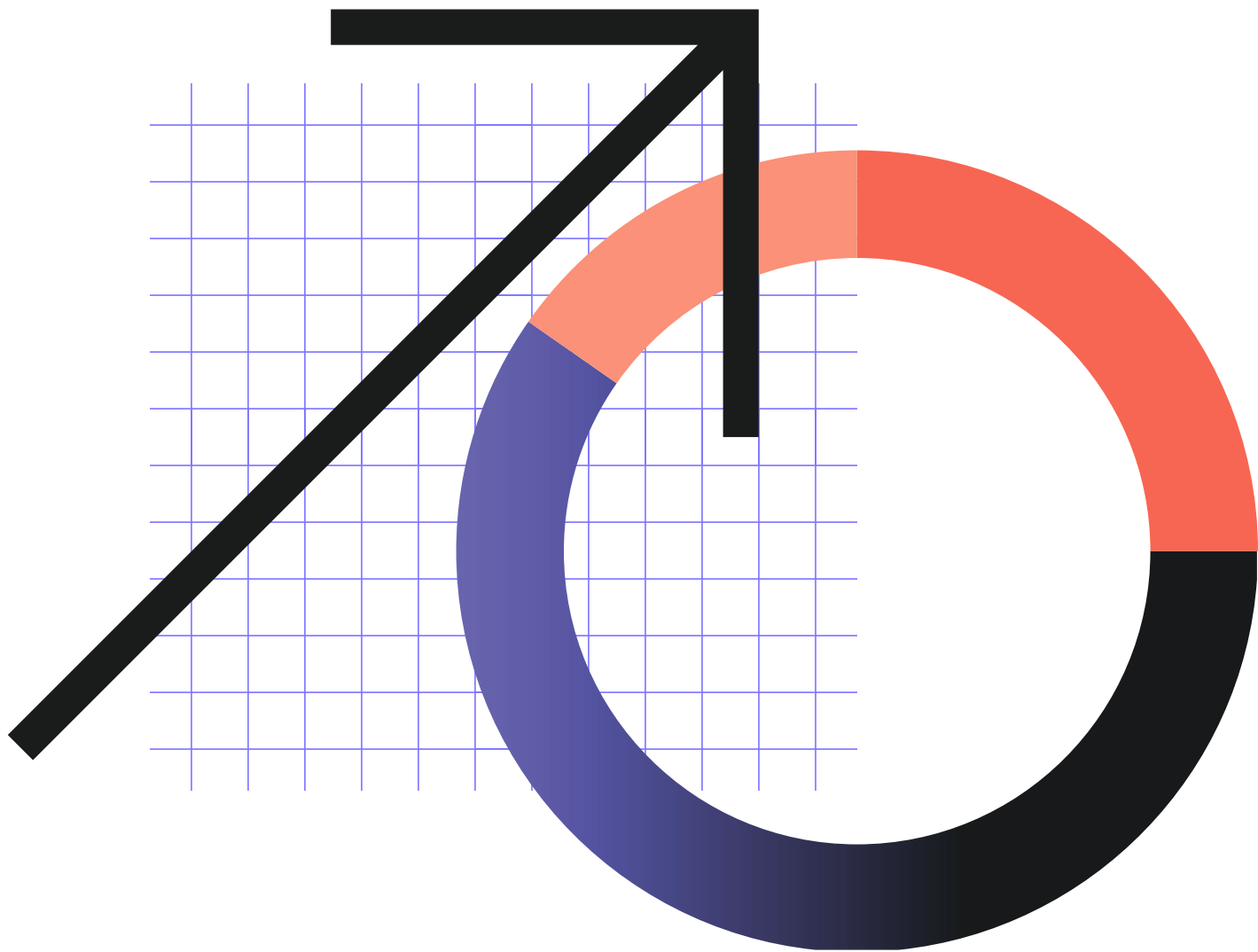


The Explosive Growth and Hidden Risks of Fund Finance

Q2 2021



Executive Summary

As the alternative markets exploded in the last decade, fund financing – that is, the providing of credit to private funds – emerged alongside as an increasingly important revenue generator for banks seeking new opportunities in the wake of the Great Financial Crisis. But as issuance of these facilities grows, it poses unique challenges that traditional risk management infrastructure is ill-equipped to support. This paper will explore how we see, broadly, the maturation of fund financing market: why it will grow as an opportunity for lenders, and how they should be prepared to scale their business efficiently.

Key Takeaways

- The regulatory response to the 2008 global financial crisis left banks reeling and looking for new opportunities. Providing credit to private funds allowed banks to capitalize on the explosive growth of alternatives fundraising.
- While attractive to lenders, the complex, one-to-many collateral relationships drastically complicates data management workflows. Banks cannot safely or efficiently manage fund finance workflows via legacy processes and tools.
- New tools that quantify exposures and make sense of large data sets will be necessary to ensure that all parties involved understand the full picture. If anything, these tools will act as an accelerant – allowing firms to make better underwriting decisions.

A Decade of Growth in Alternatives

Following the 2008 global financial crisis, the banking sector either left or steeply pared back many business lines that had historically been profit centers but carried high risks. Either due to outright regulatory bans or higher capital requirements, banks had to cede ground to unregulated entities across a broad spectrum of once-lucrative lending markets and were pushed to find new, safer income sources elsewhere.

During this same period, alternatives fundraising boomed, as investors sought uncorrelated and attractive risk-adjusted returns against the backdrop of record low yields. According to a McKinsey report, \$4 trillion dollars poured into private markets from 2010 to 2020, marking a 170% increase in AUM and outpacing the public markets by 70% over the same period.¹ And with that growth, banks with the balance sheet and necessary institutional relationships were able to find a new revenue stream in providing liquidity to this quickly expanding world of alternative fund vehicles.

This method of lending, broadly known as fund financing, encapsulates a handful of similar but ultimately different products. The most common types are: Subscription Lines, which entail lending to a general partner's (GP) fund against capital commitments from its investors (LPs); and more general Asset-Based Lines, which typically provide leverage or liquidity to a GP based on the value of the fund's collateral – be it a stake in a privately owned business or a pool of middle market loans. Both facility types utilize a borrowing base mechanism to determine availability, which usually results in strong collateral coverage and the perception of safety.

The growth in alternatives isn't expected to slow anytime soon. Preqin projects a near doubling of AUM in private markets by the end of 2025, swelling past \$9 trillion.² In private debt specifically, where use of leverage facilities is most prevalent, an IQ-EQ and IFI survey found that 95% of large investors expect the market to continue growing in the next three years.³ Fund finance, therefore, will continue to be a lucrative method for banks to capitalize on the growth in alternatives fundraising.

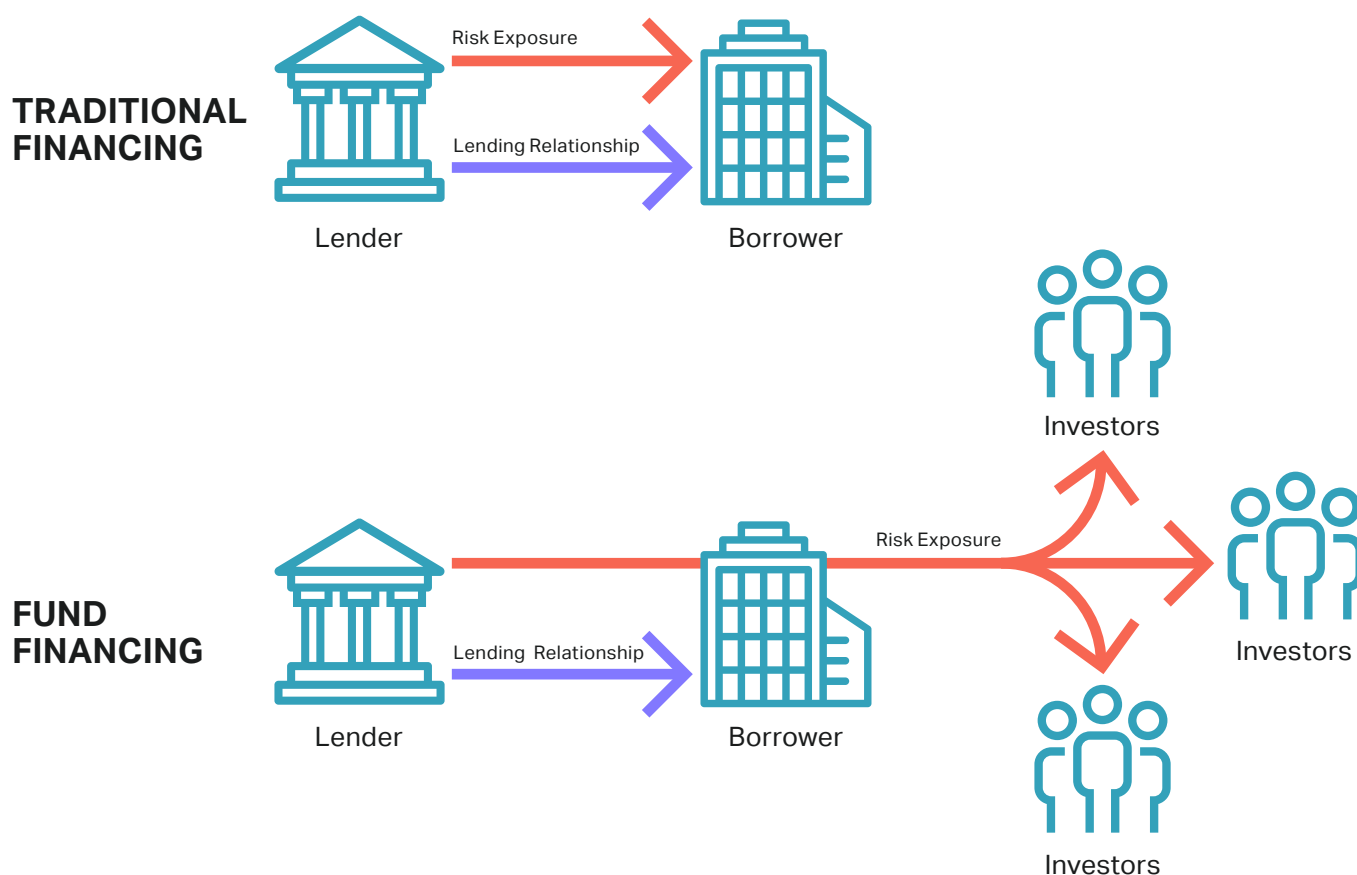
¹ <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review>

² <https://www.preqin.com/insights/research/blogs/private-equity-aum-will-top-9tn-in-2025>

³ <https://www.internationalinvestment.net/news/4020061/fund-managers-believe-private-debt-market-grow-survey>

But, of course, just as fund financing represents a new opportunity, it also brings new challenges. The critical issue now facing these lenders is their one-to-many relationship with the underlying collateral backing these facilities. Unlike traditional lending relationships, counterparty exposure alone is insufficient to gauge portfolio risk. Said differently, the lending relationship sits with their borrowing counterparty, but their collateral exposure sits with their borrower's investors or fund holdings, which may overlap across facilities and counterparties.

To better understand how banks can manage those risks – given that fund financing will almost certainly remain a key income source for bank lenders in the coming years – we first need to look more closely at some of the common facility types and structures that comprise the market.



Fund Financing Primer: Subscription, Asset-Based Lines, and Hybrid Vehicles

Fund financing covers the class of credit extended by institutions to alternative asset managers to capitalize their funds. These facilities supplement investor capital to increase the GP's dry powder or help manage liquidity. Within the fund finance universe, common facilities include subscription lines, net asset value (NAV) lines, and leverage lines.

- 1 **Subscription lines** are lines of credit or loans secured against the future – but yet unrealized – capital commitment of LPs to GPs. They enable GPs to execute on fund investments on their own timetable and increase returns during the pre-funding period. Though typically considered low risk, lenders still need to be wary of the creditworthiness of LPs when extending subscription lines to a GP.
- 2 **Leverage lines** are a type of Asset-Based facility that use a borrowing base calculation to determine availability based on the value of the fund's underlying holdings, which serve as collateral. For leverage lines, that line of credit is used by GPs to increase their dry powder above the equity invested in the fund. Importantly, these facilities are typically secured by the full holdings of the fund rather than a single asset, lowering the risk profile of the loan.
- 3 **NAV-based lines**, another subset of Asset-Based lines, are secured by the underlying cash flows and distributions that flow up to the fund from its underlying portfolio investments. They are most common in the secondaries market, where collateral will take the form of LP interests that the secondaries fund holds in different vehicles, or in the private equity world, where security is provided by the fund's equity stake in its portfolio companies. Whereas the principal goal of leverage lines is to increase the dry powder available, the primary purpose of NAV lines is to provide liquidity at the fund level when it is not being produced at the asset level.
- 4 There are also **hybrid facilities** which combine elements of both subscription and NAV lines into a single, comprehensive facility, although usually at a slightly higher cost given the added complexity.

How and Why Banks are Capitalizing on Fund Finance

The growth of fund finance has been significant over the last few years. Data from Cadwalader, Wickersham & LLP suggests that subscription line issuance alone grew by 70% from 2017 through 2019, prior to the slowdown from the pandemic.⁴ And Preqin reports that roughly 50% of private capital fund managers have used a subscription line, up from around 25% a decade ago.⁵

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Why is this? First, as noted above, alternatives fundraising continues to rise with strong structural tailwinds creating an increase in demand. Second, the risk to lenders is relatively low. On the supply side, banks view these loans as being well-collateralized, and they carry lighter capital reserve requirements, which makes them an attractive alternative to riskier forms of lending with similar yields.

The market is unlikely to slow down anytime soon. There is no shortage of funds in the market (a record 3,986 funds were simultaneously raising capital per October 2020⁶) – and many will seek some form of financing. Currently, over half of private debt and equity funds use a fund finance facility, and we expect that percentage to increase as more LPs become accepting of their managers responsibly using leverage.⁵

Still, this market is in its maturation phase, and there's room for professionalization. Lenders rightly take comfort in the overcollateralization of their facilities and the diversity they provide, but some are awakening to the fact that they need to look a level deeper – into their exposure to specific LPs or assets – to understand the true risk profile of their loan portfolio.

For example, a single subscription line may appear well-diversified by LP exposure, but may overlap significantly with other lines held by the bank. Thus, the lender needs to be able to look across exposure to its aggregate collateral pool – regardless of GP counterparty or facility – to get the full picture. This creates a disconnect between the borrower and collateral, and lenders will need to address their data and risk management processes to ensure the proper guardrails are in place.

⁴ <https://iclg.com/practice-areas/lending-and-secured-finance-laws-and-regulations>

⁵ <https://docs.preqin.com/reports/Preqin-Special-Report-Subscription-Credit-Facilities-June-2019.pdf>

⁶ <https://www.institutionalinvestor.com/article/b1nqhghd14jc58/A-Record-Number-of-Private-Equity-Funds-Are-in-the-Market-But-Closing-Them-Won-t-Be-Easy>

The Real Risk: Data Management

The one-to-many nature of fund finance collateral complicates how banks measure risk. They must look deeper into the underlying collateral being used across facilities, and ensure that they are not over-exposed to any one asset or investor. This is especially pertinent for asset-based lines, where the individual holdings can be risky and move widely in value between reporting periods or facility draws.

Digging into that collateral, though, creates significant data management challenges. A single leverage facility is relatively manageable for a lender, but analyzing collateral data across a portfolio of leverage facilities quickly becomes complicated. There may be inconsistencies in naming conventions of the underlying assets, and the sheer volume of data makes aggregation and comparison challenging. Whereas a traditional corporate lending desk is focused on the credit risk of its borrowers, a fund finance desk is responsible for tracking potentially tens to hundreds of end points across each facility, and comparing them at the portfolio level.

Using subscription lines as an example, lenders need a line of sight to each of the LPs who have committed to the fund and need to determine the likelihood of default. It is conceivable that a fund finance lender has three or four different subscription lines up against the same LP across four or five different vehicles. Here the data management challenge has gone further, it is concerned with level of detail – the granularity and interconnectedness of your data ecosystem. Measuring that single LP exposure is both critical and difficult, and cannot be done if that data is not stored and organized properly. It requires that your system is able to parse out the idiosyncratic risk of a single LP across their different commitments, and then aggregate those exposures accurately.

Real-time analysis is also an important factor here. Data must be continually monitored and standardized as changes to the quality of collateral could have an impact to the terms of the credit facility or the bank's broader portfolio. Real-time tools also help facilitate and update the trove of reporting requirement that comes with these facilities.

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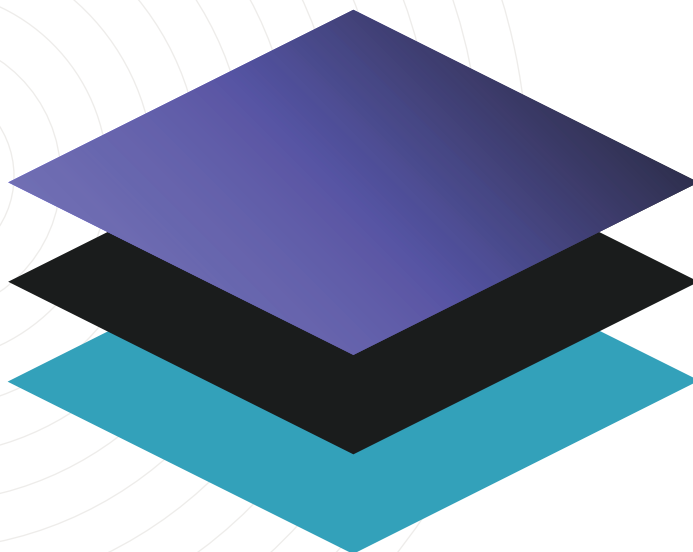
Because of these challenges, having the right data tools and environment is critical to successfully growing a fund finance book. A data platform must be able to maintain a strong line of sight to the true sources of risk (collateral) and do so with a granular eye. It should also be able to operate in real time, and simplify the process of communicating changes in risk to key decision makers.

Of course, this is all easier said than done, and good execution can take many forms. Consider a leverage line where each underlying asset is assigned an advance rate based on its performance. A bank's data solution must be able to tease out the specific data which can assign these advance rates, and then track them at a portfolio level in real time. But even a simple issue, like an inconsistency in an asset's naming convention across borrower reporting documents, can throw off the entire platform. Banks need a solution that is robust enough to handle subtleties like these and powerful enough to work consistently across their diversified portfolio of facilities.

As any business line grows, risk management procedures become more important, especially as regulatory attention intensifies. Because different borrowers frequently share data in different formats, manual reconciliation for each individual facility could expose a lender to regulatory or compliance risks or, worse, loss of principal. Putting in place a better data management protocol helps mitigate this risk and alleviates the reporting burden on the team. At Allvue, we've created a Fund Finance solution set designed specifically to help normalize disparate data, track LP or collateral asset exposures, increase transparency into deal workflows, and help both borrowers and lenders better manage the challenges of fund finance.

Fund Finance **is** Maturing

The alternatives space is set to expand its run in the coming decade, supporting growth for all those industries and products which service it. And while this presents an exciting opportunity, improving data and risk management processes will be necessary to capitalizing on opportunities in the fund finance market. Understanding the risks associated with fund facilities will be critical to a healthy maturation of the market and to sustaining its revenue potential. Better risk management and data utilization – made possible by tools that can calculate complex exposures and simplify big data – can only lead to better decision making as this segment grows.



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