

Basel III Regulations and the Move Toward Uncommitted Lines of Credit

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Background/Key Issues

Basel III, a regulatory capital framework for financial institutions, was developed by the Basel Committee on Banking Supervision (the "Basel Committee") in response to the financial crisis that began in 2008. During the crisis, banks were unable to dig themselves out of financial trouble due to their relative inability to convert assets into cash. In hopes of preventing a reoccurrence of this problem, the Basel Committee created Basel III to better regulate and supervise the financial sector and manage its risk. In so doing, Basel III's reforms target the financial sector on both micro and macro levels.

The Basel III regulations have been gradually phased in by participating jurisdictions² and, among myriad effects on the capital markets, have impacted the types of subscription credit facilities lenders are putting in place. A subscription credit facility is an extension of credit by a lender to a private equity fund (the "Fund") wherein the lender is granted a security interest in the uncalled commitments of the Fund's limited partners to make capital contributions when called from time to time by the Fund's general partner (a "Subscription Facility"). This article will briefly summarize the Basel III regulations as they have been implemented in the United States, examine a resulting increase in the use of uncommitted lines of credit, and consider

certain issues in the context of uncommitted lines of credit.

Basel III Regulations

While a full analysis and description of the U.S. implementation of Basel III (as thereby implemented, "U.S. Basel III") is beyond the scope of this article, it is worth understanding the general structure of this regulatory framework, which in the United States applies to banks, bank holding companies (except small bank holding companies with less than \$500 million in assets), certain savings associations and savings and loan holding companies (each, a "Bank"). The overall purposes of the U.S. Basel III regulations are to: (i) improve the financial sector's ability to absorb losses during periods of financial and economic stress; (ii) strengthen risk management and governance; and (iii) build greater transparency and disclosures in the financial sector.³ There are a few key components of the U.S. Basel III framework that can be linked to the recent increase in the use of uncommitted lines of credit: a liquidity coverage ratio, a capital conservation buffer, and a leverage ratio.

LIQUIDITY COVERAGE RATIO

The first key feature is the liquidity coverage ratio (the "LCR").⁴ to ensure that Banks have sufficient capital reserves to withstand any severe short-term disruption to liquidity, U.S.

Basel III requires Banks to maintain “an adequate stock of unencumbered high-quality liquid assets (“HQLA”)” that can be easily converted to cash to meet liquidity needs for a 30-day stress scenario. The goal is for a Bank to be able to meet 100% of its total net cash outflows during the 30-day stress period. Implementing a global minimum standard for bank liquidity and “reaffirming that a bank’s stock of liquid assets are usable in times of stress” should strengthen the financial sector’s ability to finance a recovery in the event of another financial and economic crisis.⁵

U.S. agencies jointly issued a final rule in September 2014 that mandates 100% compliance with the minimum LCR standards set out by the final rule, which are more stringent than those under the international Basel III framework, by January 2017.⁶ The final rule applies to large internationally active U.S. banking organizations and any consolidated bank or saving association subsidiary of one of those companies that, at the bank level, has total consolidated assets of \$10 billion or more.⁷

CAPITAL CONSERVATION BUFFER

Another key component of the U.S. Basel III framework is the requirement of a capital conservation buffer: in addition to the requirement that Banks maintain a minimum of 4.5% of common equity tier 1 capital, Banks must retain an additional buffer of 2.5% of common equity.⁸ Together, the two requirements entail that Banks retain a total of 7% of common equity tier 1 capital. Should a Bank fall below the 7% level, additional constraints will be imposed on the Bank’s discretionary distributions. Banks therefore have an incentive to keep more capital on hand, rather than lend it out, to ensure they meet this requirement.

If supervising authorities determine that the credit risk exposure of a Bank is approaching a

level of systematic risk (i.e., when judging whether credit growth in relation to measures such as GDP is excessive and could lead to increased system-wide risk), then in order to combat any risk of failure of such credit exposure, a countercyclical buffer requirement ranging in size from 0% to 2.5% of risk-weighted assets may also be imposed. This is treated as an extension of the capital conservation buffer and would remain in effect until the system-wide risk lessens.⁹

LEVERAGE RATIO

U.S. Basel III also implements a “non-risk-based” leverage ratio (which includes off-balance sheet exposure) for large internationally active U.S. banking organizations that serves as a backstop to the risk-based capital requirements mentioned above.¹⁰ This capital reserve is extra insurance in the event that, despite the new risk-based capital adequacy requirements, the Bank’s exposures turn south and the Bank must rely on its own reserves to avoid systemic collapse. A leverage ratio requirement will prevent the financial sector from building up too much leverage; the leverage ratio is meant to prevent excessive leverage and therefore avoid deleveraging processes that can weaken the financial sector.¹¹

Impact on Credit Facility Markets

The key features of the U.S. Basel III regulations discussed above serve to require Banks to keep more cash on hand in the aggregate. Accordingly, it is expected to be more expensive and/or less profitable for Banks to lend money under the U.S. Basel III regulatory regime. In the context of Subscription Facilities, this expense or loss of profit may be (i) retained by the Bank as a loss of profit, (ii) passed along to the Fund in the form of a higher interest rate margin/spread or, in connection with any existing Subscription Facility, increased costs,

or (iii) as discussed further below, mitigated through the use of uncommitted credit facilities.

Subscription Facilities have traditionally been structured as committed lines of credit, in which a Bank commits (subject to satisfaction of certain defined conditions precedent) to lend up to a certain amount to a Fund over the life of the facility. For balance-sheet purposes, this effectively involves setting aside capital reserves for the benefit of the Fund; such capital reserves cannot be used for any other purpose before repayment in full of all principal and interest thereon by the Fund or termination of the Bank's commitment per the terms of the credit agreement. Committed facilities thereby limit the amount of capital available to a Bank to satisfy the U.S. Basel III liquidity and capital adequacy requirements.¹²

Due to this increased cost, Banks have increasingly considered offering uncommitted lines of credit in an effort to satisfy borrower credit demand, including reducing the passed-along costs associated with committed facilities, while mitigating the impact of these facilities under the liquidity and capital adequacy requirements of U.S. Basel III.

In general, an "Uncommitted Line" is a line of credit offered by a Bank to a Fund that does not obligate a Bank to advance loans. Rather, the Bank agrees to make loans available to the Fund in the Bank's sole discretion. Accordingly, under an Uncommitted Line, a Bank may always refuse to advance a loan, notwithstanding the timely submittal by the Fund of a notice of borrowing, the satisfaction of any conditions precedent or the Fund's continued compliance with all obligations under the credit documentation. While all Uncommitted Lines maintain the ability of the Bank to make or withhold loans in its sole discretion, Uncommitted Lines can vary in

how they address certain issues, including maturity or termination dates and events of default.

Differences between Committed Facilities and Uncommitted Lines

Since a Bank under an Uncommitted Line does not have an ongoing obligation to lend, such a facility may not have a fixed date and may instead be open-ended. Given the Bank's discretion to refuse a request for a loan under an Uncommitted Line, the Bank has sole control over the tenor of new loans under such a facility. With respect to repayment tenor, some Uncommitted Lines are demandable, allowing a Bank to require repayment at any time upon demand of the Fund (a "Fully Demandable Uncommitted Line"). We have also seen Uncommitted Lines contain maturity dates or termination dates that function to end a Fund's ability to request additional loans and to fix a date for repayment. Similar to committed facilities, the termination of Uncommitted Lines may be linked not just to a specific date, but also to the occurrence of certain events (e.g., the termination of the Fund's commitment period). Some Uncommitted Lines are both fully demandable and also have a fixed maturity or termination date.

While the representations, warranties, covenants and obligations of a Fund are generally similar between a committed facility and an Uncommitted Line, there is often divergence with respect to how each handles defaults and other termination events. For instance, in Fully Demandable Uncommitted Lines, Banks may be willing to do away with fixed events of default such as those typically found in a committed facility, instead relying on reporting requirements to learn of any non-compliance and making a real-time decision on when to demand repayment of the Uncommitted Line at such time. Other

Uncommitted Lines take an alternative approach and retain events of default typical in a committed facility. Such Uncommitted Lines may tie termination and repayment to both such events of default and demand. Of course, some Uncommitted Lines are structured similarly to committed facilities, and once loans are made thereunder, they are subject to a maturity date or acceleration only upon the occurrence of an event of default.

Other Considerations of an Uncommitted Line

There are a number of other potential considerations that Funds and Banks may weigh when deciding whether to implement an Uncommitted Line.

First, Uncommitted Lines may not offer the same assurances to capital that committed facilities offer. A Fund that has a binding commitment to make an investment may suffer negative economic consequences if it does not have capital available when required for purposes of such investment. Banks offering Uncommitted Lines may therefore have to reassure Funds that, despite the uncommitted nature of an Uncommitted Line, they nonetheless will provide capital as and when the Fund needs it. As Uncommitted Lines have become more prevalent, more and more Funds have grown comfortable that such Uncommitted Lines can provide reliable access to capital.

A second consideration relates to fees a Fund may have to pay a Bank in connection with a facility. Funds understandably may have concerns about paying a large upfront fee. Unlike in a committed facility, where a Fund may pay an upfront fee to secure a Bank's commitment to fund, a Bank under an Uncommitted Line could refuse to make loans, even after receiving an upfront fee. Banks and Funds have found a number of fee

structures under Uncommitted Lines to mitigate this risk, including spreading such fees across the term of the facility or providing for funding fees, payable in connection with each funded loan, rather than upfront or facility fees.

Third, an Uncommitted Line can be difficult for a Bank to syndicate. Having multiple Banks, each with sole discretion as to funding its share of any requested loan, provides another potential source of uncertainty for Funds. Additionally, in connection with Fully Demandable Uncommitted Lines predicated on the Bank having sole discretion over whether to demand repayment of the line, the presence of two or more Banks, even when acting through an agent, could result in inter-lender issues where one Bank demands repayment and the other Bank chooses not to. There are also concerns if each Bank has discretion with respect to which limited partners to include in the borrowing base.

Conclusion

Based on our experience in documenting Uncommitted Lines and our view of the market, we expect there to be continued appetite in the market for Uncommitted Lines. While we expect that there will always be demand for committed facilities, particularly for larger Funds seeking larger multi-lender facilities, U.S. Basel III's requirements may encourage Banks, especially banks with less access to liquid capital, to offer additional Uncommitted Lines. Given that an Uncommitted Line, in practice, will provide reliable access to capital, and that the pricing may be favorable to Funds, Fund appetite, particularly for those Funds that share a strong relationship with the Bank, should remain consistent for Uncommitted Lines.

Endnotes

- ¹ Mark is a partner in the Banking & Finance and Fund Formation & Investment Management practices. Laura Watson is an associate in Mayer Brown's Chicago office and a member of the Banking & Finance practice.
- ² For an overview of the phase-in timelines for the various Basel III requirements, see Bank for International Settlements, "Basel III Phase-In Arrangements," available at http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf. As discussed further in this article, the United States has set its own timetable for the implementation of these requirements.
- ³ See Bank for International Settlements, "Basel III: International Regulatory Framework for Banks," available at <http://www.bis.org/bcbs/basel3.htm>.
- ⁴ For more detail on the Basel III framework, see "Leverage and Liquidity Requirements under Basel III," the Mayer Brown Fund Finance Market Review (Summer 2014), available at <https://www.mayerbrown.com/files/Publication/0ba6ef60-e03d-4b71-ac62-018407920a37/Presentation/PublicationAttachment/a5db0df1-7605-4fad-8eea-02b92962ff38/140805-NYC-NEWSLETTER-Fund-Finance.pdf>.
- ⁵ Mervyn King, Chairman of the Group of Central Bank Governors and Heads of Supervision, quoted at <http://www.bis.org/publ/bcbs238.htm>.
- ⁶ See OCC, "Description: Final Rule," available at <https://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-51.html>.
- ⁷ See U.S. Department of the Treasury, "Description: Final Rule" (October 2014), available at <https://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-51.html>; Law360, "Basel III Is Not the End of Regulatory Overhaul", available at <https://www.law360.com/articles/460903/basel-iii-is-not-the-end-of-regulatory-overhaul>.
- ⁸ The capital conservation buffer was first put into place at 0.625% in January 2016 and will reach 2.5% effective as of January 2019.
- ⁹ See Federal Reserve System, "Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer," available at <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160908b1.pdf>.
- ¹⁰ The U.S. agencies' final rule required certain public disclosures by banks to regulators connected to the leverage ratio to be made beginning in the first fiscal quarter of 2015. Full implementation of the minimum leverage ratio requirement is not due until January 1, 2018. See Federal Reserve System, FDIC, OCC, "Joint Press Release: Agencies Adopt Supplementary Leverage Ratio Final Rule," available at <https://www.federalreserve.gov/newsevents/press/bcreg/20140903b.htm>.
- ¹¹ See Department of the Treasury, Federal Reserve System, FDIC, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action," available at <https://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-88a.pdf>.
- ¹² See "Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio," the Mayer Brown Fund Finance Market Review (Winter 2014), available at <https://www.mayerbrown.com/files/Publication/db804bc9-a7a4-43b5-87d9-60ad265e8f90/Presentation/PublicationAttachment/81db968d-782f-43be-920f-60e8f6e7e017/140127-NYC-NEWSLETTER-Fund-Finance.pdf>.

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