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Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio

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On November 29, 2013, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC, and collectively, the Agencies) published in the Federal Register a notice of proposed rule making (the Proposed Rule) to strengthen the liquidity positions of large financial institutions.[2] The Proposed Rule creates for the first time a standardized liquidity requirement in the form of a minimum liquidity coverage ratio (LCR) and generally follows the liquidity ratio requirement as revised and adopted by the Basel Committee on Banking Supervision of the Bank of International Settlements (Basel LCR) earlier this year.

The Proposed Rule's LCR (US LCR) aims to require banking organizations with $250 billion or more in total assets and certain other large or systemically important banking or other institutions (Covered Banks) to hold sufficient high-quality liquid assets (HQLA) to meet the Covered Bank's liquidity needs for a thirty (30) day stress scenario.[3] As with many of the statutory and regulatory requirements emanating from the financial crisis, applying the requirements of the US LCR to capital commitment subscription credit facilities (each, a Facility) requires both seasoned familiarity with Facility structures and reasoned judgment as to the application.

The Basic LCR Ratio

Both the Basel LCR and the US LCR are in the form of a minimum ratio, the numerator of which consists of the value of the Covered Bank's HQLA and the denominator of which consists of the Covered Bank's expected total net cash outflows over a thirty (30) day period. For both the Basel LCR and the US LCR, the minimum LCR requirement is 100% (i.e., that the LCR equals or exceeds 1.0). For the numerator, assets that constitute HQLA are generally unencumbered liquid assets without transfer restrictions that can reasonably be expected to be converted into cash easily and quickly. The Proposed Rule provides categories of HQLA and sets forth qualifying criteria and haircuts for less immediately liquid HQLA. The US LCR denominator is the total net cash outflows, which is defined as total expected cash outflows minus total expected cash inflows, during the stress period. Under the US LCR, Covered Banks would be required to hold sufficient HQLA to cover the highest daily amount of cumulative net cash outflow for the stress period. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities (such as the undrawn portion of a revolving tranche of a Facility) by the predicted rates at which they are expected to be drawn down. Determining the drawdown of the undrawn portion of a Facility for purposes of

calculating the US LCR's cash outflows will be the primary focal point for Facilities under the Proposed Rule.[4]

Cash Outflow Framework

Committed Credit Facilities and Liquidity Facilities. The US LCR specifies outflow rates that are intended to approximate cash outflows for particular funding obligations during severe liquidity stress. The outflow rates were reportedly developed by taking into account supervisory experience and observation from the recent financial crisis. Outflow rates are categorized by the particular type of funding obligation and Facilities will be classified in the category titled "Commitment Outflow Amount," which includes both committed "credit facilities" and "liquidity facilities" (terms explicitly defined in the Proposed Rule). The distinction has a material impact on outflow rates, as liquidity facilities are given significantly higher outflow rates than credit facilities. Under the US LCR, a "liquidity facility" is defined as "a legally binding agreement to extend funds at a future date to a counterparty that is made expressly for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding." (Emphasis added.) The definition goes on to articulate examples of liquidity facilities, including "an agreement to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from, any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper." On the other hand, a "credit facility" is defined as "a legally binding agreement to extend funds if requested at a future date, including a general working capital facility such as a revolving credit facility for general corporate or working capital purposes." While virtually all Facilities offer their closed-end real estate and private equity fund borrowers (each, a Fund) a certain degree of liquidity (as does every corporate revolver), we think Facilities are more appropriately categorized as "credit facilities" for the reasons discussed below; however, we admit this determination is not unequivocally clear from the proposed US LCR related text. In our experience, Facilities are typically not made "expressly for the purpose of refinancing the debt of the counterparty" as required by the definition of a liquidity facility.[5] Facilities are not standby liquidity to cover a Fund's inability to issue commercial paper, obtain other short-term "debt" or the like. Rather, Facilities are established to provide general working capital to a Fund, a concept that is expressly carved out of the definition of liquidity facility: "[l]iquidity facilities exclude facilities that are established solely for the purpose of general working capital, such as revolving credit facilities for general corporate or working capital purposes."

Outflow Rates. Outflow rates on committed credit facilities and liquidity facilities are stratified by borrower classification, as the Agencies have assumed that financial institutions will be highly interconnected and most impacted during a stress period and therefore most likely to draw down all available funds. Thus, for example, a Covered Bank's outflow rate is 10% for a committed credit facility and 30% for a committed liquidity facility where the borrower is a "wholesale customer or counterparty that is not a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, or identified company, or to a consolidated subsidiary of the any of the foregoing" (such excluded entities being Specified Financial Borrowers). (Emphasis added.) In contrast, the outflow rate for Specified Financial Borrowers is 40% for a committed credit facility and 100% for a committed liquidity facility.[6] We expect that a majority (but not all) of private equity Fund borrowers will be Specified Financial Borrowers since they will satisfy the definition of "non-regulated fund," which is: "any hedge fund or private equity fund whose investment adviser is required to file SEC Form PF (Reporting Form for Investment Advisers to Private Funds and

Certain Commodity Pool Operators and Commodity Trading Advisors), and any consolidated subsidiary of such fund....” Under SEC Rule 204(b)-1, adopted under the Investment Advisers Act of 1940 (Advisers Act), and in CFTC Rule 4.27, adopted under the Commodity Exchange Act, most investment advisers of private equity funds (Sponsors) holding in excess of $150 million in assets under management are required to file Form PF. However, there are exceptions, including real estate funds that rely on the exception from the definition of “investment company” under Section 3(c)(5)(C) of the Investment Company Act of 1940, and venture capital funds whose advisers are relying on the “venture capital fund adviser” exemption from registration under the Advisers Act. We estimate that a fair portion, perhaps even a majority, of the typical real estate Fund Facility borrowers will be exempt from filing Form PF, including most core real estate Funds. However, those real estate Funds sponsored by multi-asset class Sponsors, such as those that also sponsor private equity Funds, are likely to be required to file, and hence, “non-regulated funds.” Thus, based on the above, our expectation is that the majority of Facilities will be classified as committed credit facilities to Specific Financial Borrowers under the Proposed Rule, drawing an outflow rate of 40%, but that the Facilities with Fund borrowers exempt from filing Form PF would only be subject to a 10% outflow rate.

Facility Considerations under the Proposed Rule

General Considerations. Under the Proposed Rule, Covered Banks will be required to comply with the US LCR requirement by January 1, 2017, with phased-in compliance of 80% by January 1, 2015 and 90% by January 1, 2016. Thus, current Facilities with a typical three (3) year tenor will likely become subject to the US LCR if the Proposed Rule is adopted as proposed. Consequently, even in a current Facility, Facility lenders (Lenders) might want to consider including or adding the following:

1) The stated purpose of providing working capital to the Fund should be express in the Facility documentation. If a Facility is expressly offered only to provide short term, bridge capital while awaiting the receipt of capital contributions from the Fund’s limited partners, a Facility runs the risk of confusing the Agencies and unintentionally appearing closer to extending monies “for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding” (and hence being classified a liquidity facility). Because Facilities “that have aspects of both credit and liquidity facilities would be classified as liquidity facilities for the purposes of the proposed rule,” Lenders should steer clear from any ambiguity as to intent.

2) Lenders should confirm via representation whether their Fund borrowers are required to file Form PF under SEC Rule 204(b)-1, as a lower outflow rate may be available in the event the Fund borrower satisfies an exception to the reporting requirement.

3) Lenders should pay close attention to the structure of their Fund borrowers and any alternative investment vehicles or portfolio companies a Fund borrower may wish to have join the Facility. Because different borrowers have different classifications under the US LCR, a Lender would not want to unknowingly increase its outflow rate by permitting the joinder of a new Fund entity that resulted in an unexpected, increased outflow classification.

Structural Solution. There is a potential Facility structuring solution that would provide relief to the 40% outflow rate for Lenders, although they would require material changes and concessions from Fund borrowers. The outflow rates apply only to “committed” credit facilities, not uncommitted credit facilities. As a

portion of the Facility market currently operates on an uncommitted basis, offering uncommitted Facilities (or perhaps separate committed and uncommitted tranches), would result in a 0% outflow rate on any uncommitted portion.

Real-World Cash Outflow

We believe the 40% outflow rate for Facilities under the US LCR is in complete and total contrast with the actual experience realized by Lenders during the crisis. In fact, based on anecdotal reports from many different Lenders, Facility utilization on a portfolio-wide basis never increased in a material way throughout the entire crisis, let alone during any thirty (30) day stress period. Borrowing under a Facility creates immediate negative arb for a Fund if it must hold the borrowed cash and not promptly deploy it into an investment. At the height of the crisis, Funds were in large part nervous about acquisitions because pricing marks were hard to come by. Most sat patiently and waited, and did not borrow extensively under their Facility. In fact (and ironically), some Lenders were frustrated with low unused commitment fee pricing because many Facilities were so undrawn for so long that Lenders were challenged to meet their own return projections on their Facilities. For Funds, internal rate of return (IRR) is extremely important, and paying interest on large amounts of undeployed cash can materially undermine IRR. The 40% outflow rate is, in our opinion, divorced from actual experience during the financial crisis and very conservative. It does not "reflect aspects of the stress event experienced during the recent financial crisis," as the Agencies intend, and we expect that multiple Lenders could provide clear and convincing data supporting a lower outflow rate. However, we are very sympathetic to the Agencies here, as Facilities are a largely under-the-radar lending product in a completely private market, and the Agencies cannot possibly be expected to be familiar with Facility performance characteristics without extensive industry input.[7] The Agencies have explicitly requested comments on the Proposed Rule by January 31, 2014. In light of the disconnect between actual Facility utilization during the crisis and the proposed 40% outflow rate, Lenders should consider what impact the US LCR and a 40% outflow rate will have on their Facility portfolio. They should consider how it will impact their capital requirements, internal cost of capital, and what if any impact it will have on the unused commitments fees they will need to pass along to Funds. We expect that the actual impact of the US LCR will vary significantly for different Lenders. These and other factors should be considered in determining whether a comment letter to the Agencies may be appropriate.

Endnotes

1 Paul Forrester is a respected corporate finance and securities lawyer whose practice is especially focused on structured credit, including collateralized loan obligations, energy (including oil and gas, utilities, shipping, refinery and pipeline) financings and project development, and financing (especially concerning renewable energy, industrial, petrochemical, power and transportation projects and infrastructure). Carol Hitselberger is co-leader of Mayer Brown's Banking & Finance practice, and focuses her practice in the structured finance area. Kiel Bowen is a partner in Mayer Brown's Banking & Finance practice, where his practice centers on fund finance. Adam Kanter is an associate in the Corporate & Securities practice of the Washington office.

2 For an in-depth review of the Proposed Rule, please see Mayer Brown LLP's Legal Update, "The US Banking Regulators Propose a Liquidity Coverage Ratio For Large Banking Organizations and Systemically Important Non-Banks," available at http://www.mayerbrown.com/The-US-Federal-Reserve-Board-Proposes-a-Liquidity-Coverage-Ratio-For-Large-Banking-Organizations-and-Systemically-Important-Non-Banks-10-30-2013/.

3 Under the US LCR, the specified stress period for standard Covered Banks is thirty (30) calendar days, while the stress period for certain smaller Covered Banks (those with total assets in excess of $50 billion) is reduced to twenty-one (21) calendar days. This Legal Update focuses on the thirty (30) day stress period but recognizes the twenty-one (21) day period will be relevant for certain Covered Banks.

4 Particular business segments within a Covered Bank may have additional issues in connection with a Facility, such as

the outflow rates for deposits from fund depositors, derivative exposures to a fund borrower, etc.

5 However, at least with respect to those Facilities that are merely providing short-term funding in anticipation of capital call proceeds, they are, at least potentially in the view of the Agencies, an extension of funds to a counterparty "when it is unable to obtain a primary or anticipated source of funding."

6 The outflow for any committed facility to a special purpose entity, whether credit or liquidity, is 100%

7 We also suspect that Facilities may be one of the very few lending products to financial institution-type borrowers that did not experience high outflow rates during the crisis. Thus, the default assumption by the Agencies that financial institution-type borrowers will be most likely to face liquidity constraints and hence draw down on all available funding sources may be predictably and understandably overbroad in this context.

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