Ogier

Fund finance regional perspectives and updates - February 2023

Insights - 09/02/2023

After two years of disruption caused by Covid, 2022 arrived with a new set of challenges for the global financial markets, impacting activity in the fund finance space.

"You would have been forgiven for wanting 2022 to be a return to "normal", but what we saw was war and tragedy in Ukraine, increasing tensions between the US and China, continuing supply side shortages, inflation at record levels, the highest interest rates in years, an all-powerful US Dollar, digital assets and crypto making further moves into the mainstream and making headlines, and economic and political upheaval in the UK," said fund finance partner James Heinicke from Ogier's banking and finance team in the Cayman Islands.

"It was quite a year and clearly uncertainty and challenges will persist in 2023. But it's true to say that those challenges will continue to create opportunities and we expect market conditions will drive innovation resulting in accelerated fund finance product development in 2023."

Ogier's global fund finance team has experts located in our BVI, Cayman Islands, Guernsey, Ireland, Jersey, Hong Kong and Luxembourg offices. In this briefing, our specialists offer their insights on trends and developments in the fund finance space across our regions.

BVI

Virtual Assets

In the wider BVI funds space, virtual assets have continued to be a very active asset class, from their exponential growth through to their more recent challenges. The BVI has recently enacted the Virtual Assets Service Providers Act, 2022 (the **VASP Act**). The VASP Act has not yet come into force but we are expecting that this will happen in the near future.

The VASP Act introduces a registration and supervisory framework for persons engaged in certain virtual asset business activities. However, while the new regulations apply to large section of the operators in the virtual asset space, particular those operating businesses or otherwise having possession or control over third party assets, it does not yet apply to simple issuances and sales of virtual assets, so ICOs or other token generation events might not be impacted.

Aside from the above, however, there do remain some questions as to the full extent of the scope of the VASP Act, and particularly how it interacts with existing BVI regulatory regimes – such as under those applying to investment funds and other traditional securities and investment business - but we are expecting the BVI regulator to issuance guidance notes and subsidiary regulations to the VASP Act in the future that should clarify matters. For the time being though, we do not expect structures to become subject simultaneously to dual regulatory regimes.

Cayman Islands

A tale of two halves

The first half of 2022 generally felt very much like a continuation of where we had left off in 2021. In the second half of 2022 we saw a market shift – whilst some subscription lenders remained very active we saw a reduction in total new money subscription facilities, although we worked on a slew of facility amendments and joinders.

NAV

In 2022 we continued to see more NAV facilities in both the closed and open ended fund space. Given the increase of closed ended fund structures over the last decade there is a burgeoning number of closed ended funds whose life cycle is beyond their commitment and investment periods. In a more challenging exit environment fuelled by macroeconomic uncertainty we saw a rise in the use of continuation vehicles as an alternative to traditional exits. With an increase in non-bank lenders in the NAV space and with the secondaries market predicted to be active in 2023, we expect that NAV financing will increasingly offer potential liquidity solutions.

Fund level credit support

Fund level credit support (be that direct guarantees or other credit support such as equity commitment letters) appeared to be on the increase in 2022. As portfolio company borrowing and refinancing becomes more challenging in a higher interest rate environment we expect fund level credit support to increase further in 2023.

Exempted limited partnership formation

The Cayman Islands exempted limited partnership (**ELP**) has a variety of uses and, as many will be aware, is the vehicle of choice for closed-ended funds in Cayman. As of the end of 2021, the total number of active ELPs reached a record 34,343. ELP formations continued to increase in 2022, albeit at a slower pace than 2021. A total of 4,515 ELPs were formed in 2022; down from 5,601 ELPs in 2021 (which was a record year for ELP formation in Cayman). But this doesn't tell the whole story. In the second half of 2022 the pace of ELP formation decelerated significantly – 1,919 formation in the second half of 2022; 825 formations in Q4 of 2022 (down from 1,448 in Q4 of 2021). Of course, ELPs are not only used for closed-ended funds, but the statistics do indicate slower closed ended fund formation.

Guernsey

New insolvency law

Guernsey has modernised its insolvency legislation, with the introduction of a new insolvency law and rules, which came into force on 1 January 2023. The new law brings Guernsey's insolvency legislation in line with comparable jurisdictions such as England and Wales, by remedying issues in the previous regime such as the lack of creditor oversight in a voluntary liquidation and the lack of statutory clawback provisions.

Alternative lenders

We are seeing a greater appetite for fund finance products from alternative lenders, who are able to provide the credit support and flexibility that banks may not be able to provide currently.

Hybrid/NAV facilities

In the last two years, NAV/hybrid facilities have become increasingly popular, and we expect this to be an area of growth going forward.

Single investor strength

As in Jersey, we continue to see instances of lender credit approval focusing on the strength of a single investor (in a multi-investor fund).

GP facilities

Despite the market expectation that providing GP facilities would be a popular trend in 2022, the numbers were not particularly high. However, it could be an area of growth in 2023.

ESG

ESG is well established in the fund finance market and we expect to see ESG considerations become increasingly important as regional and international regulation continues to develop this year.

Hong Kong

Extending credit in a challenging market

Notwithstanding current global and local macroeconomic and geopolitical challenges, financiers and funds remain positive in their mid-to-long term outlook on the APAC equity markets. Further, whilst sponsor backed M&A deal volume was markedly down in 2022, liquidity in the debt markets remained essential for sponsors, especially those that needed to refinance maturing facilities or manage investments remaining on the balance sheet for longer in the more challenging exit environment. Therefore, banks and other financiers have continued to provide sufficient liquidity to support APAC based funds during 2022. We expect lenders to continue to strategically deploy balance sheet to refinance maturing debt and finance the right kind of new credits in 2023.

Alternative facilities

In current market conditions, we expect alternative financing structures to continue to increase in prevalence in 2023. Net asset value (**NAV**) facilities (and, to a lesser extent, hybrid facilities) are now truly in play, after being discussed from the side-lines for several years. Further, GP facilities are becoming an increasing proportion of the overall APAC fund level indebtedness.

Environmental, social and governance (ESG)

ESG is now well established in the APAC debt finance market, and fund finance is no exception. We expect this to continue, balanced against a need for financiers to ensure the ESG bona fides of the relevant fund and that the fund has the necessary tools in place to perform against the ESG principles set out in the loan documentation.

Ireland

Growing funds centre

As of summer 2022, Ireland was the third largest funds centre in the world with investment fund assets totalling €3,903 trillion and more than 8,500 Irish domiciled funds, including sub-funds.

Irish Collective Asset-Management Vehicle (ICAVs)

The ICAV vehicle introduced in 2015 continues to be a popular choice for newly established funds in Ireland. It provides administrative flexibility and is particularly attractive to US investors as it may be eligible to elect to be treated as a transparent entity for US federal income tax purposes. The ICAV is now the most commonly used structure for new funds established in Ireland.

ILPs

The recent updates to Investment Limited Partnership laws mean it is now possible to use the investment limited partnership structure to create umbrella funds – allowing sub-funds for different types of assets and investors. Prior to these changes there were very few ILPs but numbers have increased to 30 over the last year.

LPs

Limited partnerships continue to be the favoured structure in Ireland for unregulated investment funds.

ESG funds

The SFDR continues to have an impact and it is thought that the restructured ILP law will allow for more 'green' funds to be operated in Ireland.

Feeder fund structures

We have seen an increase in financings involving feeder fund structures and in these scenarios the structuring of the security package is important as an Irish regulated fund is not permitted to give guarantees to support the obligations of a third party (which can include a sub-fund in an umbrella structure). 'Cascading pledges' are often used here to ensure the rule on guarantees is not infringed.

Non-bank lenders

We have seen an increase in non-bank lenders providing financing to fund structures, particularly in the commercial real estate space.

Irish Property Funds

The Central Bank of Ireland has recently published a macroprudential policy framework for Irish property funds authorised under domestic legislation and investing 50% or more of their assets under management in Irish property. A leverage limit of 60% has been introduced along with regulatory guidance on liquidity timeframes. This new framework could have an impact on asset-backed lending into Irish Property Funds – to be monitored in 2023.

Jersey

Limited liability companies (LLCs)

Jersey is modernising its corporate framework with the introduction of LLCs, aligning the jurisdiction with other prominent fund finance centres. US familiarity with LLCs might give rise to fund managers attracting US investors. This is an exciting development for jurisdiction and we look forward to being part of this growth.

Alternative lenders

There is a shift towards alternative lenders in the fund finance space. We expect this trend to continue, in particular in relation to unconventional transactions where commercial banks have less risk appetite and additional credit constraints.

Single investor strength

We continue to see instances of lender credit approval focusing on the strength of a single investor (in a multi investor fund) sometimes supported with an investor letter and, as a result, those lenders have had to navigate capital call mechanics (which generally only contemplate pro rata calls across all investors instead of discretionary calls against selected investors) in the context of capital call security accordingly.

Risk retention vehicles (RRVs)

We continue to see Jersey RRVs and advise on their financing arrangements. We look forward to seeing how the structured finance market develops this year, particularly in the European CLO space, and its impact on RRV activity.

ESG

We continue to see facilities with ESG incentive margin reductions baked in.

Hybrid/NAV facilities

We have also seen more NAV/hybrid facilities than previously, with lenders happy with the credit worthiness of the assets of the relevant fund(s) when the commitment period has ended or is near to ending.

GP facilities

There was 'market chatter' relating to a trend of providing GP facilities in 2022, this could potentially be a rising area in 2023, but we did not see high numbers last year.

Luxembourg

Security

It is generally accepted market practice in Luxembourg to require either standalone or, as is usually the case for US files, parallel Luxembourg law governed security over the capital call rights of a Luxembourg fund in respect of its investors. Having a Luxembourg law pledge over uncalled capital commitments is necessary to provide protection to the lender in case of enforcement, allowing the lender to enforce the pledge in Luxembourg while pursuing traditional avenues of enforcement pursuant to the US or English law governed loan documents. This is often combined with another Luxembourg pledge on any bank accounts which may be held by the fund (obligor) in Luxembourg to ensure any amounts received from investors are captured on such account.

Investor notices

Subscription credit facilities have traditionally been viewed as low risk for lenders. Consistent with our Guernsey colleagues, on European originated deals post Abraaj we have seen lenders taking a stricter approach with respect to the investor notice. In Luxembourg, evidence of delivery is now an expected requirement, in addition to the usual requirement of investor notices being delivered to investors on the same day as closing. Tighter restrictions on investors transferring out of the fund are also included in the loan documents with lenders requiring prior written consent to the transfer of any fund interests.

Due diligence on delegated powers

Where a Luxembourg fund is an alternative investment fund it will be required to appoint an alternative investment fund manager (**AIFM**). On occasion, AIFM agreements are not drafted with a subscription facility in mind and can therefore sometimes be unclear as to delegation of specific powers. As part of the due diligence process, it is important to thoroughly review any AIFM agreement, investment adviser agreement or investment management agreement, in tandem with the fund's limited partnership agreement, to ascertain exactly what rights have been delegated from the fund and its general partner to an AIFM, or sub-delegated to an investment advisor (**IA**) or investment manager (**IM**), as applicable. Should any power beyond general portfolio and risk management services be delegated to an AIFM, IA or IM, it is becoming increasingly common practice to add such parties to the loan documents.

NAV facilities

Whilst subscription facilities remain the most common fund finance product, NAV facilities have picked up considerably in the last couple of years. With a variety of forms and lenders (including alternative lenders),more activity is expected in this space and NAV financings should continue to be an area of growth in the near future.

About Ogier

Ogier is a professional services firm with the knowledge and expertise to handle the most demanding and complex transactions and provide expert, efficient and cost-effective services to all our clients. We regularly win awards for the quality of our client service, our work and our people.

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