Assessing lender risk in fund finance markets

(Fifth edition)

CAREY OLSEN

A zero-risk product?

Despite being a relatively long-standing lending product, there have been limited public payment defaults by funds in the fund finance space, and consequently, few test cases to discuss or examine. As a result, the market has legitimately considered this to be a safe product for lenders, and encouraged more market actors to participate. However, with Brexit and the COVID-19 pandemic making a significant negative impact on the socioeconomic climate, lenders need to be more alert than ever to their possible exposure[1].

Risks can be exacerbated by the lender having no direct contractual nexus with fund investors (who might ultimately be responsible for repaying fund borrowings). As the market continues to be seen as an attractive method of generating returns for investors, managers and lenders alike, the number of funds, and lenders participating in them, has continued to increase. Investors have continued to pour record amounts of capital into the secondaries market. 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 the Cayman Islands, Guernsey and Jersey, 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 herein relate to:

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

In discussing these 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. We also explore and consider briefly how developments in fintech might be able to reduce or mitigate these risks or eliminate them altogether. Institutional lenders are investing heavily in fintech in other areas of their business, and there are some obvious efficiencies that could be achieved in this space.

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 corporate general partner and the fund limited partner (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, will often invest in a feeder vehicle for ERISA purposes which, in turn, invests in a master fund.

Whilst, in many cases, the feeder fund will have a direct relationship with the lender and be an obligor under the facility agreement, there are a significant number of structures where the lender has no direct contractual relationship with the feeder fund and, in such cases, a common option is to take cascading security.

In these circumstances, the feeder fund may present a greater degree of risk to a lender, as the lender will be a further step removed from the ultimate investors and source of funds, 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 main fund, although this is not always permitted under the 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. Cascading security is where the feeder vehicle grants security over its uncalled commitments to the main fund and, in turn, the main fund grants 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).

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.

Legal perspective

Capacity and authority

Complex cross-jurisdictional fund structures can present a plethora 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 document(s) and all ancillaries. 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, and it should also be considered whether either entity holds any power or right in its own capacity.

Where the general partner fully 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 in 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

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 this security, particularly where the finance documents are governed by, for example, English law or New York law, and the general partner or the manager is a Jersey 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 where they are 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 security of the 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) provide that security must be taken in the jurisdiction where the asset has its *situs*. Therefore, in the Jersey example, where a Jersey bank account is to be secured, a Jersey security interest will need to be obtained over that account, irrespective of the existence of any foreign law debenture.

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 sthe perfection requirements applicable to the Cayman *situs* property.

Overall, we would also note that 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 the European market, and in particular in the UK, will largely see taking local law security as 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 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. Technology can be used to aid contractual review and reduce document review times; however, it should be used in conjunction with a traditional review to ensure there are no gaps or that no new contractual limitations are introduced.

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 worse 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.

As technology develops and contract mapping, legal automation and smart contracts become more widely adopted in legal and banking practice, risks related to capacity may be almost entirely removed, as contracts can be programmed to be automatically drafted to track each party's various capacities based on the constitutional documents and wider contractual arrangements.

The numerous blockchain initiatives launched in the banking and finance space 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]. Consideration should therefore also be given to whether such contracts are enforceable under the laws of all the relevant jurisdictions. Jersey law, for example, should recognise smart contracts as enforceable legal contracts provided that the usual rules of contracts are met. This is explored at length in the forthcoming article by Emma German, "*The Recognition Of Smart Contracts In Jersey*"[4].

In parallel fund arrangements, there are often 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). This effectively caps the ability of each parallel fund to guarantee the liabilities of the other requiring amendments to be in the facility.

In practice, it can be hard, or even impossible, for a lender to adequately monitor whether these 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. This highlights the importance of robust information covenants within facility agreements and/or third-party security documents, as well as 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.

Again, if conditions and data contained in loan agreements are captured and monitored from the moment the facility is in place on an ongoing basis using technology (e.g. using blockchain technology), this could mitigate this risk. Presently, as we understand it, post-completion loan documents are sent to lenders in a PDF "bible" of transaction documents from which only a limited section of information is pulled and input manually into monitoring platforms, immediately limiting the monitoring that can be done. If lenders had "live" access on a blockchain platform to: (i) account information for all accounts (even those not held with them) and if automated payments were set up on certain trigger events (e.g. payments in and out); and (ii) relevant client information (e.g. in relation to the fund assets and investors), constant automated monitoring of caps and covenants would become possible.

Equally, it is important to confirm the presence of other, more subtle restrictions that may have similar consequences for a lender; for example, intra-fund cost-sharing limitations (where payments in respect of guarantees or indemnities given to lenders are classed as partnership expenses within the ambit of such provisions).

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 perhaps 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

2 ISDA have 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 11 December 2020].
3 Clifford Chance (2019) "The digital future of syndicated loans: Loans & Tech: Now and the future" https://talkingtech.cliffordchance.com/en/industries/fintech/the-digital-future-of-syndicated-loans.html [accessed on 11 December 2020].
4 See: German, E (2021) "The Recognition Of Smart Contracts In Jersey" to be published in the February 2021 edition of the Jersey and Guernsey Law Review.

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 or 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 covenant prohibitions on the general partner as manager from cancelling or waiving investor commitments. Jersey 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. If notice is given using method (b), we advise lenders to request evidence that each investor has accessed and reviewed the notice if uploaded to an investor portal. This may not always be practical.

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

Remedies: The principal remedy for balance-sheet-solvent structures 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:

i. 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;
ii. equitable remedies including claims against the management and dishonest assistance;
iii. tortious remedies including inducing a breach of contract and lawful or unlawful means of conspiracy; and
iv. 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 Ardil Salem entitled: "*Fund finance and releases of investor commitments: How can lenders protect themselves?*"[5].

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

Ideally speaking, in our view, fund documents should 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 fund 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 such level of dishonesty or knowledge on the part of such investors. There is added protection in the form of a statutory clawback in the Limited Partnerships (Jersey) Law 1994 which provides that, for a period of six months from the date of receipt, a limited partner is liable to repay (in whole or part) a payment it received representing a turn 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.

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.

5 Russell, A, Munden, R and Salem, A (2018) "Fund Finance And Releases Of Investor Commitments: How Can Lenders Protect Themselves?" [online] Available at: https://www.careyolsen.com/briefings/fund-finance-and-releases-investor-commitments-how-can-lenders-protect-themselves. [Accessed on 11 December 2020].

Competition in the market

Recent years have 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.

Unsurprisingly, the presence of new market players has made the market more competitive. One result has been to drive down margins, serving to increase further the need to avoid unnecessary structural or other concerns, which is no doubt popular with borrowers; margins predicated on lenders rarely or never losing money require deals to be structured accordingly. Notwithstanding that fact, another result has been an 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.

While the number of new participants, the reduction in costs and the innovation in terms are doubtless to be welcomed from the perspective of the market as a whole, 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.

Concentration 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.

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],which took effect on 1 January 2019, address, among other things, the aggregation of bank exposures, and in particular, exposures to 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:

i. there is no economic interdependence[9];
ii. 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 have access to its own assets on a bankruptcy only and not partnership assets (save in relation to partner liabilities owed to the general partner such as for fees); and/or
iii. 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 a fund functionary's 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

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 11 December 2020].
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.

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 land 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 thereof. 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 in the borrowing base provisions relating to the calculation of the borrowing base, will assist the lender in managing concentration exposures.

With the increased use of automation, artificial intelligence and data science in the financial services industry and more widely, lenders are becoming increasingly aware of the value of the data that 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 would be to use artificial intelligence 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). This in turn could feed into a blockchain storing and managing data about the borrowing structure and covenant package so that active monitoring can be undertaken, ensuring that more informed decisions can be taken more quickly, e.g. in relation to certain breaches and under defaults or automation of payments.

As outlined above, a lender's success will be intrinsically linked to its identifying to which parties to 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 the future, market behaviour itself may well change, with the increased use of artificial intelligences and algorithms in investment management and strategy, and quantitative investing – which may well lead to more passive investment management, less influenced by human decision-making. When considered from a lender's perspective, trying to manage risks associated with investment management, the more clinical and analytical the investment decision-making, the easier it will be to model, predict and manage.

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 which 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 has required banking institutions to increase their capital and liquidity buffers which should help alleviate certain liquidity pressures and equip lenders to tolerate greater stress in financial markets, including due to the economic fallout of COVID-19 and Brexit. However, recent equity market volatility, liquidity tightening, widening funding spreads, operational fails, and other challenges have put significant pressure on the financial markets. *The October 2020 IMF World Economic Outlook*[10] is a sobering read, with its title "A Long and Difficult Ascent" reporting on the steep contraction in global economic activity and the impact of subsequent COVID-19 outbreaks on the speed of any recovery.

10 International Monetary Fund (2020) World Economic Outlook: A Long and Difficult Assent, Washington, D.C.: International Monetary Fund, Publications Services [online] available at: https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020 [accessed on 11 December 2020].

"Deep recessions invariably entail widespread liquidity shortfalls... Prolonged liquidity shortfalls can readily translate into bankruptcies and firm closures... there have been a few prominent bankruptcies... and the rate of corporate bond defaults more broadly is at its highest since the global financial crisis... the risk of a wider cross-section of firms experiencing deep liquidity shortfalls and bankruptcies is tangible... Such events would lead to large job and income losses, further weakening demand. At the same time, they would deplete bank capital buffers sand constrain credit supply, compounding the downturn."

We are aware that certain bank lenders are already taking steps to strengthen their liquidity and reporting capabilities and, in some cases, to monitor them more frequently.

Generally, lenders may take a number of steps to manage exposure, including: (i) stress-testing the loan book; (ii) monitoring for concentrations of investors, functionaries and sectors as outlined above; (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, and in addition to the typical loan-to-value covenants and other financial covenants within facility documents.

ESG risks

ESG risks are increasingly being recognised as credit risks in their own right[11]. S&P recently reported that many lenders have adopted explicit ESG policies and that more than half of institutions surveyed 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 when the legal and regulatory framework moves to requiring more rigorous reporting standards in line with the EU taxonomy, the UK taxonomy (in due course) and local law requirements. As these reporting standards 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.

As noted above, many of these risks 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. In the near future, technology could provide solutions to data management and analysis, making it easier and quicker to access, record and analyse data collated by the lender. In addition, artificial intelligence programmes may be implemented to assist with collating due diligence, monitoring and harnessing publicly available information.

However, there are 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. The recent LMA conference on syndicated lending shows the level of interest and planned development in this space, showcasing initiatives such as developments in legal tech, e.g. automating document production (which is being used in the legal market) and blockchain initiatives of LMA and Euroclear.

11 See: https://www.spglobal.com/marketintelligence/en/news-insights/blog/esg-investing-is-becoming-critical-for-credit-risk-and-portfolio-management-professionals.

Authors

Robin Smith
Partner

D +44 (0)1534 822264
E robin.smith@careyolsen.com

Robin is a partner in the banking and finance team of the Jersey office of Carey Olsen. He acts for both lenders and borrowers on complex financings, refinancings and restructurings and has significant experience in relation to all types of financing of investment funds. He is consistently recognised in legal directories, both as an individual and as part of the team which he leads. Robin trained as an English solicitor in London. Following his move to Jersey in 2002, he spent six years at another leading law firm in Jersey, prior to joining Carey Olsen in February 2008. Robin is qualified as a solicitor in England and Wales, a Jersey Advocate and was educated at King's College, London.

Alistair Russell
Partner

D +1 345 749 2013
E alistair.russell@careyolsen.com

Alistair is a partner in the corporate and finance group of Carey Olsen in the Cayman Islands and advises on all aspects of finance, corporate, investment funds and commercial law.

He has advised clients on a broad range of transactions including financing, private equity, joint ventures, mergers and acquisitions and capital markets, and is described by clients in IFLR1000 as "the best Cayman lawyer we've ever worked with".

Alistair is rated as a Leading Lawyer – Highly regarded in IFLR1000 2019. Alistair was formerly with Skadden, Arps, Slate Meagher & Flom and Cleary, Gottlieb, Steen & Hamilton, each in London. He obtained a Bachelor of Civil Law with distinction from Christ Church, Oxford University, and an LLB with first class honours from Kings College London.

Alistair was admitted as a solicitor of the Supreme Court of England and Wales in 2008 and as an attorney-at-law in the Cayman Islands in 2013.

Emma German
Senior Associate

D +44 (0)1534 822474
E emma.german@careyolsen.com

Emma deals with a breadth of international corporate and finance transactions. She advises lenders and borrowers including global financial institutions, trustees and ultra-high net worth individuals on all aspects of Jersey corporate, banking and finance matters. Emma has particular experience in fund finance and the financing of Jersey investment holding structures, including unit trusts and partnerships. She has worked on several high-profile transactions. Emma's expertise includes the raising of finance through the issuance and listing of Eurobonds and other securities on the International Stock Exchange. Emma has a special interest in the application of fintech developments to finance transactions.

Emma is an advocate of The Royal Court of Jersey. She is a barrister of England and Wales (non-practising) and an English solicitor. She was educated at King's College, London University.

Emma joined Carey Olsen in 2005. In 2016, she was seconded to The Royal Bank of Scotland International Limited.

Originally published in conjunction with Global Legal Insights.

PLEASE NOTE

Please note that this guide is only intended to provide a very general overview of the matters to which it relates. It is not intended as legal advice and should not be relied on as such. © Carey Olsen 2021.

Our offices

Jurisdictions

Bermuda

Carey Olsen Bermuda Limited
Rosebank Centre 5th Floor
11 Bermudiana Road
Pembroke HM 08
Bermuda

T +1 441 542 4500
E bermuda@careyolsen.com

British Virgin Islands

Carey Olsen (BVI) L.P.
Rodus Building
PO Box 3093
Road Town
Tortola VG1110
British Virgin Islands

T +1 284 394 4030
E bvi@careyolsen.com

Cayman Islands

Carey Olsen
PO Box 10008
Willow House
Cricket Square
Grand Cayman KY1-1001
Cayman Islands

T +1 345 749 2000
E cayman@careyolsen.com

Guernsey

Carey Olsen (Guernsey) LLP
PO Box 98
Carey House
Les Banques
St Peter Port
Guernsey GY1 4BZ
Channel Islands

T +44 (0)1481 727272
E guernsey@careyolsen.com

Jersey

Carey Olsen Jersey LLP
47 Esplanade
St Helier
Jersey JE1 0BD
Channel Islands

T +44 (0)1534 888900
E jerseyco@careyolsen.com

International offices

Cape Town

Carey Olsen
Protea Place
40 Dreyer Street
Claremont
Cape Town 7708
South Africa

T +27 21 286 0026
E capetown@careyolsen.com

Hong Kong

Carey Olsen Hong Kong LLP
Suites 3610-13
Jardine House
1 Connaught Place
Central
Hong Kong

T +852 3628 9000
E hongkong@careyolsen.com

London

Carey Olsen LLP
Forum St Paul's
33 Gutter Lane
London EC2V 8AS
United Kingdom

T +44 (0)20 7614 5610
E londonco@careyolsen.com

Singapore

Carey Olsen Singapore LLP
10 Collyer Quay #24-08
Ocean Financial Centre
Singapore 049315

T +65 6911 8310
E singapore@careyolsen.com

OFFSHORE LAW SPECIALISTS

BERMUDA BRITISH VIRGIN ISLANDS CAYMAN ISLANDS GUERNSEY JERSEY
CAPE TOWN HONG KONG LONDON SINGAPORE

careyolsen.com