP

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?

This week the FFA held the inaugural FFA University 2.0 at Cadwalader's offices in New York. The intensive full-day program was geared towards mid-level and more senior bankers and lawyers in the fund finance space. This interesting and educational event included a roster of seasoned presenters who are some of the foremost experts and deal makers in the fund finance space.

The slate of panels kicked off with "Advanced Issues in Subscription Facilities," which was led by Terence Hatton, a managing director at MUFG, and Yomi Akinyemi, a director at Wells Fargo. They discussed topics ranging from Negotiation Hotpoints – which include current pressure points like tenor – to items such as holds to rated note feeders.

Next up was "NAV Loan Structures and Issues" with Daniel Toblib, Vice President at Macquarie Bank Limited - Representative Office, and Cadwalader partner Brian Foster. We talk a lot here about how NAV is hot. Daniel and Brian's detailed presentation gave the crowd the nuts and bolts on NAV, with topics ranging from transaction structures to what it means to be fully secured vs. having security "lite." They went deep on the key substantive issues in these deals from valuation to due diligence to cure plans. We all left the presentation a bit smarter on NAV.

"Key Factors and Trends in Fund Finance Credit Ratings" was next, led by KBRA's Pramit Sheth, senior managing director and John Hogan, managing director. They explained how credit ratings support the expansion of private capital markets and gave us insight into the components of a ratings determination.

Next up we saw two presentations that looked at the borrower and then the lender side of fund finance. "The Private Equity Business Model" was the topic of the presentation by Gregg Myers, CFO, Global Infrastructure Partners, and Matthew Chase, a partner at Latham & Watkins. The "Credit Provider Spectrum" with Zac Barnett, Managing Director, Fund Finance Partners and Michael Timms, Investment Director, 17Capital, discussed the range of product types and lenders as well as key differences among various credit providers.

Few would dispute that the most timely presentation was that of FFA Chair Jeff Johnston who discussed regulatory capital and near term implications for fund finance. Jeff thoughtfully broke down this complicated and nuanced topic. He explained the background of the relevant regulations and how they work in practice to explain his view of the changes we are seeing in banks' appetite for fund finance. While the event was not recorded, Jeff posted an article summarizing the discussion on his LinkedIn profile.

The last substantive topic of the day was "Secondary Fund Lending & Collateralized Fund Obligations" with Ron Franklin, Proskauer partner, Kevin Alexander, partner at Credit Group, Ares Management and Gopal Narsimhamurthy, Managing Director, KBRA. This presentation touched on some of the innovative products, deals, and structures in the markets and how they came to be. Their discussion of the evolution of NAV financing technology and how secondaries deals work helped to give the audience a sense of a number of deals beyond subscription.

The day concluded with a market update with Nick Mitra, managing director at SG Americas Securities, LLC and Jocelyn Hirsch, partner at Kirkland & Ellis. Closing remarks from Mike Mascia inspired us all to be better leaders and to cultivate the next generation of leaders.

As was evident from the day, there is always more to learn, and the fund finance market continues to be ripe for innovation and talented bankers and lawyers. We are grateful to the FFA for such a stellar program.







## FFA EMEA Diversity in Fund Finance Event

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The FFA EMEA Diversity in Fund Finance team will host a panel discussion on November 10 in London titled, "Why Diversity Makes Good Business Sense." The panel will cover topics such as why diversity is important to organizations from an operational/profitability perspective, what progress is being made in implementing DE&I policies and how the promotion of diversity issues in any institution is critical to success. For more info and to register, visit [here](#).

## **KBRA Assigns Rating to Nassau CFO 2022 LLC**

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Kroll Bond Rating Agency (KBRA) last week announced it has assigned ratings to \$600 million of debt issued by Nassau CFO 2022 LLC in a collateralized fund obligation transaction (the “Transaction”).

The Transaction consisted of three tranches of rated debt totaling \$378.0 million, unrated subordinated notes totaling \$172.0 million and a liquidity facility of \$50.0 million. The Transaction is indirectly backed by interests in a pool of private equity, private credit, and other private capital LP interests in alternative investments that is diversified by strategy, general partner exposure, vintage and asset concentration. Proceeds from the rated debt will initially be used to acquire the LP interests, fund ongoing capital calls, establish reserves and finance various transaction costs.

To view KBRA’s complete New Issue Report summarizing its rating, please click [here](#).

## Fund Finance Hiring

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Fund Finance Hiring

Silicon Valley Bank is seeking to hire a Vice President, Relationship Manager for its Global Fund Banking team, with the position based in Austin. More information is available [here](#).

## 2022 Finance Forum Keynoter Muggsy Bogues: 'Small Ball Meets Big Finance'

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Former NBA standout Muggsy Bogues will tip things off as keynote [speaker](#) at Cadwalader's 2022 Finance Forum on Thursday, October 27 at the JW Marriott in Charlotte.

At just 5-3, Muggsy played for 14 years in the NBA, including nine years with the Charlotte Hornets. Muggsy's theme is "Small Ball Meets Big Finance," and he'll focus on his lifelong responses in the face of adversity, moments that changed his life, and his ongoing commitment to excellence on and off the court.

The full Finance Forum program is nearly finalized. Click [here](#) for a list of current panel topics and to register.

## The Legal 500 UK 2023 Recognizes Cadwalader's Fund Finance Team

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**Samantha Hutchinson**



**Nathan Parker**



**Mathan Navaratnam**



**James Hoggett**

The Cadwalader London Fund Finance team continues to receive industry recognition for its market leadership. Most recently, *The Legal 500 UK* 2023 edition has ranked the practice group as a prestigious Tier 1, while recognizing UK practice head Samantha Hutchinson as a “Leading Individual,” Nathan Parker as a “Next Generation Partner” and special counsel Mathan Navaratnam and associate James Hoggett as recommended attorneys. For more information, please visit [here](#).