The 2024 Outlook for Private Credit and Alternative Lenders

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2023 was the year in which private credit markets very much moved centre stage.

Industry conferences seemed to attract record attendees, most major advisors now field specialist private credit teams, industry bodies are focusing more on the issues relevant to private credit and alternative lenders and, of course, regulators have started to pay increased attention to the potential risk arising from non-bank financial institutions (NBFIs).

None of this really came as a surprise.

Deal volumes in private credit markets and the role of alternative lenders have steadily grown over the last decade and, despite broader macro-challenges (or perhaps, because of?) the indication is that 2023 did not see a slow-down. Certainly our experience was that transaction volumes held up.

It is striking how diverse and complex the private credit market is. This is reflected in our own deal experience: we have worked with specialist and household-name lenders, debt funds, institutional investors, and high net-worth individuals across different asset classes. Individual deal volumes ranged from a few to hundreds of millions.

Looking ahead to 2024, conversations with our clients suggest that although both the global political and economic outlook is uncertain, cash continues to flow into investment funds and institutional investors and will need to find a home which achieves returns. We expect an active market, but with greater focus on managing and mitigation potential risk scenarios

Our key take aways from 2023

- The range of underlying assets has been, and remains, broad.
- We are seeing funding chains becoming increasingly complex. Large asset managers either invest the capital of their own funds or manage mandates on behalf of third party institutional investors, such as insurance companies, pension funds or high net-worth individuals. 'Origination' is often outsourced by large asset managers to other specialist and smaller asset managers who then take the final funding decision and take charge of administering the debt. Capital providers usually have preferred transaction structures and will try to use these across their deals. Given the range of assets, jurisdictions, identity of funders and deal structures themselves, transactions can become complex, even if relatively small in size.
- Capital providers take very different approaches to the level of control in respect of their funding arrangements. We have seen both extremes: very hands-off as well as tight controls. This can make for challenging deal dynamics.
- At the same time individual originators of assets are becoming increasingly sensitive to the need to harmonise, optimise and control their own funding arrangements. With growing and maturing books of business, there can be a greater need to move assets between different funding arrangements.
- Against this background uniform market practice was, and probably continues to be, elusive.
- We started 2023 with a number of particular uncertainties.
- More generally, the sudden jump in interest rates had the potential to open up a gap between the costs of funding and the return on assets, especially if refinancing of older assets was required.
- The broader property sector came under special scrutiny with question marks over market valuations, high building material costs, some uncertainty over the quality of historic underwriting standards and (at the SME section of the market), the maturing of CBILS loans (one of the Government backed Covid 19 pandemic loan schemes).
- In the end, our experience was that the level of defaults remained relatively contained. Where deals encountered difficulties, especially in deals with complex underlying assets, lenders often decided to fall back on their ability to control a deal and ride things out. Lenders accepted that complex assets can be difficult to sell.
- ESG considerations have been increasingly prevalent. Regulatory change, ranging from the Consumer Duty, securitisation reforms to adjustments to prudential frameworks, are continuing to influence market dynamics.

Practice points

The following issues were reoccurring themes across transactions and will continue to be in 2024:

Control: In the back leverage market, principal capital providers often want complete control: hands-on oversight and the need for waiver and consent approvals. Whilst discretionary "eligible asset" transactions are available, where a credit provider takes a portfolio view leaving loan management to the underlying lender, our recent experience is that control is key.

Securitisation or not securitisation? Alternative lender clients often establish separate entities to ring-fence portfolios and facilitate separate funding lines for each portfolio. There is also often tranching of debt to the portfolio entity, with a senior line alongside mezzanine and / or junior or subordinated shareholder funding. As tranching of credit exposures is a key feature for an arrangement to fall under UK / EU securitisation regulations, a common question that arises is whether or not the arrangements amount to a securitisation for the purposes of these regulations.

If securitisation: who is the originator? The identification of the "originator" remains one of the key legal issues in securitisation transactions carried out by alternative lenders. The variety of different legal structures used by alternative lenders means that this analysis is often less clear-cut than it is in the public securitisation market. The analysis keeps evolving as regulatory technical standards and guidance get updated and refined.

Scope of Reliance Letter and Opinions: Again, in the back leverage markets, the credit provider needs, wherever possible, direct reliance on underlying due diligence reports, legal opinions etc. This can cause some deal friction. Whilst there is no market standard and lenders take different approaches, CREFC Europe have a template reliance letter (previously created for the senior/mezzanine loan markets) that can be adopted where practicable.

Importance of Servicer/ Servicer Risk: Where capital providers are utilising various originators to distribute credit, the servicing of the debt originated becomes of paramount importance. Each originator manages its portfolios and its relationships with its clients differently and when it comes to negotiating the servicing arrangements we have become increasingly aware of the need to balance a funder's need to harmonise servicing and reporting with an originator's requirement to be able to run its business efficiently.

Legal watchlist for 2024

Particular legal issues on our watchlist for 2024 are:

- Regulatory focus on NBFIs
- Regulated firms in the retail market: implementation of Consumer Duty (watch out for fair value assessment) by July 2024
- Requirement for back-up servicers, question marks over wind down plans
- Development of an UK securitisation regime and the scope for (gradual) divergence from the EU securitisation regime
- Updated UK financial collateral regime
- Implementation of the UK reform of the capital framework for insurance companies (Solvency II) with potential implications for the investment behaviour of UK insurers
- For funds and asset managers: AIFMD II
- ESG taxonomy and reporting and the development of ESG performance criteria in debt arrangements

We will monitor developments and identify changes that could impact your business. If you want to hear more, please speak to us.

Relevant other Fieldfisher Publications

What are the legal issues to consider when setting up an alternative lender in the UK?

Emissions allowance financing – Structuring, legal and regulatory considerations

Becoming a UK Authorised Bank

Deal highlights

Real Estate funding lines

- Platform funding line by a lender into a non-bank lender Capital Rise for residential and development loans in South of England
- Back-to-back loan for refinancing of non-bank lenders covering London's most expensive property
- Bridging and Development Lender on implementation of participations and participations-based funding lines from asset managers

Real Estate Private Securitisations

- Private securitisation of bridging loans funded by an investment fund with senior debt provided by an investment bank
- Private securitisation of bridging and buy-to-let loans by UK investment bank

Trade Finance/Supply Chain Finance

- Receivables financier on hybrid factoring and supply chain finance deal

Other asset classes

- Specialist lending and savings bank on funding lines to businesses providing finance on a variety of asset classes in addition to real estate, including VAT and tax credits, funeral finance, SMEs, key workers and boats

Distress

- Specialist lending bank on its enforcement and recovery strategy in relation to a regulated business which provides short term loans to individuals for travel

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