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Rated subscription lines: An emerging solution to the liquidity crunch?

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Introduction

In June 2023, credit rating agency Fitch Ratings ('**Fitch**') published its '*Subscription Finance Rating Criteria*', a global methodology supporting the assignment of ratings to fund obligations that are backed by capital call commitments. Whilst fellow rating agency, Kroll Bond Rating Agency ('**KBRA**'), had by that point already rated numerous facilities – including alternative liquidity solutions such as NAV facilities – through application of its '*Investment Funds Debt Global Rating Methodology*', the Fitch methodology was notable for being the first to be tailored to the exact structure of subscription lines as well as being the first clear indicator of a demand for the rating of these products by one of the 'Big Three' agencies. At the time of writing, Moody's has recently published its proposed methodology for rating subscription credit facilities with request for comment that suggests it will adopt an agreed approach by early 2024, whilst S&P Global has published an advance notice announcing proposed new methodology for analysing subscription lines. The ratings agency industry is highly concentrated and with this indication that there will soon be active involvement from all three of the leading agencies, subscription lines are now clearly seen as a target market for credit rating products, and rated fund finance products across the spectrum is clearly a trend for market participants in all guises to watch.

The recent advent of these more detailed ratings methodologies coincides with a point in the market where fund finance products, throughout the lifecycle and capital stacks of fund vehicles, have never been so heavily in demand from asset managers across asset classes and strategies. However, this also comes at a time when the supply of available capital, for subscription lines in particular, has been increasingly limited from some traditional sources with certain providers having scaled back or withdrawn their balance sheet allocations, in part due to applicable capital adequacy requirements, having reached their manager or asset class concentration appetites and/or internal hold constraints – all driving higher pricing and pressure on advance rates in both the US and Europe. In this chapter, we consider the elements of fund and finance documentation that are likely to be in focus when assigning credit ratings and explore what their application may mean for the fund finance market in the medium to longer term.

The focus here is subscription lines, which, as a more established and generally less bespoke product, is perhaps the natural place for the ratings agencies to have focused their development of specific criteria. The trend of seeking ratings is also on the rise in the area of more structured liquidity products falling under the fund finance banner (NAV, hybrids, preferred equity, etc.), but detailed consideration of the relevant structural, commercial and legal elements pertinent to understanding these products largely falls outside the ambit of this chapter. Whilst the

methodologies we shall be discussing apply globally, we have predominantly analysed their application through the lens of advising on European-style subscription line facilities and with reference to financial services regulation in the United Kingdom.

An overview of the published methodologies

KBRA's '*Investment Funds Debt Global Rating Methodology*' and Fitch's more bespoke '*Subscription Finance Rating Criteria*' both work in a broadly similar fashion, combining numerous weighted quantitative and qualitative factors to produce their overall credit rating. Whilst never previously packaged in this way before, the factors under consideration will not be new to either lenders, whose own origination and credit teams will have applied similar thinking when originally underwriting these facilities, or to experienced legal advisers, who will be accustomed to reviewing fund and finance documentation with the same commercial and legal risks in mind.

The security package of a subscription line will typically include security over the unfunded capital commitments of the fund's investors, and the right to make capital calls from those investors, and so it is of little surprise that the rating of a subscription line involves extensive analysis of the credit quality and diversification of the limited partner ('**LP**') pool. Many investors in funds managed by alternative asset managers will be investment grade quality institutional investors, themselves rated entities, providing a natural starting point for assessing credit quality. For unrated investors, Fitch has created a classification framework that first considers the ultimate investor (if it is not the LP itself) before analysing the investor characteristics including assets under management, its operating history and its domicile sovereign ceiling. Risk considerations when approving the facility may already see certain investors excluded from the borrowing base of a subscription line, and so it is reasonable to assume that most investors reviewed for the purposes of a rating will generally be of high credit quality. KBRA has published analysis of its ratings of subscription lines that shows a clear correlation between the percentage of LPs rated or approximated to be equivalent to an A- rating and stronger initial ratings of these facilities.

Under KBRA's broader methodology, it applies a matrix approach when analysing quantitative factors, including the asset quality and coverage, which, when applied to subscription lines, means analysing the scope of the borrowing base, the quality of the contractual commitments to fund and the ongoing maintenance of that borrowing base. Having already begun its assessment of the LP pool, Fitch's quantitative approach follows on neatly from this via its 'Portfolio Credit Model' process, which looks to project LP capital call defaults and losses. The main drivers of these projected defaults are drawn from their initial analysis detailed above, by inputting LPs' rating assumptions and domiciles, as well as the facility maturity. Given the high proportion of institutional investors in the collateral base, subscription lines have historically had an extremely low rate of default, and even in the context of those rare occasions of LP default, haircuts, overcollateralisation and remediation provisions contained in facility documentation are often robust enough to ensure that full recovery is very likely (see also the *Finance documentation* section below).

Both agencies' quantitative approaches result in an initial rating indicator, which is then further notched by a qualitative assessment covering the manager, fund, and facility terms. Whilst there is an expectation of the typical weighting applied to each qualitative element, each is variable as a result of how great their potential impact is on the overall credit quality of the debt.

Following a rating assignment, the facility will be subject to continued surveillance by its rating agency, with its rating to be reviewed at least annually or more regularly should there be material changes to any component attributes (including the manager, the fund and the facility itself) as well as any major macroeconomic shifts.

Governing documents of the fund and the facility agreement

With the governing documents of the fund already scrutinised during the lender due diligence for any subscription line, it is of no surprise that a thorough review of these documents and the facility agreement itself form an integral part of the qualitative assessment within the ratings process. In this section, we focus on each document in turn and consider how the drafting of certain elements could contribute to attaining a more favourable rating in the context of the methodologies published to date.

Limited partnership agreement and side letters

Defaulting LP remedies

As noted above, LP default remedies are actively considered when producing these ratings, and limitations on these remedies are considered one of the higher impact terms in Fitch's qualitative assessment. Strong LP default remedies included in the limited partnership agreement ('**LPA**') can increase recovery rates and provide significant economic incentive for LPs to fund capital calls, and therefore will positively impact the facility rating. Similarly, any LPA or side letter provisions that limit the general partner's ('**GP**') and/or fund's ability to exercise its defaulting LP remedies will obviously have a negative ratings impact. The Fitch methodology looks specifically at projected recovery rates, and so it may be that those remedies that will directly lead to a higher recovery in the event of a default (such as a forced transfer or sale of the defaulting LP's interest and overcall (as discussed further below)) may result in a greater uplift than those remedies that act primarily as economic incentives (such as suspension of voting rights and exclusion from future investments). The KBRA methodology looks at defaulting LP remedies as part of the alignment of interests between the fund and the LPs, and there is not the same stated focus on how a particular remedy affects the fund's recovery.

Overcall

The ability to overcall in the event of a defaulting LP is unsurprisingly specifically noted by both Fitch and KBRA as a desirable LP default remedy. Although neither of the methodologies go into specific detail, it would be reasonable to expect that LPAs that provide for the GP's ability to overcall without limitation (up to the amount of each non-defaulting LP's undrawn commitment) will receive more favourable treatment than overcall provisions that include limitations on the amount or number of subsequent calls or the items for which overcalls may be made. It remains to be seen how the ratings agencies evaluate LPAs that do not have explicit overcall rights, but which do not explicitly prohibit or limit overcalls – funds lawyers in Europe often taking the view that if an LPA is silent, the GP can effectively overcall by simply calling capital again, but this does remain largely untested in practice.

Lender protections

Notwithstanding that it is not explicitly set out in either published methodology, it is reasonable to expect that an LPA that includes language specifically contemplating subscription facilities and an acknowledgment by LPs of certain lender protections related thereto would positively impact the facility rating. These provisions would likely make it much harder for an LP to refuse to fund to a lender and accordingly would theoretically boost the expected recovery rate on a default. The relevant provisions would include: (i) specific

powers of the GP and the fund to incur subscription facility debt and secure such debt with capital call rights, capital contributions, and the remedies against a defaulting LP; (ii) an acknowledgment by the LPs that their capital commitments and capital contributions may be pledged to a lender in respect of subscription facility debt; (iii) the agreement by the LPs to fund their capital contributions called for the repayment of subscription facility debt without defence, set-off or counterclaim and in accordance with the instructions provided by the lender; (iv) an acknowledgment by the LPs that their claims are subordinated to the claims of the lender; and (v) express third-party rights being afforded to subscription line lenders.

Ability to call following end of investment period

Any limitation on the GP's ability to call from LPs during the expected life of the facility will potentially affect recovery rates and will, therefore, likely factor into the facility rating. We would expect that LPAs that specifically provide that capital can be called to repay indebtedness at any time, including after the suspension, termination or expiration (scheduled or otherwise) of the investment period, would have a positive impact on the rating, particularly if the LPA specified that such calls could be made regardless of when the debt was incurred (pre- or post-expiry of the investment period).

Transfers and withdrawals by LPs

The pool of included (and to some extent non-included) LPs at any given time is obviously a key factor in the ratings analysis. Therefore, it is possible that LPAs and/or side letters that allow LPs to transfer and/or withdraw without GP consent in certain circumstances may negatively impact the facility rating, as the fund may come to comprise a less creditworthy pool of LPs over time. It appears that, based on the Fitch methodology, two special purpose vehicles ('**SPVs**') with a common parent may even be rated differently because an SPV's rating is not just based on its sponsor's own rating; as a result, it is conceivable that even affiliate transfers (which are often permitted under fund documentation without GP consent or with consent not to be unreasonably withheld) might impact the applicable facility rating.

Fund jurisdiction

Funds organised outside of the typical fund jurisdictions (which, although not specified in either methodology, would presumably include Delaware, England, Scotland, the Channel Islands, Luxembourg, Ireland and the Cayman Islands) may be given a lower assessment in Fitch's recovery rate analysis, as there may be some uncertainty regarding governance and enforcement in these jurisdictions. Whilst the majority of borrowers in the European market will come from one of the typical fund jurisdictions, it is worth keeping this in mind particularly in respect of opportunities in emerging markets in the space.

Key person risk

The KBRA methodology references key person risk in the investment team as a factor to be considered. As a result, it is possible that LPAs that only allow LPs to suspend or terminate the investment period after multiple key persons have departed (and with a narrow definition of 'departure' and/or permissive replacement processes) may be evaluated differently to LPAs under which a Key Person Event is triggered after the departure of one or a small number of identified key persons.

Most favoured nation

Standard most favoured nation ('**MFN**') clauses that provide LPs the benefit of favourable provisions contained in the side letters of other LPs in the borrowing base have been noted by the ratings agencies as potentially leading them to notch down by several notches the

credit rating of an LP that benefits from broad MFN clauses. The extent of such notching would typically reflect how favourable/potentially problematic the provisions contained in the most favourable LP side letters are from a lender perspective.

Sovereign immunity

This type of clause reserves the right of an LP comprising a government/state entity to claim sovereign immunity in the case of any dispute relating to the fund documents. In the absence of a waiver of this right, ratings agencies have noted that they may notch down LP ratings by up to three notches.

Finance documentation

Turning to the provisions contained in the finance documentation itself that may have a bearing on an overall rating, these are unsurprisingly under the currently published guidance focused on controls, rights and triggers, which directly pertain to the day-one and ongoing make-up of the borrowing base and related advance rates.

Structurally, baseline expectations of a typical capital call security package (with linked account controls and powers of attorney) will be measured, as will the level of over-collateralisation (i.e. the level of uncalled commitments secured *versus* debt quantum). Whether an 'all-investor' or 'cherry-picked' borrowing base is adopted under the facility will likely be relevant to the assessment of its current and future make-up, as will whether flat or stepped advance rates are employed (usually by reference to how 'called' the investor base is at any given time). In a similar fashion, appliable concentration limits, LP ratings triggers and the relative strength and breadth of 'Exclusion Events' for removing LPs from the borrowing base will obviously also be highly relevant, including the extent to which such provisions extend to ultimate beneficial owners and credit support providers of SPV or non-substantive direct investment vehicles. Other likely positive factors may also include any requirements for minimum capital calls either before initial utilisation and/or regularly during the life of the facility and robust protections around changes to the fund structure and required future accessions of feeder funds and/or AIVs (where applicable).

Whilst not currently covered in detail in the published methodologies, it also seems highly likely that the construction and number of financial covenants contained in the subscription line will also be examined in terms of determining the relative strength and breadth of downside warning triggers and protections. In this context, beyond standard UCC cover, the inclusion of downwards-looking financial covenants in the form of minimum NAV or NAV-linked loan-to-value ('**LTV**') covenants or investment value-based tests are likely to be seen as positive factors directly linked to maintaining investor willingness to fund capital calls. Appropriate parameters around a borrower's exercise of covenant cure rights are also logically likely to be reviewed, as is the inclusion and scope of protections and events of default linked to overall LP base defaults, exclusions and shifts (via LP transfers) – all potentially providing further comfort on changes in LP sentiment, behaviour and concentration.

Subscription lines: The right now

Stepping back from the detail of the methodologies, to fully appreciate the expected benefits that subscription line credit ratings will offer, it is necessary to consider their current place in what has, of late, been a changing market.

Allocations to private capital have grown exponentially over the past 20 years, albeit a challenging macroeconomic market has seen fundraising slow throughout 2022 and 2023. The total uncalled capital or so-called 'dry powder' that anchors a subscription line's collateral base stood at approximately USD3.5 trillion as of June 2022 (source: *Preqin*),

whilst fundraisings have grown ever larger, with CVC Capital Partners IX amassing EUR26 billion in July 2023 to make it the largest buyout fund of all time. This extreme growth has been mirrored in both the typical levels of reliance on, and size of, subscription lines. Now a ubiquitous product in a fund manager's toolkit to smooth the capital call and investment process, both managers and LPs investing across all alternative strategies have become broadly comfortable with their usage given the benefits of both reducing administrative burdens and improving liquidity management. Perhaps more controversially, managers have also been keen to use them to shorten the amount of time between capital calls and distributions, potentially improving internal rates of return, particularly earlier in a fund's life. As the size of funds has increased, so too has the size of these facilities needed to support them, with the subscription finance market estimated to have stood at USD750 billion at year-end 2022, having almost doubled in five years.

This surge in activity has been somewhat dampened by a lending market that has not only at times struggled to keep pace with the demands of its customer base, but which has become actively balance sheet constrained, creating an increasingly problematic liquidity gap between levels of supply and demand. Due to their typical nature as revolving credit facilities, subscription lines have traditionally been the preserve of the banks, including sizeable books held by those institutions with large enough balance sheets to designate them as 'Globally Systemic Important Banks'. Subscription lines were, for many years, a reasonably attractive product for these banks to offer; extremely low risk due to almost zero default rates and, whilst they did not necessarily generate high returns, they were often thought to be a useful relationship offering to the largest managers, designed to attract ancillary wallet and adjacencies attached to their investment activities.

As the macroeconomic landscape has become more challenging across the globe – which was further amplified in Europe by the war in Ukraine and the resulting energy crisis – interest rates have risen rapidly, impacting the spreads on subscription lines, which crept up from a historically low position to 300 bps and beyond. When considered alongside the evolving capital adequacy requirements under Basel 3.1 that require banks to set aside capital relative to their assets, the much-favoured subscription line is now, for some, a far more expensive product for lenders to offer. This has meant that meeting the still-growing demand from asset managers has become impossible for the traditional providers without severely impacting the amount they would have available to lend elsewhere in their business. Given that subscription lines were already a low profitability product, it has become harder for certain lenders to justify maintaining their exposure to these assets when it comes at the expense of other lending.

Late in 2022, it was reported that Citi would dramatically scale back its subscription line lending, with suggestions that its book would ultimately be cut by over two-thirds, representing an immediate liquidity gap of over USD40 billion. This was soon followed by the collapse of several US regional banks in the first half of 2023. The affected banks, First Republic, Silicon Valley Bank, and Signature Bank, were all active in the subscription line lending market, and whilst ultimately all three were rescued, their collapse introduced an additional layer of uncertainty and a reminder of the balance sheet pressures facing the industry.

It is also worth noting that, whilst the sponsor reaction to this market instability has, in many cases, been to diversify their banking relationships to ensure that they are not over-exposed to any one institution, lenders are often needing to take the opposite approach. In the face of an obvious widening gap between supply and demand, several banks are conducting detailed analysis of their books and rationalising their relationships to focus on the managers that matter most to them institutionally.

Can the introduction of ratings help to bridge this liquidity gap?

Set in this context, it immediately becomes clearer why ratings have started to emerge as a possible solution for bridging the liquidity gap and that they have multiple applications in this regard.

Firstly, under the regulatory regimes of certain jurisdictions, a lender obtaining a rating for a facility will enable them to access much more favourable capital treatment for that lend. If ratings were to become the norm for subscription lending, this revised treatment would immediately support lenders (and banks in particular) in better managing their capital by reducing the capital charges that this business line would otherwise attract.

Secondly, ratings have the potential to greatly bolster the increasing interest from non-bank lenders in the fund finance market, predominantly (at least in the subscription line space) from insurance companies and pension funds. To date, this has included both private credit funds and institutional capital pursuing direct day-one participations in club deals, a necessity where the increasing debt quantum of facilities has required larger clubs of lenders. Subscription lines, as primarily bridging and working capital facilities, have traditionally been structured as multi-currency revolving credit lines. With both private credit funds and institutional capital preferring to invest in single currency term loans, there has been an emerging trend for banks to continue offering revolving credit facilities, with institutional capital either lending through a series of term loans that rank *pari passu* in the structure or for institutional capital to be introduced via back-leverage, sub-participations or similar structured intra-funder arrangements.

This entrance of institutional capital into the lending pool has also included banks introducing the wider syndication of facilities to their own institutional investor base, as investors actively seek to purchase portions or tranched exposure to bundled subscription line loans. This securitisation-type approach to subscription line lending is another means of banks choosing to proactively manage their balance sheets, made far easier and more accessible by the institutional capital markets where such structures benefit from a market-accepted credit rating. Whilst institutional investors have built a strong understanding of subscription lines as LPs investing in funds, they are much newer to analysing these products from the perspective of a lender or as an investor in a related debt instrument. Much like the banks themselves, many institutional investors are from regulated industries and, as such, have capital reserve and risk-based capital requirements, which can be much lower when investing in rated debt instruments. Obtaining a rating will therefore make a subscription line a more attractive investment to these investors and increase the marketability for banks relying on selling down a portion of the loan to non-bank lenders in order to manage their own capital constraints as part of emerging 'originate to distribute' strategies.

From the sponsor's viewpoint, it is easy to see that ratings could lead to more favourable pricing where it drives wider access to potentially deeper and cheaper pools of capital. Another interesting angle for sponsors to consider is the extent to which these processes and interactions with institutional capital providers, alongside their increased understanding and knowledge of the sponsor's structure and arrangements as part of any ratings analysis, will result in them forging fruitful relationships with a wider pool of institutional investors, potentially opening the way to gaining their support with their investor hats on in future fundraisings.

To date, ratings of subscription lines have typically been sought by the lender and often regarding only their own exposure under the loan, with most decisions kept confidential rather than published publicly. As the implementation of Basel 3.1 takes effect, its focus

on risk-weighted assets will presumably see all lenders in the subscription line market keen to ensure that they receive the most favourable capital treatment available, allowing them to reflect that in their pricing. It therefore seems likely that ratings will quickly become commonplace and be a service (and cost) that is incorporated into the lending arrangements more standardly and likely paid for by the relevant sponsor.

A new era for fund finance?

Whilst the immediate benefits set out above, as well as their ubiquity in the market, mean that the subscription line has been a natural entry point to the fund finance market for credit ratings, there is an expectation that this could rapidly expand to include other fund financing products. At the time of drafting this chapter, Fitch has already announced an intention to produce a similar methodology for NAV facilities, whilst KBRA has stated that it is seeing an increased interest in ratings for hybrid facilities, particularly in respect of continuation funds – themselves a popular trend in response to a challenging liquidity climate with slow M&A activity and difficult valuation and exit conditions.

KBRA has already rated numerous NAV and hybrid facilities, primarily in relation to private equity, credit and secondaries funds who have, to date, been the predominant users of this liquidity product. As the profile of NAV lending only continues to grow, and LPs and others rightly educate themselves on their characteristics and usage, external ratings may have an important role to play in standing behind the credit and risk profiles of these lending structures. It is worth noting that NAV lends are often highly bespoke in nature and structure and more nascent as a product. As such, it will be interesting to see how specialised rating methodologies can be produced that look to review these facilities in an entirely consistent manner given the differing nature of underlying portfolio assets that form the relevant collateral pool.

What is clear is that the usage of these ratings is only just beginning. Much like other innovations in the fund finance industry over the past 25 years, we have little doubt that both lenders and sponsors alike will find that they quickly develop a taste for this new technology as they find a variety of ways to employ and finesse it for mutual benefit. Its emergence may not fully plug the liquidity gap alone, and space precludes an exploration of other emerging solutions, such as bespoke credit risk insurance products. However, after a challenging period for liquidity in some areas, we are moving into a new era for fund finance that will undoubtedly continue to build on an appetite for innovation that has always been inherent in the market.

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