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Assessing Lender Risk in Fund Finance Markets

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Risk analysis in an evolving market

Despite being a relatively long-standing lending product, there have been limited public payment defaults by funds in the fund finance space. Consequently, the market has legitimately considered this to be a safe product for lenders and encouraged more market actors to participate. While the market has weathered, even prospered, in the face of certain challenges (from the 2008 global financial crisis to the US bank failures of March 2023), there are a new set of challenges (and opportunities) ahead. The ongoing impact of armed conflicts in Ukraine and the Middle East and the recent elections in a number of major Western democracies have caused aftershocks in the wider macroeconomic environment. Although macroeconomic factors and new tighter capital adequacy rules have impacted lenders, the fund finance market has proved resilient in the face of these headwinds. The lack of liquidity in the market has led to an increased focus on innovative solutions and non-bank lenders entering and expanding their footprint in the fund finance market. With these changes in mind, lenders of all shapes and sizes should remain alert to their possible (and changing) exposure.[1]

In 2024, the market saw continued growth in the use of NAV facilities. Market changes also saw an increase in the use of other alternative lending structures, for example, hybrid facilities. There was also an increase in the number of funds looking to leverage their rated feeder vehicles as those gain in popularity.

The market saw global interest rates start to come down throughout 2024 and, although this has resulted in tightening margins, the lower cost of borrowing could be beneficial for utilisation rates as the interest rate market approaches the equilibrium.

In an evolving market, there is an increased focus on mitigating risk and now is a good time for lenders to conduct their gap analysis and to protect against potential future risks. We examine below some of the key and emerging risks that lenders should be aware of and discuss strategies to manage and mitigate these risks.

Our expertise is in advising lenders in relation to funds established in our key jurisdictions, principally Jersey, the Cayman Islands and Guernsey, although we also see activity in the British Virgin Islands and Bermuda. The market in each of these jurisdictions is broad and we see all types of alternative asset classes. The areas of risk that we focus on below relate to:

- complex fund structures, primarily involving fund partnerships; and
- market risk.

Complex fund structures

Typical structures in our jurisdictions

In Jersey and Guernsey, funds are commonly established as either corporate vehicles/corporate group structures (using companies limited by shares, protected cell companies or incorporated cell companies) or, more frequently, limited partnerships with a corporate general partner, often with an interposed GPLP between the corporate general partner and the fund limited partnership (referred to as the "private equity model", "layering", or "stacking"). To this basic framework is added any number of entities from a variety of jurisdictions: (i) fund asset-holding structures; (ii) carried interest and fee-sharing structures; (iii) feeder funds; and (iv) co-investment and other managed entity arrangements, each of which may guarantee and cross-collateralise lending.

In the Cayman Islands, the exempted limited partnership is the most common form of entity used to establish closed-ended funds, although funds may also be formed as exempted limited companies or limited liability companies.

In the British Virgin Islands, closed-ended funds are most commonly structured as limited partnerships. Less common, but nevertheless possible, funds may be structured as British Virgin Islands business companies.

Feeder vehicles

Investors, for example, US investors, for ERISA purposes, will often invest in a feeder vehicle, which, in turn, invests in a master fund.

The feeder fund may present a greater degree of risk to a lender in a subscription line financing, as the lender will be a further step removed from the ultimate investors and source of funds for repayment of borrowings, and will need to rely on a chain of drawdowns (both at the master fund level and subsequently at the feeder fund level) in order for capital commitments to be paid down into the master fund borrower. To mitigate this risk, lenders will typically seek to join the feeder vehicle as a party to the finance documents, and take security over the uncalled commitments in the feeder vehicle in addition to that of the master fund, although feeder fund security is not always permitted under the relevant constitutional documents.

Where this type of security is not possible, either due to restrictions in the security regimes in certain jurisdictions or, if the constitutional documents of the feeder vehicle contain limitations as to borrowing or guaranteeing, preventing the feeder from providing direct security, then the lender may be able to take cascading security as an alternative. In a cascading security structure, the feeder vehicle will grant security over its uncalled commitments to the master fund and the master fund will, in turn, grant security over its rights in the feeder vehicle security agreement to the lender (the terms of which would include an appropriate power of attorney and step-in rights).

Legal perspective

Capacity and authority

Complex cross-jurisdictional fund structures can present a number of capacity issues that need to be fully understood in each jurisdiction. This is most evident where there are layered or stacked general partner or manager arrangements across jurisdictions, and it is crucial that the correct capacities are tracked through the relevant transaction documents. In the fund documents, the power to issue drawdown notices to limited partners is almost invariably vested in the manager or general partner on behalf of the fund vehicle, but it should also be considered whether either entity holds any power or right in its own capacity.

Where the general partner delegates any of its powers relating to the calling of capital or the enforcement of the same to a manager, the security should fully reflect that chain of authority and capture both the rights of the general partner under the partnership agreement and also any such rights delegated to the manager pursuant to any management agreement. Failure to do so may cause step-in rights to be ineffective on enforcement.

Similarly, it is surprising how often we come across bank account mandates that do not align with the structure as initially presented to the lending bank, or that do not reflect the correct chain of authority or rights in respect of the monies in the account. In these instances, either the mandate or security agreement should be amended to ensure that the named account holder is the grantor of the account security, and that both reflect the chain of authority for each of the grantor's capacities.

Cross-jurisdictional funds

Where a combination of jurisdictions are involved in a fund structure, there is an added level of complexity in determining the appropriate governing law for the security package, as the contractual arrangements may well be governed by a mixture of regimes.

We are often asked to advise on the most appropriate governing law for the security, particularly where the finance documents are governed by, for example, English law or New York law, and the fund vehicle is a Jersey, Guernsey or Cayman Islands entity.

In these circumstances, from a Jersey and Guernsey law perspective, we are likely to advise that specific local law security is taken over contractual arrangements that are, themselves, governed by such laws. Usually, such structures also have a general partner or manager in Jersey or Guernsey. An added complexity arises where there is a general partner resident in a different jurisdiction to the governing law of the limited partnership agreement. In such case, generally, we would expect the governing law of the security over the capital call rights to follow the governing law of the limited partnership agreement, but careful analysis is required.

In contrast, in the Cayman Islands, it is not particularly common as a matter of market practice to take Cayman Islands security simply because the fund documents are governed by the law of the Cayman Islands or if the general partner or manager is formed within the jurisdiction.

Similar issues may need to be considered in light of the *situs* of the collateral involved. For example, some security regimes (such as Jersey and Guernsey) provide that security must be taken in the jurisdiction where the asset has its *situs*. Therefore, where a Jersey or Guernsey bank account is to be secured, a Jersey law security interest or Guernsey law security interest, respectively, will need to be obtained over that account, irrespective of the existence of any foreign law security.

Again, in contrast, the Cayman Islands do not generally have any mandatory provisions of law that would require Cayman Islands security be taken over assets with their *situs* within the jurisdiction, and courts will generally respect and give effect to valid foreign law security. However, it is worth noting that, notwithstanding the governing law of the security taken, there are a number of standard provisions that should invariably be included within Cayman Islands security documents that are helpful to lenders and are, in our experience, usually absent from foreign law security documents. It is also of integral importance to ensure that, no matter what the governing law of the security itself may be, any security taken properly reflects the perfection requirements applicable to the Cayman Islands *situs* property.

Overall, in our experience there is a relatively clear difference in practice between markets; the US market would tend to use US law security over capital call rights where local law permits, whereas in the European market, and in particular the UK, taking local law security is the preferred approach even where English law security is considered sufficient under local law. The former US-style approach is not possible in respect of security over Guernsey or Jersey law-governed capital call rights unless the security agreement complies with all local law requirements and the relevant provisions are governed by local law. It is therefore usually much more efficient to start with a local law document.

Contractual matrix

As noted above, a careful review of the full contractual matrix is vital in ascertaining the extent of the parties' capacities, rights and powers. In time-limited situations or repeat transactions, there may be pressure from parties to undertake a limited review of documents in an attempt to shorten the transaction time and lower the legal spend. This is likely to be a false economy, as the review may identify gaps and issues that, left unchecked, could have expensive consequences.

For example, investors will regularly seek to effect changes to the terms of the partnership/constitutive documents to meet their requirements, whether by way of direct amendment to the documents themselves, or by way of side letter. If a complete and timely review is not conducted, relevant contractual provisions may be missed or discovered too late in the process. Indeed, what may seem a minor amendment from the perspective of an investor or a fund (such as restrictions on the power of attorney or additional procedural hurdles for the delivery of drawdown notices) could, for a lender, result in costly consequences; for example, by defeating an integral aspect of the security package or rendering it difficult or impractical to enforce the underlying commitments.

Any introduction of conditionality to an investor's obligation to fund a drawdown may put the ability to draw the capital at risk. If lenders require the full pack of fund documents at an earlier stage, before they are executed, and allow due time for these to be reviewed, this situation can largely be avoided. Further, if engaged early enough during the period when the fund is negotiating its constitutive documents and/or side letters with cornerstone investors, lender counsel can often add value by suggesting minor clarifications and amendments to the drafting, which could avoid the need for future complex drafting in the facility, or less attractive lending terms for the fund. There has been a notable shift in the market as both borrowers and lenders appreciate the value in this type of due diligence, as well as the potential exposure where it is not undertaken.

Technological assistance

When used in conjunction with a traditional review, technology can be a useful aid to reduce document review times and ensure there are no gaps or new contractual limitations introduced.

As technology develops, contract mapping, legal automation and smart contracts will likely become more widely adopted in legal and banking practice. There are numerous blockchain initiatives in the banking and finance space, which shows that contracting by smart contract is increasingly seen as a credible means of contracting, for example, blockchain solutions for standardised contracts such as ISDA[2] and discussion around the digital future for syndicated loans[3].

In parallel fund arrangements, there are often either prohibitions or intra-fund limits in the parallel investment agreements or co-investment agreements, making guarantees subject to either a specific limit (being the lower of a percentage of the fund commitment or the aggregate of undrawn commitments) and/or requiring they be given in accordance with the partnership proportion (often linked to the capital commitments in each fund), effectively capping the ability of each parallel fund to guarantee the liabilities of the other. Practically, this means: (i) there will need to be amendments to the standard facility agreement drafting; and (ii) it is hard, or even impossible, for a lender to adequately monitor whether such caps have been breached, particularly as committed levels in parallel funds may shift as a result of defaulting or excused investors or due to secondary movements where the transferee prefers to be an investor in the other parallel fund. Not only does this highlight the importance of robust information covenants within facility agreements and/or third-party security documents, but also the importance of relationships with fund administrators who will be in possession of key information, in the event that step-in rights are exercised following a default.

Feedback from industry participants[4] indicates that the use of artificial intelligence ("**AI**") and machine learning has been most effective in the fund administration space and less effective in connection with due diligence and deal sourcing. Consequently:

- the extent to which AI will play a significant role in, for example, negotiation of side letters and side letter reviews conducted by lenders and their legal counsel is linked to whether that technology can be developed to produce reliable data based on interpretation of more complex contractual provisions; and
- there is hope that the success of AI in the fund administration space could give lenders "live" access on a blockchain platform to account information for all accounts (even those not held with them).

Waiver of commitments

Though clearly a notably rare event, and indeed, one that many lenders would perhaps see as a diligence matter, recent cases have demonstrated that it is worth considering how to prevent or protect against the unilateral waiver or release of investor commitments by a fund, notwithstanding that it may be a breach of the finance documents to do so.

Some jurisdictions have enacted specific statutory provisions to mitigate the risk of waiver in certain circumstances by enabling lenders to enforce the original fund obligations directly against the investors. While in the Cayman Islands this statutory protection has been introduced with respect to limited liability companies, it is not something that applies to exempted companies or exempted limited partnerships, which represent the majority of Cayman Islands funds. Similarly, under Jersey and Guernsey law, in the absence of express statutory provisions regulating lending to fund vehicles, lenders would only have access to more practical solutions (such as notifying the investors about the granting of security to the lenders) and traditional remedies.

Market practice has developed to mitigate such risks through practical means by ensuring that borrowers give their investors notice of the security being granted as well as relevant covenants in the facility agreement, including the usual prohibitions on the general partner or manager cancelling or waiving investor commitments. Jersey, Guernsey and Cayman Islands practice remains pragmatic and does not usually require a signed acknowledgment of the notice to be provided by each investor (although this would be preferred), but lenders are advised to request and obtain evidence of notice being given to investors. Notice can be given: (a) in the traditional manner by hard copy; (b) by uploading the notice in investor portals; or (c) by emailing the investor. We typically see combinations of (a), (b) and (c) being used depending on the general context, the particular lender and the make-up of the investor base. If notice is given using method (b) alone, we advise lenders to request evidence that each investor has accessed and reviewed the notice if uploaded to an investor portal (wherever possible). A similar approach has evolved in Guernsey, but the Security Interests (Guernsey) Law 1993 also expressly provides for investors to specify an address within Guernsey at which notice of security can be validly given in respect of Guernsey security. This allows investors to specify in the constitutive or subscription documents that notice of capital call security can be served on them at the address of the general partner or fund's administrator in Guernsey. This flexibility allows notice to be validly served on the general partner or administrator and for the general partner or administrator to provide acknowledgment of the notice of security on behalf of the investors, albeit lenders will typically want comfort that the notice has in fact been sent to investors as well.

These steps are not required under statute but are practical steps to evidence that actual notice of the security has been given to investors, and may go some way to mitigate certain risks on enforcement.

Remedies

The principal remedy for balance-sheet-solvent structures, if there were to be a waiver of commitments in breach of the terms of the finance documents, is to call an event of default, accelerate the debt and enforce the transaction security. However, for insolvent structures or where the default prompts insolvency, the remedies include:

- redress under the relevant statutory framework relevant to fraud and solvency generally and, in respect of corporate entities, transactions at an undervalue and fraudulent trading;
- equitable remedies including claims against the management and dishonest assistance;
- tortious remedies including inducing a breach of contract and lawful or unlawful means of conspiracy; and
- customary law remedies in relation to fraud and, particularly, defrauding creditors.

These are explored in greater detail in respect of funds domiciled in the Cayman Islands in the article by Alistair Russell, Richard Munden and James Webb entitled: "*Fund finance and releases of investor commitments: How can lenders protect themselves?*"[5].

In Jersey and Guernsey, the relevant factual matrix will dictate the most appropriate course of action for the lender and clarify why the general partner or manager agreed to the waiver in the first place, but the starting point will usually be to consider what consideration (monetary or otherwise) the general partner or manager received in return for granting the waiver.

In our view, fund documents should ideally be drafted so as to provide lenders with a direct contractual right against investors preventing such a waiver, or release without lender consent. While this may not be practicable in many cases, efforts to move the market in this direction for certain types of funds would no doubt be welcomed by lenders. Notably, this is a right they are afforded statutorily in certain jurisdictions (for example, in the State of Delaware).

Where such a right is not granted (for instance, because the fund documents have already been executed), we would recommend that lenders ensure that the usual contractual restrictions on the fund's ability to waive or release the commitments are clearly communicated to the investors. This may help a lender seek a variety of remedies in the event of an unauthorised waiver, given that many such remedies will involve demonstrating a level of dishonesty or knowledge on the part of such investors.

There is also an added protection in the form of a statutory clawback in the Limited Partnerships (Jersey) Law 1994 and the Limited Partnerships (Guernsey) Law 1995, each of which provides that, for a period of six months (or one year, in the case of the Guernsey statute) from the date of receipt, a limited partner is liable to repay (in whole or part) a payment it received representing a return of its contribution to the partnership with interest to the extent necessary to discharge a debt or obligation of the limited partnership incurred during the period that the contribution represented an asset of the limited partnership.

A waiver would probably hold if an investor would not reasonably be expected to know that it was given without lender consent or in breach of the fund's obligations and such investor had provided consideration or altered its position in reliance on the waiver. For these reasons, we would recommend that lenders seek to protect their position in this regard.

Market risk

As lawyers, we generally leave technical market analysis to those better qualified; however, in the course of our work, certain trends do become apparent that are of note in the context of risk. We look at four of those trends below, being:

- competition in the market;
- concentration risk;
- liquidity in the market; and
- the impact of environmental, social and governance ("**ESG**") factors on credit risk.

Competition in the market

Prior to the US bank failures in 2023, recent years had seen an appreciable increase in the number of lenders and borrowers in the fund finance space, a fact echoed by many advisors and market participants.

In addition, subscription line facilities have historically benefitted from lower margins, which is beneficial from a borrower perspective. Although macroeconomic factors and new tighter capital adequacy rules are thought to have widened margins on subscription line facilities, the fund finance market has proved resilient in the face of these headwinds. These same headwinds have, however, served to increase the need to avoid unnecessary structural (or other) concerns; margins predicated on lenders rarely or never losing money require deals to be structured accordingly. Prior to the advent of tighter capital adequacy rules and current macroeconomic impediments, there had already been a shift away from the increased pressure on lenders to accept greater levels of risk (for example, in the form of a more lenient covenant package, including hitherto "unfashionable" classes of investor within the borrowing base, or lending to funds whose managers have a shorter track record) and a move to increased scrutiny of the investor base and fund track records. Lenders and borrowers alike should remain vigilant in ensuring that they and their counterparties are sufficiently familiar with the product and its pitfalls and are being properly advised.

The macroeconomic climate has, unsurprisingly, impacted lenders. One notable change, as briefly mentioned below, is as a result of the "stress capital buffer" regime established by the Federal Reserve, which has required certain lenders to reduce their exposure to certain types of subscription line financing. This, in conjunction with the US bank failures in 2023 that resulted in the insolvency of certain lenders active in the subscription line market, caused a comparative lack of supply in the market.

Innovation has nevertheless been prevalent, partly in response to market pressures. NAV facilities, despite carrying higher margins than subscription line facilities, are increasingly popular, not least for their flexibility, with certain sponsors turning to NAV loans to fund portfolio asset acquisitions where leveraged finance facilities are unavailable or priced unattractively. Separately, in 2023, Fitch Ratings finalised its rating criteria for subscription line facilities, a move that should boost supply in the market from, for example, regulated insurance companies that prefer to invest in rated debt instruments as they carry lower capital adequacy requirements.

Investor risk

Central to any lender's risk-management strategy will be how it approaches concentration risk and, more specifically, its exposure to specific investors, fund managers and fund sectors. Macroeconomic factors and tighter regulatory capital requirements have resulted in greater focus on managing this risk.

In relation to investors, lenders will often encounter the same entities across multiple funds (in particular, large institutional investors such as pension funds and sovereign wealth funds). Over-exposure to such an investor will increase the risk that its default on its commitments will translate into a lender ultimately being out of pocket.

European Banking Authority Guidelines[6] address, among other things, the aggregation of bank exposures, and in particular, exposures to a group of connected clients[7]. The guidelines aim to help lenders identify all relevant connections among their clients, and specifically, two types of interconnection: (i) control relationships; and (ii) economic dependencies that lead to two or more customers being regarded as a single risk (subject to certain exceptions).

A control relationship is deemed or likely to exist where, for example, an entity appears in the consolidated financial statements of a structure or holds, with respect to another entity, a majority of the voting rights, the right to appoint or remove management, or the right to otherwise exercise a dominant influence[8].

An economic dependency is deemed to exist where the financial difficulties or failure of an entity would be likely to lead to funding or repayment difficulties for another. For example: (i) where the source of funds to repay the loans of two or more borrowers is the same and there is no independent source of income to service the loans (for example, parallel funds with the same borrowing base); or (ii) where there are common investors or managers that do not meet the criteria of the control test (for example, there are common shareholders but no controlling shareholder, or they are managed on a unified basis).

Notwithstanding the foregoing, in the context of many fund structures, a lender may often be able to demonstrate an exception to the need for aggregation. In particular, this may be the case where the lender can show that:

- there is no economic interdependence[9];
- the entity is bankruptcy remote – this will normally be the case for funds that are limited partnerships, as there should be no commingling of partnership and general partner assets (even where the general partner is general partner of multiple partnerships), as the general partner will only have access to its own assets on a bankruptcy of the general partner and not partnership assets (save in relation to partner liabilities owed to the general partner such as for fees); and/or
- there is structural de-linkage of the obligations of an entity from its parent.

Nevertheless, lenders are advised to exercise caution in relying on an exception because, in practice, in the case of affiliated funds or funds under common management, they are more likely to be "connected" and will be affected by the success and reputation of the other funds and their managers, irrespective of ring-fencing of assets.

To that end, it is essential that lenders assess fund functionaries' credentials whether they are managers, sponsors, or administrators. For experienced lenders active in the fund finance market, existing relationships with fund functionaries will enable lenders to have visibility on a given manager's track record and performance. Funds promoted by high-quality and established sponsors with a track record would be expected to be lower risk. However, for more recent entrants to the market, relevant information will be less readily available. It is therefore important for lenders to understand both the expertise and experience of the functionaries' key people in terms of portfolio management, investment criteria, business plan and financial model.

At the investor level, the most active lenders will generally hold significant information in relation to the investors and their participation in calls made by funds with which such lenders have an existing relationship. The more informed the lender when assessing whether to include or exclude an investor from a fund's borrowing base, the more reliable the borrowing base should arguably be. Many institutional investors are themselves subject to various reporting standards, including in relation to the provision of financial and other key investor and stakeholder information. Further, there is a wealth of publicly available information in relation to many pension funds and sovereign wealth funds including their financial accounts, their executive managers, their organisational structure and details as to their investment portfolio. In addition, lenders that act as account bank to fund entities can also leverage their overview of account activity.

There is a range of sophistication in the financial modelling carried out by lenders and the monitoring of those models. Newer entrants to the fund finance sector may not have the same resources available to them, and this can lead to different conclusions being drawn by such lenders in relation to the inclusion of investors in borrowing bases, which can be apparent on syndicated or club transactions.

Conducting a thorough review of all the investor side letters and expanding the covenant package in the facility agreement to include: (i) covenants relating to concentration risk; and/or (ii) concentration limits that apply to the calculation of the borrowing base, will assist lenders in managing concentration exposures.

As above, with the increased use of automation, AI and data science in the financial services industry and more widely, lenders are becoming increasingly aware of the value of the data they hold in the course of, and for the purposes of, carrying out their business and understanding the dynamic between behavioural science and risk. By deploying new technology such as blockchain or other distributed ledger technology, innovation, and data analytics, lenders can use the data that they hold to build a clearer picture of market activity and, in turn, to determine and anticipate risks. The most obvious form of technology that could be used in this context is AI, which can be applied to conduct due diligence on funds, sponsors, and investors and keep up to date with sector trends and risks, valuations of fund assets, portfolio companies and net asset values ("**NAVs**").

A lender's success will be intrinsically linked to successfully identifying the parties to which it should extend financing. Lessons can be learnt from the tech giants in modelling and manipulating data to establish trends and map the behaviour of key market players, noting the confines of ensuring that this is done for proper purposes in accordance with the prevailing data protection regimes.

In a syndicated loan context, the more efficiently data is shared among the syndicate, the quicker the syndicate will be able to react to situations such as requests to increase facilities and amend terms. The developments in the syndicated market space, and Loan Market Association ("**LMA**") initiatives to explore technology and automation, should mean that in the future, a common syntax is applied to syndicated lending, and a common standard can be applied that will improve the customer experience.

Liquidity risk

Liquidity is a perennial risk attached to lending and lenders will be familiar with the challenges this presents post-financial crisis, in the wake of the ***Basel III Framework*** and the introduction of liquidity ratios.

The revised regulatory landscape post-financial crisis required banking institutions to increase their capital and liquidity buffers, to help alleviate certain liquidity pressures and equip lenders to tolerate greater stress in financial markets, such as the ongoing macroeconomic headwinds arising out of Brexit, the armed conflicts in Ukraine and the Middle East and the management of inflation and the interest rate environment.

Credit ratings for subscription line facilities have played a significant role in fostering the participation of insurance companies in the subscription finance market as they permit insurance companies to obtain favourable regulatory capital treatment. In addition, the calculation of risk-weighted assets under Basel IV means that for certain lenders, credit ratings for subscription line facilities will reduce the capital reserves the lender needs to hold, thereby freeing up capital to be invested in other transactions. This is particularly important given that Basel IV will significantly increase regulatory capital requirements for fund finance facilities. Increased use of credit risk insurance has also alleviated lender liquidity risk.

However, recent equity market volatility, liquidity tightening, oscillating funding spreads, operational fails, and other challenges have put significant pressure on the financial markets. We are aware that certain bank lenders have taken steps to strengthen their liquidity and reporting capabilities and, in some cases, to monitor them more frequently. There is also the introduction of new capital rules by the Federal Reserve that will force certain US lenders to hold more capital relative to their "risk-weighted assets"[10].

Generally, lenders may take a number of steps to manage exposure, including: (i) stress-testing the loan book; (ii) monitoring concentrations of investors, functionaries and sectors; (iii) considering the profile of investors with higher potential for exposure (including in terms of jurisdiction of domicile, ticket size, track record of making payments following drawdown requests, likelihood of themselves being a levered fund) and other reputational matters, noting that if a borrower is at the later stages of the fund cycle or the fund is fully committed, the lender may be less sensitive to the inclusion of such investors and borrowing base requirements may be relaxed accordingly; and (iv) considering whether there are any mismatches between the level and frequency of fund distributions made to investors and the level and frequency of capital calls made by the fund.

In terms of NAV and hybrid facilities, there is an additional liquidity risk to lenders, where assets provided as collateral for the facilities are overvalued or lose value and become insufficient to meet the borrower's obligations under the facility. Inability of lenders to challenge valuations could also play a role here.

Facility information covenants, requiring borrowers to obtain robust and frequent asset valuations or requiring notification of any significant change in NAV, would assist the lender to monitor downstream valuations, in addition to the typical loan-to-value covenants and other financial covenants within facility documents.

ESG risks

ESG risks have been recognised as credit risks in their own right as early as late 2019 (if not earlier)[11]. Most lenders have adopted explicit ESG policies, and an increasing number of institutions have an ESG-dedicated resource in their credit risk teams. Lenders are therefore both increasingly aware of the risks and actively managing these risks as part of their usual assessments of credit risks. This should serve them well as the legal and regulatory framework increasingly moves to requiring more rigorous reporting standards in line with various taxonomies and local law requirements. As reporting standards and regulations continue to develop, we are likely to see ESG provisions given more prominence in the substantive fund constitutive documents, rather than left as an optional extra for investors to request in their side letters. As a result, more fund managers and lenders alike will need to ensure that a fund's performance is monitored against the ESG key performance indicators ("**KPIs**").

It is well known that in the fund finance market, sustainability-linked loans ("**SLLs**") are more frequently used in subscription line facilities across all asset classes, but in particular by private equity funds, whereas green/use of proceeds loans are more commonly utilised by impact funds or in connection with NAV financings. The publication of the LMA's SLL model provisions, which seek to standardise drafting and drive efficiency, is one of a number of steps, including the publication of the Loan Syndications and Trading Association ("**LSTA**") Guidance on SLL principles in fund finance, that are beneficial from a lender risk perspective.

However, concerns relating to "greenwashing" and the associated litigation risk are increasingly prevalent. The use of third-party verification of KPIs and sustainability performance targets mitigate those risks, as do EU and UK initiatives relating to regulation of ESG ratings providers, but there are costs associated with both. The various EU regulations (including the EU Sustainable Finance Disclosures Regulation) and the UK Sustainability Disclosure Requirements underscore that from a lender perspective, SSLs and green/use of proceeds loans are becoming more complex from a reporting, monitoring and compliance perspective. Lenders remain vigilant in their approach to regulatory risk, but it is clear that direction of travel is towards greater integrity in the ESG market, based on a regulatory framework that requires transparent sustainability standards that allow investors to assess whether investment opportunities are genuinely orientated towards sustainability. Greater resources will be required to navigate the reporting, monitoring and compliance requirements, and there will be a cost dimension related to this.

The ability of lenders to access, analyse and rely on the integrity of information will be central to their ability to navigate what is a complex and changing landscape. Of the risks noted above, many of these may be managed and mitigated by real-time access to information (e.g. by way of blockchain or otherwise), as it adds colour to the facts, which are borne out through the financials, and facilitates better-quality decision-making by the lender. Further, regulatory rules that require borrowers to report sustainability information such as the EU's Corporate Sustainability Reporting Directive should enable lenders to calculate more effectively their own sustainability metrics.

There are also other steps that lenders can introduce now to maximise the information they receive, such as placing the burden on fund functionaries to store, maintain and share management information, financial information and investor lists on systems that can be readily accessed such as private web portals or a private blockchain, for the lender to freely access. This would increase transparency, as such information could be made available in real time to lenders and assist in easing the burden of monitoring the performance of the loan.

Retailisation of funds

High-net-worth individuals ("**HNWIs**") have traditionally been excluded from the borrowing base for subscription line facilities due to:

- the borrowing base mechanics, in particular advance rates calculated on the basis of objective creditworthiness criteria such as ratings or other readily available credit information, which HNWIs are unlikely to be able to satisfy; and
- the requirement for lenders to conduct know-your-customer ("**KYC**") checks on investors conflicting with HNWIs' desire for anonymity.

However, the retailisation of private funds (i.e. fund managers seeking sources of capital beyond the typical institutional and sophisticated investor base) has led to a growth in more HNWIs becoming part of the investor base. Certain lenders have, in turn, begun to reassess the traditional approach. In a number of instances, feeder vehicles are used to pool the subscriptions of HNWIs (such feeder vehicles, "**HNW Feeders**"), which then participate in the master fund. The use of a HNW Feeder in this manner poses the same risks as other feeder vehicles discussed above. However, there may be more standardised information available on the underlying HNWIs in a HNW Feeder and the lender may be able to rely on the KYC diligence performed by the HNW Feeder. This makes the credit assessment and KYC process more efficient and thereby makes the inclusion of a HNW Feeder in the borrowing base more palatable for lenders.

Lenders will still need to carefully consider the advance rates applicable to any HNW Feeder based on the composition and concentration of the HNWIs in the feeder fund and the rights and remedies available against any defaulting partners in the HNW Feeder.

ILPA NAV guidelines

In July 2024, the Institutional Limited Partners Association ("**ILPA**") published its keenly awaited NAV-Based Facilities Guidance, the key aspects of which are investor engagement and consent, conflicts of interest and disclosure of information. The guidance identifies the following key limited partner concerns relating to NAV facilities:

- Limited partners often have limited insight into when NAV-based facilities are being used.
- Lack of governance related to the use of NAV-based facilities in limited partner agreements ("**LPAs**"), which drives the lack of transparency.

- Where the LPA is silent, general partners have taken different approaches to how they treat NAV-based facilities. For example, some general partners have interpreted traditional fund-level leverage provisions in LPAs as providing sufficient authority for them to undertake NAV-based facilities without limited partner or Limited Partner Advisory Committee ("**LPAC**") engagement or consent. As many NAV-based facilities involve the creation of a special purpose vehicle below the fund, some general partners have interpreted LPAs to mean that NAV-based facilities are not captured by the fund-level leverage limits as prescribed in the LPA.
- The potential for a conflict of interest between general partners and limited partners where general partners use NAV facilities to fund distributions, as this leads to the inference that general partners are looking to improve the ratio of distributions to paid-in capital.

To address these concerns, the ILPA guidance recommends:

- LPAC consent is obtained before general partners enter into a NAV facility to fund distributions, even if the LPA provides the general partner with authority to enter into NAV facilities more generally.
- If there is no general authority to enter into NAV facilities in the LPA, LPAC consent should be obtained irrespective of the purpose for which the proceeds will be applied.
- Engagement with LPAC should encompass disclosure of the use of proceeds and rationale for the facility, the size of the facility, the collateral, key covenants, tenor, interest rate and any additional obligations imposed on limited partners, such as recallable distributions.
- New LPAs should specifically prescribe the type of NAV facilities the fund is allowed to enter into, specify leverage limits and include reporting obligations to ensure that limited partners are fully aware of the nature of any NAV debt.
- A set of recommended disclosures to limited partners that includes the size of and rationale for using the facility, interest rate, tenor, collateral and financial covenants.

Market commentary on the ILPA guidelines has generally been favourable. From a lender perspective, it is an important and helpful step in the evolution of NAV financings. Enhancing dialogue between general partners and limited partners and balancing the desire for engagement and transparency on the limited partner side with the benefits that NAV facilities provide to funds (such as financing bolt-on acquisitions or refinancing portfolio company debt more cheaply at fund level) is clearly a welcome development. Indeed, market behaviour appears to have already responded to investor criticism of the use of NAV facilities to fund distributions even before the publication of the ILPA guidance and without there being an overt LPA requirement to do so – in July 2024, the *Financial Times* reported that according to 17Capital, the use of NAV loans for this purpose had fallen to 3% of all NAV loans in 2023, down from 25% in 2022[12]. This exemplifies a crucial factor of lender risk in NAV financing – in the same way that the reputational damage to investors of not funding a capital call is a significant disincentive to doing so in the subscription line market, the reputational damage to funds of acting in a manner that is detrimental to its investors acts as a market protection in the NAV facility market.

Conclusion

This chapter has shown that, despite having a reputation as a low-risk product, the fund finance sphere is not without risk, but rather is a low-risk product due to the effective management of the risks present. In managing the current and evolving risks, we highlight the importance of engaging lender counsel at an early stage, both to conduct full diligence on the structure and to manage the documentation risk.

As the fund finance market continues to evolve, lenders will need to remain alert to the risks associated with lending in the market, notwithstanding the continued low default rate. In particular, the rapidly evolving macroeconomic picture may require the re-balancing of lending books or new approaches to risk migration.

1 This is in addition to the complexity and cross-jurisdictional dimensions of many fund structures, the size of the financial transactions and, in some cases, relatively slim margins.

2 ISDA has issued a number of whitepapers and academic papers in relation to the broader legal and regulatory aspects of distributed ledger and smart contracts technology. See: https://www.isda.org/2019/10/16/isda-smart-contracts [accessed on 5 November 2023].

3 Clifford Chance (2021) "The digital future of syndicated loans 2021" available at: https://www.cliffordchance.com/briefings/2021/06/the-digital-future-of-syndicated-loans.html [accessed on 5 November 2023].

4 Insights Survey 2024: Seven key findings, available at: https://www.privatefundscfo.com/insights-survey-2024-seven-key-findings. See also Raj Gidvani (2024) "Believe the hype: How AI is adding value in fund administration" [online] available at: https://www.privatefundscfo.com/believe-the-hype-how-ai-is-adding-value-in-fund-administration/?utm_source=newsletter-daily&utm_medium=email&utm_campaign=pfcfo-daily&utm_content=04-12-2024 [accessed on 8 December 2024].

5 Russell, A, Munden, R and Webb, J (2019) "Fund finance and releases of investor commitments: How can lenders protect themselves?" [online] available at: https://www.careyolsen.com/sites/default/files/CO_CAY_CORP_Fund-Finance-and-releases-of-investor-commitments%2C-how-can-lenders-protect-themselves_10.19_0.pdf [accessed on 8 December 2024].

6 Committee of European Banking Supervisors (CEBS) (2018) "Final Report, Guidelines on institutions' stress testing" CEBS [online] available at: https://eba.europa.eu/documents/10180/2282644/Guidelines+on+institutions+stress+testing+%28EBA-GL-2018-04%29.pdf/2b604bc8-fd08-4b17-ac4a-cdd5e662b802 [accessed on 5 November 2023].

7 As defined in Article 4(39) of Regulation (EU) No 575/2013.

8 Although these criteria are non-exhaustive, and other aspects may be relevant.

9 For completeness, there should also not be a material positive correlation between the credit quality of the parent and subsidiary entities in a control relationship; however, this should not apply to fund structures either.

10 See: https://www.ft.com/content/e594087e-126b-4376-90ad-2a245c8313f3 [accessed on 5 November 2023].

11 See: https://www.spglobal.com/marketintelligence/en/news-insights/blog/esg-investing-is-becoming-critical-for-credit-risk-and-portfolio-management-professionals [accessed on 5 November 2023].

12 See: https://www.ft.com/content/a1c57e7e-ce6a-45ba-b0d7-3442d42b4a91 [accessed on 8 December 2024].

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