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## Fund Finance

### 1. Fund Finance: definition and scope

Fund Finance represents a specific category of financing for investment funds, both securities and real estate funds. These are banking instruments generally provided on a revolving basis, designed to meet the temporary liquidity needs of fund managers.

In Italy, Fund Finance remains a niche market, although the sector is maturing, driven by the expansion of private equity, private debt, venture capital and hedge funds. Internationally, particularly in the United Kingdom and the United States, this market has long since reached a size that constitutes a distinct asset class in its own right.

### 2. Main types of Fund Finance

Within the Fund Finance universe, there are two main categories of products, each with specific characteristics and purposes.

#### 2.1 Subscription Lines (Capital Call Lines)

Subscription Lines are the most traditional form of Fund Finance. They allow managers to anticipate capital calls from investors, thus avoiding the need to immediately activate administrative capital call procedures. The bank's credit exposure is therefore linked to the financial strength of the fund's investors and their payment commitments.

The main advantages for funds include:

- **Liquidity certainty:** they guarantee immediate availability of funds to complete investments, mitigating the risk of delays or defaults by investors (it being understood that the ultimate

risk of investor default remains with the fund);

- **Return optimisation:** they improve the fund's IRR (Internal Rate of Return), as investor payments can be deferred and rationalised, with calls concentrated once or twice a year instead of being made for each individual investment;
- **Operational flexibility:** they allow for more flexible management of the timing of capital calls, in compliance with the limits and conditions set out in the fund's management regulations;
- **Support tools:** they offer the possibility of issuing guarantees in favour of third parties or advancing amounts to the seller pending the actual availability of funds.

From a contractual structure point of view, Subscription Lines are normally characterised by:

- A revolving structure, with availability generally between 12 and 18 months;
- A term-out option (extension) exercisable at regular intervals;
- A security package consisting of the pledge or assignment as collateral of the fund's receivables from investors and on the pledge of the current account into which payments are made;
- Irrevocable mandate with power of attorney in favour of the lending bank to directly exercise the call for funds in the event of default, typically granted within the scope of a trilateral agreement between the financing bank, the fund and the depository bank.

The credit analysis carried out by the banks focuses mainly on the quality of the investors, assigning each one a rating and a specific advance rate, as well as conducting in-depth due diligence on the fund's governing documents, the mecha-

nisms and conditions for enforcing subscription commitments, and any side letters with individual investors.

## 2.2 NAV Facilities (Asset-Backed Facilities)

NAV Facilities represent a more recent and sophisticated evolution of Fund Finance. Unlike Subscription Lines, in this case the credit analysis focuses on the value and quality of the investment portfolio held by the fund. The financing is based on the net asset value (NAV) of the fund and secured by specific security interests over the assets and/or the cash flows generated by them, rather than on the investors' payment commitments.

This type of product is particularly suitable for funds that have completed their investment period, that envisage a single closing with full subscription of capital, or that have exhausted or almost exhausted the commitments available from investors.

The main reasons for using NAV Facilities include:

- **Access to liquidity:** it allows the fund to be obtain liquidity when other sources of capital are unavailable or too costly, for example to finance restructuring, management expenses or divestments;
- **Support for distressed investments:** it allows the fund to raise financing secured by the overall portfolio in order to support underperforming investee companies or to remedy breaches of financial covenants;
- **Debt refinancing:** it offers the possibility of replacing overly expensive financing at the portfolio company level with a more efficient line obtained at the fund level;
- **Additional investments:** it allows new investments to be added to the portfolio towards the end of the fund's life, increasing its returns;
- **Acceleration of distributions:** it allows distributions to investors to be brought forward before the final liquidation of the fund or pending the complete disposal of the assets.

The structure of the security package in NAV Facilities differs significantly from Subscription Lines. Typically, it includes pledges on current accounts where distributions are made or proceeds from disposals are credited, and in some cases may extend to pledges on shareholdings in portfolio companies or contractual rights deriving from investments, where these are not already pledged as collateral for loans granted by *senior* banks.

A critical element in the negotiation of NAV Facilities is the methodology for valuing the underlying portfolio, as the basis for calculating the loan is determined by the NAV of eligible investments. The main financial covenant is generally represented by a loan-to-value test assessed and certified by an independent third party, which requires that the debt used does not exceed a specified percentage of the NAV of the underlying investments of the fund.

## 3. Legal characteristics

### 3.1 NAV Facilities (Asset-Backed Facilities)

NAV facility agreements are complex documents that govern in detail:

- **Methods for determining NAV:** generally calculated according to international accounting standards (IFRS or US GAAP), with periodic revaluations to determine the amount of the loan available;
- **Terms of use:** funds must comply with specific financial covenants, such as debt limits and debt coverage requirements;
- **Default events:** including a significant reduction in NAV that causes the LTV thresholds to be exceeded and failure to comply with financial covenants that may justify the enforcement of security or the activation of early repayment obligations.

### 3.2 Collateral Structure

In NAV Facilities, the net asset value of the fund is the benchmark for determining borrowing capacity, but does not in itself constitute collateral in the traditional sense. In the event of default, the creditor could theoretically seize all of the fund's assets (within the limits of the collateral provided actually created, taking into account the principle of asset segregation of the fund pursuant to Article 36 of the Consolidated Law on Finance), although such enforcement may prove complex when the assets are illiquid, difficult to value, or when the investee companies are already pledged as collateral in favour of senior banks. For this reason, NAV Lending is typically accompanied by ancillary security such as pledges on bank accounts.

## 4. Advantages for lending institutions

In addition to the benefits for funds, Fund Finance also offers significant advantages to banks and other lenders:

- **Development of strategic relationships:** it enables lenders to build strong relationships with management companies, gain early insight into the underlying investments and position themselves favourably to provide financing at the level of the target companies;
- **Favourable risk-return profile:** the loan-to-value ratio is generally maintained at a level not exceeding 20% of the overall value of the fund, with a relatively low risk of default and the fund not being subject to ordinary insolvency proceedings, without prejudice, however, to the risk of deterioration of the underlying portfolio;
- **Portfolio diversification:** it provides exposure to an asset class that is relatively uncorrelated with traditional corporate lending activities.

## 5. Critical aspects and risks

### 5.1 Operational complexity

The ‘dynamic’ nature of the NAV guarantee requires ongoing monitoring processes and periodic valuations of the underlying assets. The illiquidity of certain investments can significantly complicate enforcement procedures in the event of default.

### 5.2 Legal aspects specific to the Italian market

In Italy, the creation of pledges on the fund’s receivables from investors requires compliance with onerous formalities set out in Article 2800 of the

Civil Code, including notification to the debtor or acceptance by the latter by means of a document bearing a certified date.

This aspect has historically limited the use of pledges on receivables in the security package for Italian funds, favouring alternative structures such as trilateral agreements with the depository bank.

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