Regulatory capital constraints will curb bank lending for years to come, but won't stop corporate borrowers from recovering their appetite for credit. Investment funds are logical candidates to help fill the gap – if fund managers and regulators can adapt. Clifford Chance partners Jeff Berman (New York), Nick O'Neill (London) and Mark Shipman (Hong Kong) weigh the opportunities and obstacles.

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Investment funds: Lifeboats in a sea of change

Fast read Investment funds: life boats in a sea of change

- The process of de-risking the banks is in full swing.
- Corporates need to access debt to refinance existing lines of credit.
- In a capital-constrained world, funds could play a more expansive role.
- But pricing visibility and regulation remain key concerns.
- We recommend a light hand on the regulatory tiller.

> "Becoming a direct lender is potentially attractive to a wide variety of funds."

The world economy cannot afford another banking crisis like the one it has just endured. So the process of de-risking the banks has begun, and will continue for some years into the future. We cannot yet know exactly where that will take us; but what is certain is that long-term structural changes in the global banking sector are underway. Regulatory developments such as Basel III mean that bank credit will be significantly harder to obtain – and significantly more expensive for borrowers who can get it.

While corporate demand for credit may – for now – be suppressed, the need for debt financing is not going away.

Today's economic uncertainty is clearly discouraging growth and dampening market activity. Even in a stagnant or recessionary environment, however, there is a need for niche and specialist lending to support business operations and maintain liquidity. And although many corporate treasury departments currently boast full cash coffers, some US$1.2 trillion of corporate debt will mature through to 2015 in the European bond markets alone. If the banking sector cannot meet this demand – and it seems plain that it will be increasingly unable to do so given regulatory capital constraints – borrowers will have to look elsewhere.

Attention has turned to the investment funds sector. In particular, it is suggested that private equity and hedge funds are well suited to act as parallel lending institutions that can channel new lending to corporate borrowers. Collectively, funds represent an attractively large pool of capital: they are sufficiently diverse in their specialist knowledge and strategic objectives to accommodate a wide range of business borrowers and financing propositions, and they have the potential to be more flexible and adaptable in meeting needs across the full spectrum of credit risks.

Of course, funds are already important participants in the credit markets and are likely to perform an increasingly significant role in the future. In the post-crisis world, fund managers may not find it so easy to achieve their historic rates of return: against what can be earned elsewhere, at least on a risk-adjusted basis, the stable returns available from corporate lending may not look too dismal.

What role for funds?

Investment funds can – and do – participate in the restructuring of the banking sector in three ways.

They can invest in bank equity as shareholders, or be a source of liquidity to banks. Funds can also be part of the de-risking process, by purchasing the distressed assets sitting on banks' balance sheets. This is happening to some extent already, as pressure on banks to dispose of toxic assets is enabling funds to make opportunistic acquisitions. By permitting banks to replace risk-weighted loan assets with zero-weighted cash, these transactions effectively release bank capital for new lending.

The third way, offering potentially greater benefit to corporate borrowers, is direct lending by funds.

So far, this last option has been more of a discussion point than a meaningful source of new financing. There has been some activity in the US, rather less in Europe and virtually none in Asia. But from our conversations with leading organisations in this area it is abundantly clear that actually disintermediating the banks and becoming a direct lender is potentially attractive to a wide variety of funds.

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Funding growth

€440bn emergency support fund for the Eurozone

The European Financial Stability Facility (EFSF), created by the euro area member states (EAMS) in June 2010, represents a vital lifeline in volatile markets. As part of an overall rescue package of €780 billion, EFSF is able to issue bonds of up to €440 billion backed by guarantees issued by the EAMS to provide financial assistance to any EAMS which gets into financial difficulties.

Following work earlier in 2010 on an €80 billion stability support loan provided by euro area member states to Greece, Clifford Chance Paris partner Jonathan Lewis and his pan-European team worked on the support package. Quick thinking was required on one of the biggest loan and capital markets packages ever put together, and certainly the largest Clifford Chance has ever worked on.

Our advice helped ensure that the Facility was structured in a way that would be welcomed by the markets and would meet the demands of cash-poor sovereign states. "He (Jonathan) and his team," the *Financial Times* said in February 2011, "had the complex task of bridging the gap between the needs of governments and rating agencies using commercial law."

In December 2010, the team advised on the first loan facility agreement entered into by the EFSF and Ireland (and the related bond issues) and has since advised on further EFSF lending (including Portugal).

We have yet to see what role banks will carve out for themselves in an ascendant funds sector.

Funding growth

Innovative fund financing

The joint acquisition by an affiliate of global fund manager Apollo Global Management and Fonds Stratégique d'Investissement – France's state-sponsored investment fund – of Alcan Engineered Products from Rio Tinto sets a vital precedent for future ventures between public and private sector funds.

Lawyers from 10 different Clifford Chance offices worked closely with our client Apollo, creating an innovative financing structure to fund the future working capital requirements of the Alcan unit, a leading global manufacturer of aluminium products.

While we would expect private equity and hedge funds to be the leading players, funds specially set up for corporate lending might attract investments from other pools of capital, such as sovereign wealth funds, insurance and pension funds, and even large corporate treasury departments.

Certainly, funds could be part of the solution for frustrated corporate borrowers. But in a sea of change, roiled by waves of new regulation, nothing is plain sailing. So what would help to turn this potential into reality, and what are the hazards? Could a direct lending strategy be holed below the waterline, sunk by ill-adapted management or regulatory interference?

Adapting to the new reality

If investment funds are to become significant corporate lenders, the funds sector will need to develop the necessary skills base. There are a number of credit funds already in the market, but generally they buy paper in secondary transactions rather than originating loans themselves. As a result, only a few fund managers have experience in dealing directly with borrowers and underwriting new extensions of credit.

But skills can be hired in – and as the banks narrow their focus, they will be shedding the people who made the loans that their balance sheets can no longer support. Commercial bankers might well be persuaded to transfer their knowledge and skills to the funds sector, notwithstanding the necessary transition to a new business model and culture, if there were paying jobs to be had.

And the required expertise would not necessarily have to be brought in-house. If corporate lending looks like an attractive market, a 'traditional' fund manager should be able to establish contractual or joint venture relationships with specialist advisory firms that have a track record in the direct lending space.

Structured for success

Fund structures will also need to be adapted to participate in the credit asset class. Hedge funds are typically structured as open ended, offering redeemable interests to investors, while private equity funds are almost always closed ended, strictly limiting investors' opportunities for liquidity. Each model has its pros and cons for a direct lending strategy: open-end funds could be fitted with longer redemption cycles, greater incentives for investors who agree to lock-ups and perhaps roomier side pockets (notwithstanding their current unpopularity among investors), while closed-end funds could be modified to permit more flexible recycling of investment proceeds. Ultimately, of course, funds need to raise capital from investors, and competition for investor dollars will determine which model carries the day.

Banks, too, can be expected to adapt. They will continue to be a force in the corporate lending market notwithstanding constraints on their lending capacity. We have yet to see what role banks will carve out for themselves in an ascendant funds sector. They are unlikely to forgo their customer relationships without a fight, and can be counted on to develop new ways to stand as intermediaries between customers and, say, hedge funds.

Regulatory developments

As the funds sector deepens its involvement in originating and distributing credit and trading credit products, the regulators are not sitting idly by. There are calls to scrutinise this activity more closely. And the references to 'shadow banking' – rather than something less sinister, like 'parallel lending' – leave no doubt as to where the regulators think closer scrutiny will lead.

Given the funds sector's potential value in meeting a potentially critical shortfall in available credit, we have argued for a restrained regulatory response by national and supranational authorities. Additional regulation should only be imposed if the growth of parallel lending poses a clear risk to investors, particularly retail investors, that is not addressed by current rules.

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Direct lending by funds gives rise to neither a true 'shadow banking' system nor any meaningful increase in systemic risk: unlike many banks, none of today's hedge funds is, by itself, big enough, leveraged enough or interconnected enough that its failure could destabilise the financial system.

As for investor protection, fund managers are already subject to strict regulation, either currently existing or soon to be in effect in all major jurisdictions, such as the new Alternative Investment Fund Managers Directive (AIFMD) in the EU and the Dodd-Frank Act in the US. For example, under the AIFMD, regulators will be able to access information on the leverage incurred by all private funds, and to limit the leverage they take on, and under Dodd-Frank the SEC will have expanded supervisory authority over fund managers' marketing, disclosure and conflict of interest practices.

Whatever else happens, the prospects for direct lending by funds will ultimately hinge on a single factor: pricing – not only as an asset class, but also in terms of regulatory compliance.

At present it is hard for banks to price their lending activities until they know how they will be affected by Basel III. And until the banks know how to price the market, it is impossible for funds and other alternative pools of capital to gauge how attractive that market is.

If fund managers have to bring in new expertise, and develop new fund structures, the pricing will have to make it worth their while, permitting them to offer competitive returns to alpha-seeking investors. It is easy enough to see how funds can do well with a credit strategy when they are buying balance sheet assets from banks at a few cents on the dollar and making a handsome return. It's not so easy to do it by lending directly to corporates at 5% per annum.

Yet if the need is great enough the price will follow. Corporate borrowing costs will be rising in any case; Basel III makes that a certainty. This is where regulators, political leaders and governments will have a part to play: if funds face lower compliance costs than banks, they will have more room for manoeuvre.

The lighter the better

In our view, the prospects for direct lending by credit funds boil down to two questions:

Can fund managers afford to do it?
The risk-return profile of direct lending will have to be favourable enough to attract and reward investment professionals with the right skills. It will also have to be competitive with the alternative strategy of simply taking distressed assets off the balance sheets of banks in the process of de-risking.

Can governments afford not to encourage it?
Regulators have the power, and the opportunity, to stifle this new source of corporate credit at its inception. In our view there is no reason for them to do so, and every reason for them to forbear. At a time when any global economic recovery remains elusive and fragile, no potential source of funding for business growth should be needlessly constrained.

In practice, the second question will be decisive. As the extent of regulation has a direct bearing on costs, it may well determine whether fund managers can afford to become direct lenders. It seems clear to us that in this case the interests of cash-strapped companies – and economies – are best served by a very light hand on the regulatory tiller.

If regulators follow this course, then once the upturn comes, we may well find ourselves with a strikingly changed market for credit intermediation. Banks may continue to rule the waves, but the appearance of funds on the horizon will have turned into a lasting strategic challenge.

Funding growth

PPP potential in Poland

The European PPP (Public-Private Partnerships) Expertise Centre, acting on behalf of the European Commission, instructed Clifford Chance Warsaw to prepare a comprehensive report investigating legal obstacles on combining EU Structural Funds and Cohesion Fund grants with public and private financing in PPP projects in Poland. Poland was the first EU member state where such detailed assessment of the legal feasibility of the 'blended' PPPs was undertaken.

This instruction reflects the position of Clifford Chance Warsaw, which provides unrivalled comprehensive legal services in relation to PPP projects in Poland. The Polish PPP market is perceived by investors as highly attractive given the unprecedented scale of planned infrastructure investments and the absolute necessity of private sector involvement.

Clifford Chance has been playing an active role in advising globally on infrastructure projects and related initiatives implemented under the PPP scheme for many years.

Funding growth

Transforming the hedge fund landscape

Clifford Chance advised on the US$1.6 billion acquisition by Man Group plc of rival NYSE-listed alternative investment manager GLG Partners Inc. With US$71 billion of funds under management as at 30 June 2011, the enlarged group is a world-leading alternative investment management business and a key player as the sector enters a period of significant opportunity.

Longstanding client Man Group drew on a cross-practice area team of Clifford Chance lawyers to provide M&A, Capital Markets, Regulatory/Antitrust and Employment/Employee Benefits advice on this transformational deal.

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