

The Banking Law Journal

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The Benefits of Term Debt Tranches in Fund Finance Products, and What to Consider When Utilizing Term Debt

*By Kiel A. Bowen, Mark C. Dempsey and Andrew L. Hogan**

In this article, the authors explore how term debt tranches can bolster lending capacity and accommodate debt issuances.

With new banking rules on the horizon for financial institutions, lenders are looking for new strategies to bolster lending capacity and accommodate debt issuances. One such option is term debt. This article explores the promising prospect – for lenders and borrowers alike – of utilizing term debt tranches to attract new lenders into the existing market and provide even more flexibility to existing collateral structures.

BACKGROUND

A persistent liquidity crunch has prompted both borrowers and arrangers to earnestly explore novel avenues for financial flexibility, thereby increasing the demand for new lender participants in the fund finance market. Moreover, Basel III endgame and related rules will require financial institutions to comply with stricter capital and loss-absorbing capacity requirements, in turn imposing a need for lenders to adapt by adopting novel strategies to bolster lending capacity and accommodate debt issuances. The 2023 banking market disruption further prompted new entrants to the fund finance market.

WHY IS TERM DEBT AN ATTRACTIVE SOLUTION?

In an environment primarily consisting of one-year maturities, banks have an annual opportunity to reprice subscription facilities to follow market-driven interest rate adjustments. While term debt does not need a longer tenor, longer-maturity term debt can allow borrowers to hedge this risk by locking in either a fixed-term rate or floating rate with certainty that the debt will not mature in the short term. Even in one-year term facilities, term debt can allow borrowers access to non-traditional liquidity providers. Often, term lenders cannot offer revolvers due to operational reasons or return-on-investment targets. The funding sources for non-traditional lenders may be unable to accommodate funding borrowers on the shorter two- or three-day timelines that traditional banks offer. Additionally, the unused commitment of a

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revolving facility will drag down the return that non-traditional lenders seek. A term loan to the borrower solves these issues for all parties involved.

Depending on a fund's structure, term debt can have multiple uses. At the special purpose vehicle (SPV) level, term debt can allow a fund to leverage a particular investment or warehouse a continuation fund. A term loan to the fund itself can allow for longer-term, portfolio-wide leverage. And at the investor level, term debt can be used to make catch-up payments for later fund closings as well as solve investor-specific structuring complications. At each of these levels, an arranger has an opportunity to create a lasting relationship between their borrower client and lending partners. However, there are certainly unique issues to consider in any term fund finance structure, especially if term and revolving components are provided by different lenders.

WHAT SHOULD BORROWERS AND ARRANGERS CONSIDER WHEN EXTENDING TERM DEBT TO SUBSCRIPTION CREDIT FACILITIES

Agent Selection

One of the initial considerations for borrowers and arrangers is selecting the agent. When term and revolving lenders are not the same entity, the revolver will often be provided by a traditional bank while non-bank lenders will fund the term tranche. Although a bank lender may have the capability to serve as the agent (which the term lender may not), the revolving tranche may mature before the term tranche, potentially leading the revolving lender to manage a facility in which they have no exposure. Parties should assess whether employing a third-party agent makes sense, allowing revolving lenders to exit upon maturity without burdening term lenders with agent responsibilities.

Friction Among Lenders

When revolving and term lenders are distinct entities, borrowers and arrangers should consider potential sources of friction. For instance, the term tranche typically carries a higher yield than the revolver, leading the term lender to request that the term tranche be advanced first. The term tranche may also feature a prepayment penalty and follow a different payment schedule. However, there are certain instances where the term lenders will want to be repaid higher than usual in the payment waterfall.

The payment waterfall, especially during a default scenario, will likely be a highly negotiated provision. Parties will need to determine the payment order of principal, interest, and fees of both debt tranches along with the borrower's needs for capital (ranging from already committed investments to residual at the end of the waterfall). The lenders should consider whether certain lenders have higher priority with respect to certain collateral or if one lender is wholly

subordinated to the other. If there are differing maturities, a shorter-dated revolving lender may have different concerns in collateral sales than a longer-dated term lender so the parties will need to consider who can make decisions on the sale of collateral and when these decisions can be made.

Finally, the lenders may have different perspectives on smaller items, such as voting rights over amendments or certain negative covenants, that should either be made by one or all lenders.

Collateral

On any longer-dated maturity for a loan provided to a fund, lenders must consider the changing collateral. A fund's uncalled capital commitments will naturally reduce over time as the value of the fund's investments increases. If the term tranche is secured by uncalled capital, term lenders should plan for the gradual reduction in uncalled capital commitments through scheduled amortization of the term loans. If the facility is secured by investments, standard financial covenants should be included to ensure adequate collateral coverage.

Rating

Insurance company lenders have been increasingly active in the fund finance space. They are well-positioned to provide a term tranche but will often need structural accommodations. Primarily, insurance companies will look to have the term tranche rated by a rating agency. This requires cooperation by the borrower and arranger to provide the rating agency with the necessary documentation.

Alignment and Misalignment with the Borrower

Given the potential for a longer-dated maturity, it is critical to understand the alignment and misalignment of interest between the lenders and the borrower. To the extent the borrower is at an investor level in the fund structure, all parties must consider when the borrower may be deemed a defaulting partner by the underlying fund. Lenders rely on the value of investments for repayment, making fund-initiated default remedies detrimental to lender interests.

Additionally, term lenders may rely on regularly scheduled amortization payments, necessitating an understanding of the expected distribution of cash proceeds from investments and how much control the underlying fund and its affiliates have over those distributions.

If the borrower is a fund, lenders must comprehend how the fund's needs will evolve over time. This involves discussions about the broader debt requirements of the fund structure, delving into investments, and understanding how the fund will manage its portfolio. As the borrower will engage with the facility over

an extended period, it may request greater flexibility to make distributions, permission to incur additional debt, and relief from certain covenants during a ramp-up period.

If the debt is utilized at the SPV level beneath the fund to warehouse an investment, lenders should be mindful of the concentration risk posed by that investment. Covenants should be considered on investment-level debt, and a comprehensive understanding of the investment details is essential.

CONCLUSION

As the fund finance market continues to evolve, we expect to see more term debt and remain optimistic about its use going forward. Although term debt arrangements in the fund finance market can address liquidity challenges, interest rate uncertainties, and shorter maturities, implementing term fund finance structures also requires careful consideration of factors like agent selection, lender friction, payment waterfall negotiations, and understanding the interests of all parties involved.