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Asset financing for credit funds

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Introduction

Innovation is never far from the credit fund market and in this article, we look at the evolution of banks looking to offer creative financing solutions for specific assets within credit funds' loan portfolios.

The commercial drivers behind these transactions are varied, both for the credit fund and the bank.

For the credit fund, these products can be used either as a form of leverage to increase the internal rate of return (IRR) on specific loans (often called "back leverage"), as an alternative to syndication for parts of the capital structure in their existing loan portfolio or as a bridge financing mechanism to gain short-term liquidity.

For the banks, these products present a more capital-efficient financing method than some of the more traditional products offered in this space, such as margin loans, with greater protection from credit risk via ownership of the underlying loan as opposed to a security interest.

These solutions deploy a variety of products, including total return swaps (TRS), repos, and sub-participations, sometimes combined with a repackaging of the assets into a structured note.

The key takeaways are:

- for funds that wish to offer their investors leveraged returns, TRS and repo structures offer an attractive and cost-effective means of gaining leverage on a specific asset;
- these products can also be an effective route to syndication of a specific investment where, for whatever reason, more traditional syndication is not possible; and
- these products can be more competitively priced than more traditional fund finance arrangements and can be offered on a more bespoke basis.

We will now explore the commercial drivers, how these products work and the main legal and regulatory considerations in more detail.

Why do credit funds want these products?

Enhancing IRR

These solutions offer credit funds the ability to reap returns from the full principal amount of a loan without needing to fund and/or hold it in full. In addition, by utilising a TRS or repo, the cost of finance can be lower than more traditional forms of financing which are less capital efficient for the bank (e.g. margin loans or direct participation in syndication). Furthermore, if a fund guarantee is given, the credit risk on the structure is mitigated such that the pricing can be even more favourable.

Syndication

These solutions also offer an opportunity to bring in bank capital to hold a portion of a credit fund's existing portfolio of loans. This can be thought of as an alternative to syndication. By deploying lower cost capital from the bank to hold a lower earning portion of the portfolio, this frees up capital to be deployed on higher return investments by the fund.

Bypassing hurdles to legal ownership

The synthetic nature of some of these structures allows funds to benefit from the capital growth of an asset without legal ownership, bypassing administrative and operational hurdles or blanket restrictions, for example due to regulatory restrictions on lending to borrowers in certain jurisdictions.

How do these products work?

Total Return Swap (TRS)

A TRS replicates the cash flows produced by an underlying asset (a loan for our purposes) to give one of the parties economic exposure to the loan without being the legal owner or holder of it. The TRS will be only partially funded by the party gaining the economic exposure to the loan, giving that party a levered exposure. Under the TRS there will be cashflows between the two parties under two separate "legs":

Total return leg

Under the total return leg, one party (the bank) will pay the other party (the fund) the total return on the underlying loan. This will include interest, fees, and appreciation or depreciation in the market price of the loan over the lifetime of the TRS. Typically the bank (or an SPV, depending on the structure) will hold the loan as lender of record as its hedge position to ensure it can meet its payment obligations under the TRS, although there is no legal requirement to do so.

Financing leg

Under the financing leg, the credit fund will:

(i) advance to the bank a portion of the principal amount of the loan (the "Initial Exchange Amount"); and

(ii) pay a quarterly financing rate on the remaining portion of the principal (the "Balance") which represents the amount of leverage being incurred by the fund via the TRS.

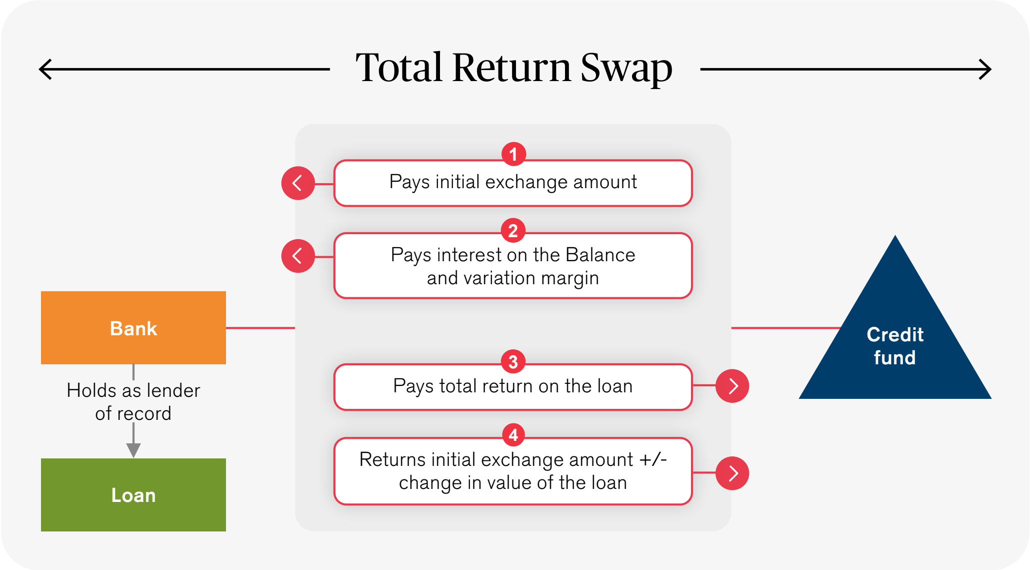
The ratio of the Balance compared with the principal amount of the loan is the "LTV" of the transaction. LTVs offered will vary depending on the commercial factors discussed in further detail under "Commercial negotiation points".

At maturity

When the TRS matures, the loan will be valued and the bank will return the Initial Exchange Amount to the fund. If the market price has increased since day one, the bank will pay the fund this increase; if it has decreased in value, the bank will deduct the decrease from the Initial Exchange Amount.

Margin

Some structures include a variation margin mechanic whereby the fund must "top up" the bank for drops in the market value of the loan from the initial price during the life of the TRS in order to preserve the LTV.

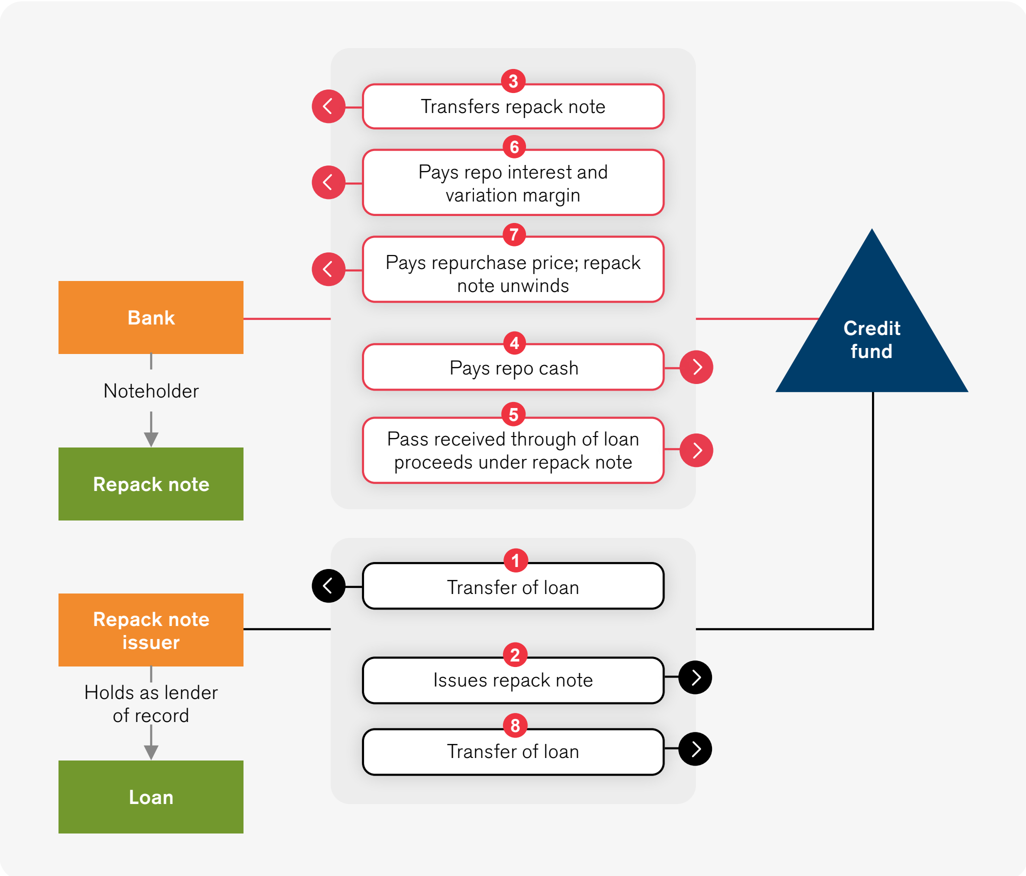


From this we can see that the bank is not exposed to the market risk on the loan insofar as the LTV remains sufficiently low. If there is a variation margin mechanic, the bank is further protected from the risk of the loan falling in value so much that is is no longer adequate security for repayment of the Balance. Any upside from an increase in market value of the loan goes to the credit fund once the balance is repaid to the bank.

Repo and repack structures

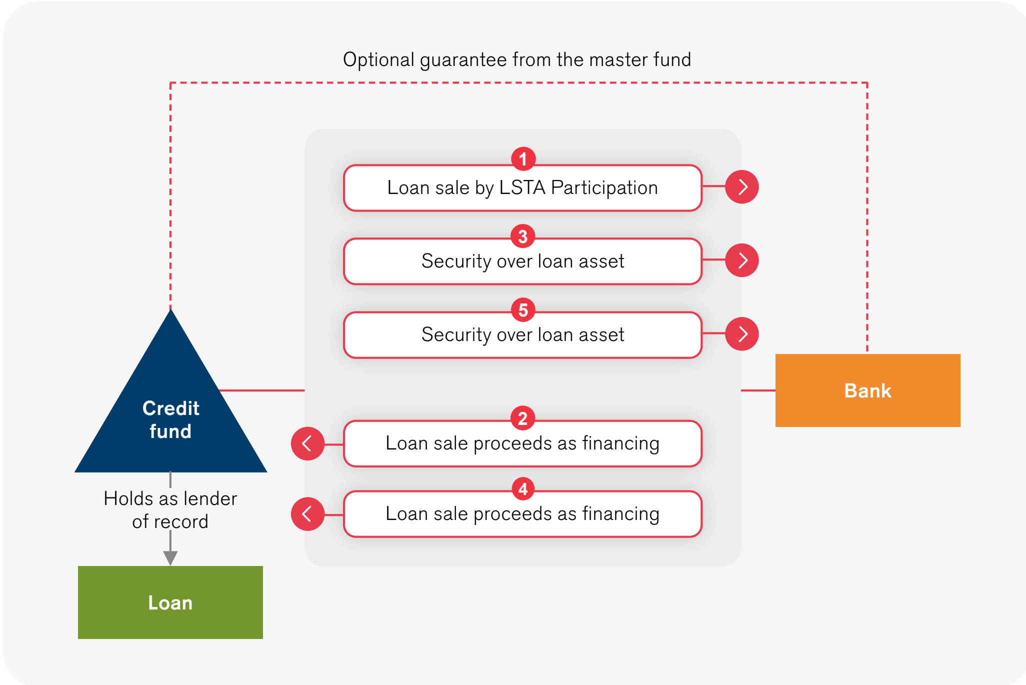
As an alternative to TRS, repo structures can be used. At its simplest, this involves the sale of the asset in return for financing and its repurchase at a later date. On its own, it therefore suits the more liquid end of the asset spectrum, where the asset is already a transferable note. However, it can be combined with repackaging structures for use with loan assets. Under these structures, the loan is repackaged into a pass-through note issued by an SPV which holds the loan as lender of record. The note can then be repo'd. Repackaging can also be used with the TRS structure described above. Under this, the bank holds the loan note instead of the loan itself and transfers the payout under the note to the fund under the total return leg of the TRS.

Using a repack structure allows the bank to achieve an optimal capital and tax structure, resulting in more favourable pricing on the financing leg under both a TRS or a repo structure. There may be circumstances where a repo is more suitable than a TRS – for example due to different regulatory treatment.



LSTA "loan repo" structures

A further product uses LSTA-form participation documents to mimic a loan repo. This is often offered in circumstances where a fund wishes to obtain short-term bridge financing pending investor drawdown. A sub-participation on a specific loan within the fund's portfolio is granted to the bank giving the bank full economic rights in return for a principal payment. To "repay" the financing, the sub-participation is terminated and the bank receives its principal amount back, plus interest. The fund grants security to the bank during the life of the structure to support its repayment obligation.



Commercial negotiation points

Valuation

The market price of the loan is established at the beginning and end of the transaction and during the life of the transaction. The initial price will be the benchmark against which any capital growth will be determined. Control over the valuation and the extent to which market data and objective price points can/must be used will be a key negotiation point.

Typically the bank will act as calculation agent and valuation agent in respect of the loan; credit funds should consider when they would want dispute rights over these valuations (at a minimum the bank's determination of the final price should be disputable), the types and sources of data that should feed into the valuation, the practicalities of determining a daily valuation of an illiquid loan and how borrower information received by the lender of record will be shared.

Margin

The ability to call for variation margin following a drop in the market value of the loan is a key mitigant for the bank's credit risk on the credit fund for repayment of the Balance. If the fund defaults, the bank will realise the market value of the loan in order to repay itself the Balance. If the LTV has fallen significantly during the life of the transaction, then the proceeds may not be enough to cover the Balance (plus associated costs of unwind). Variation margin protects the bank from this risk.

While we have seen banks offer margin holidays based on the LTV remaining above certain thresholds, all structures we have seen involve some degree of margin call. Additional margin calls triggered by breaches of financial ratios in the underlying loan may also be included.

Funds will need to consider how they will fund any margin calls during the life of the transaction, particularly in circumstances where the transaction is held outside the main fund structure, for example in an orphan SPV. If this presents serious difficulties, alternatives could include increasing the Initial Exchange Amount or obtaining a guarantee from another entity within the structure. If the bank has recourse to investors as well as the loan, then the need for variation margin may be less important.

Maturity mismatches and early termination

Typically we see a term of three years being offered on the TRS and repo products and a shorter term of 1-6 months on the LSTA loan repo structure. However, the term of the underlying loan may be much longer. Funds will need to consider whether they roll or extend the financing, exit the underlying loan completely, or source capital to buy into the remaining portion of the loan which was funded by the bank.

It is also standard to see an optional early termination right granted in favour of the credit fund, usually coupled with a make-whole requirement on the credit fund to compensate the bank for lost payments on the financing leg for the remainder of the term. Credit funds should scrutinise these make-whole payments to assess the extent they would also be liable for the bank's termination costs (including hedging costs).

Voting Rights

The fund and bank will need to agree how much control each of them will have over voting rights on the loan; a key characteristic of a TRS is not to grant voting rights in respect of the underlying asset and a repo passes ownership of the asset (plus associated voting rights) to the bank. However we have seen credit funds being appointed as “voting agent” as a means of retaining voting control during the life of the financing. The Facility Agreement will need to be checked for restrictions on the divestment of voting rights by lenders.

Information regarding the loan

The Facility Agreement will need to be checked to ensure information received by the lender of record can be passed to the relevant parties under the financing structure – both for the purpose of diligencing the loan at the outset of the transaction and on an ongoing basis if needed to determine addtional margin calls linked to financing ratios.

Borrower relationship sensitivity

Where the structure involves the lender of record changing, the fund will need to consider how that will affect their relationship with the underlying obligors and their sponsors. Where that might be an issue, the structures can be altered to consider transfer of the loan economics to the bank via sub-participation rather than outright sale.

Termination triggers

Termination triggers typically include the standard termination rights in the relevant master agreement (the ISDA Master Agreement for a TRS or the Global Master Repurchase Agreement (GMRA) for a repo structure) plus triggers driven by a default under the loan, which are usually based on the Failure to Pay, Insolvency and Restructuring Credit Events in the 2014 Credit Derivatives Definitions as well as the optional early termination right for the fund described above.

Support from/recourse to the fund investors.

The amount and price of financing that a bank will offer in respect of a particular asset may depend on the recourse they can have to the wider fund. If they face an asset-holding SPV with no fund guarantee, the financing is typically more expensive and may be subject to more stringent margin requirements.

Legal and regulatory considerations

The parties will need to consider the legal and regulatory context of each structure. These will include:

- **trade reporting** of the TRS under EMIR or Dodd-Frank (plus other obligations depending on the jurisdiction and nature of the relevant entities) and of the repo under Securities Financing Transactions Regulation (SFTR);
- **tax** – the parties must agree which party will bear the risk of withholding on payments under the loan and ensure no additional withholding is imposed on payments under the TRS or repo;
- the fund's wider tax structure to ensure **no tax leakage** occurs;
- the possibility for **basis risk** within repack structures where there is potential for mismatch (for example between the TRS or repo and relevant collateral); and
- general **enforceability** of the transaction in the relevant jurisdiction and any potential recharacterization risk (particularly under the LSTA loan repo trading).

When can these products not be used?

There are certain barriers which may prevent asset-specific leverage being put in place, including where the loan:

- is subject to transfer restrictions;
- prevents the sharing of any confidential information; or
- specifically restricts sub-participations or using derivatives to transfer the economic risks of the loan.

The fund should also consider any restrictions in its constitutional documents and investor disclosures regarding the use of leverage to enhance returns (or otherwise) or regarding the use of specific products (such as derivatives) which may force a fund to go down the repo route.

We have seen sub-participations used as alternatives to outright transfer where transfer restrictions or borrower sensitivities are a barrier. We have also seen orphan structures considered for structures where leverage restrictions are a concern. For loans with robust restrictions on divesting economic risk and/or voting rights, we have seen possible solutions involving a transfer of the loan to an SPV affiliate which then appoints the fund as voting agent.

Our team

The Macfarlanes derivatives and trading group combines experts in OTC derivatives, repos and secondary loan trading under one team and is uniquely placed to advise on these transactions.

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