

Private Credit Liquidity: Implications for Product Expansion

State Street and Apollo's ground-breaking collaboration on a private credit ETF has given rise to excitement in some corners of the private credit markets and consternation in others. In this Market Comment we explore what increased liquidity and product expansion mean for the private credit markets going forward, including the effects on private credit's famous "illiquidity premium".

The insurance industry continues to search for an illiquidity premium. With the insurance industry still constituting the largest purchaser of private credit instruments, we see continued demand for an illiquidity premium, which we might define as the additional yield generated by private, illiquid debt instruments for a given measure of credit risk, when compared with publicly traded, more liquid debt instruments. Life insurers in particular are apt to match private credit instrument duration to expected claims payments.

Recent trends point to slightly enhanced liquidity generated by private credit trading desks. While private credit trading is by no means a phenomenon at this stage, it is nonetheless noteworthy that private credit trading desks are either up and running or under development at numerous banks and non-bank financial institutions. If we think of private credit trading profits as a secondary objective and increased liquidity as the primary objective— in order to create additional financial product offerings – then this seemingly fledgling trend is in fact far more noteworthy than it may seem at first glance.

Enough liquidity, but not too much, is what we can expect to see in the near term. The existence or absence of private credit trading desks is undeniably a contributing factor in favor of liquidity. However, the continued demand among insurance companies to buy-and-hold higher yielding, illiquid debt instruments (already in the trillions of dollars) will continue to outweigh whatever liquidity is generated through private credit trading.

Risk management in the era of private credit asset-based lending takes on additional dimensions. It's important to distinguish between on balance sheet assets (let's call this ABL) vs. what meets the legal definition of asset-backed securities (let's refer to this as ABS). Even where assets are secured, credit evaluations of ABL necessitate an understanding of the issuer's creditworthiness. This is especially true as insurance regulators become increasingly uncomfortable with significant credit ratings uplift by way of ABL collateral. Navigating the bankruptcy laws upon issuer default is not typically an instantaneous undertaking in the U.S. And where insurance companies are matching expected claims payments to debt maturity, even perfect recovery – years after default – can pose problems for insurers.

MARKET COMMENT

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I. CURRENT STATE OF LIQUIDITY: THE SEARCH FOR AN ILLIQUIDITY PREMIUM

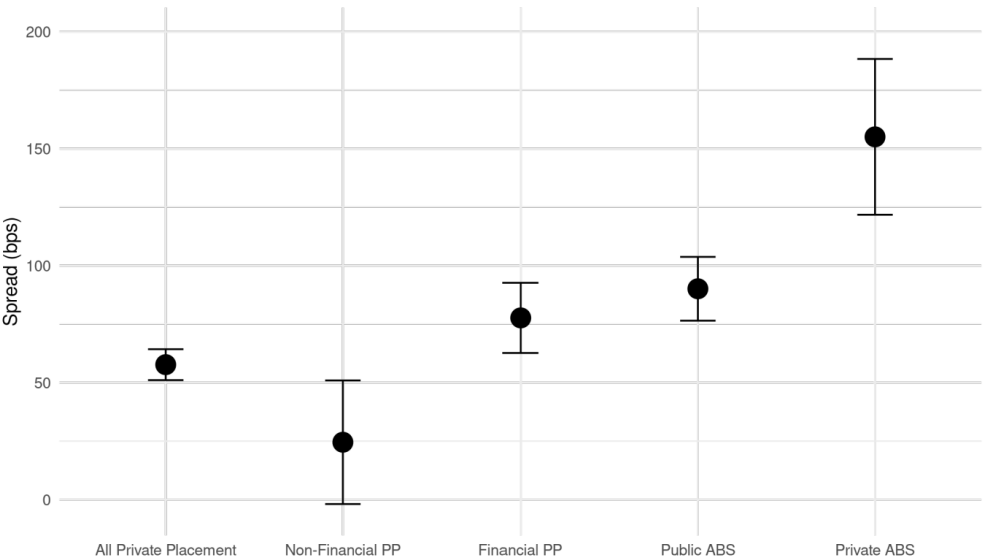
While many still quote the 2023 Federal Reserve statistic on private credit, which came in around \$1.7 trillion, more recent figures put U.S. private credit around \$3 trillion, with roughly 2/3 (or \$2 trillion) held by insurance companies.

Private credit purchases by life insurance companies. The relative predictability of life insurance claims allows life insurers to match expected claims payouts to debt instrument maturities. In this buy-and-hold market, the illiquidity premium (which we might define as the additional yield generated by private, illiquid debt instruments for a given measure of credit risk, when compared with publicly traded, more liquid debt instruments) is compelling. Apart from distressed assets, we rarely see life insurers seeking to trade their private debt holdings. Thus, any demand for private credit secondaries trading is not likely to be met with a significant supply from the life insurance industry.

Private credit purchases by annuity providers. The pro-cyclical effects of private credit holdings by annuity providers are rather self-evident. When annuity companies purchase higher yielding private debt instruments, they can provide greater interest rates to fixed annuity contract holders. This in turn creates greater demand for their annuities, which in turn results in greater demand for private credit instruments. Although there is a different market dynamic at play, as compared to life insurance companies, here again it’s hard to envision that annuity providers will be inclined to trade any private debt instruments apart from distressed assets.

Increasing demand by property and casualty insurers. When compared with life insurance claims, property and casualty claims are a good deal more difficult to predict. So while we might not see the same volume of private debt purchases among property and casualty insurers, the illiquidity premium has not escaped their notice. And here again, these insurance companies are far more likely to take liquidity than to provide it.

Spread Over Public Bond Yield



II. EMERGING TRENDS: PRODUCT EXPANSION VIA ENHANCED LIQUIDITY

One of the more exciting trends in the private markets entails bringing public market financial infrastructure to the private markets. We're just now starting to see the emergence of private credit ETFs.

What the SEC has to say about funds (investment companies) and liquidity. The SEC has been clear that redeemability is a defining feature of open-end investment companies. In all cases where redemptions are made via the fund company (this includes open-end mutual funds and ETFs), liquidity will be a critical consideration. Rule 22e of the Investment Company Act enforces shareholder rights of prompt redemption. Rule 22e-4 of the Act requires that fund companies establish and enforce a written liquidity risk management framework. This framework, which includes classifying each portfolio asset's level of liquidity, is overseen by the fund's board of directors. The SEC has effectively established a maximum net asset threshold of 15% for illiquid assets. For many years, the industry standard for creating a private credit fund has been to create a business development company, structured as a closed-end fund. As closed-end fund shares are not redeemed directly from the fund company, historically illiquid private credit assets would not be subject to the SEC's 15% threshold.

The role of private credit trading desks. The role of the private credit trading desk is to make the case that certain private credit assets are now liquid and therefore not subject to inclusion in the 15% calculation. The State Street / Apollo IG Public and Private Credit ETF places private credit assets at between 10% and 35% of the fund's portfolio at any given time. Apollo has contractually agreed to provide the fund with intra-day, firm, executable bids on all AOS (i.e., Apollo-sourced) Investments held by the fund.

Now that we've seen version 1, what will version 50 look like? Private credit product expansion is made possible by increased liquidity. The State Street / Apollo ETF is just the beginning. With increased liquidity, we can envision other forms of product expansion in the future, such as majority-private credit ETFs, passive investment private credit ETFs, etc.

Excerpt from the SPDR SSGA Public and Private Credit ETF Prospectus

The Fund intends to invest in private credit, which refers to a wide range of credit instruments, such as instruments that are directly originated, issued in private offerings, issued to private companies, and/or issued to borrowers by non-bank lenders (i.e., non-bank lending instruments), including, but not limited to, asset-backed and corporate finance instruments sourced by Apollo (each such instrument, an "AOS Investment"). The Adviser does not negotiate any terms of any fixed income instruments (i.e., terms of the notes invested in by the Fund), including, but not limited to, AOS Investments, and the terms of any private credit instrument, including, but not limited to, AOS Investments, would be negotiated and determined by an originator, which may be an affiliate of Apollo or a third-party. The Fund can invest across numerous types of instruments, including, but not limited to, consumer finance, residential mortgage loans, commercial real estate, hard assets (through securitized loans), and financial assets. Private credit, including, but not limited to, AOS Investments, generally are not publicly-traded, however, such instruments could be publicly traded and may be investment grade. Private credit, including AOS Investments, will generally range between 10-35% of the Fund's portfolio. Private credit, including AOS Investments, may comprise less than 10% or more than 35% of the Fund's investment portfolio at any given time. The percentage allocation of Fund investments to private credit, including AOS Investments will be determined solely in the discretion of the portfolio managers of the Fund and will vary depending on several factors, including the portfolio managers' viewpoints regarding available AOS Investments or other private credit instruments, market conditions, credit analysis, and other factors the portfolio managers deem to be relevant at any given time. The Fund may also seek to achieve exposure to these instruments through investments in private funds, closed-end investment companies ("CEFs") structured as "interval funds," or business development companies ("BDCs"), which may be managed by Apollo or its affiliates; such investments will be limited to 15% of the Fund's net assets.

Apollo has contractually agreed to provide intra-day, firm, executable bids on all AOS Investments held by the Fund, and is contractually obligated to repurchase AOS Investments held by the Fund in accordance with the Bid Quotation and Purchase Agreement (defined herein) between Apollo and the Fund. With respect to non-AOS Investments held by the Fund, Apollo may, but is not contractually obligated to, purchase non-AOS Investments from the Fund. The ability to sell AOS Investments to Apollo is not exclusive. The Fund could and may seek to sell AOS Investments to any interested, willing, and eligible counterparty. Apollo does not have a contractual obligation to identify and make available (or offer) any investment for the Fund to buy.

III. LONGER TERM IMPLICATIONS: ENOUGH LIQUIDITY, BUT NOT TOO MUCH

The existence or absence of private credit trading desks is undeniably a contributing factor in favor of liquidity. However, the continued demand among insurance companies to buy-and-hold higher yielding, illiquid debt instruments (already in the trillions of dollars) will continue to outweigh whatever liquidity is generated through private credit trading. In the end, we're likely to see just enough liquidity in private credit to permit product expansion into more and better open end funds and ETFs, but not enough to change the buy-and-hold nature of the asset class, given the needs and preferences of the insurance industry.

Contractual Agreements. We think that the contractual obligation of Apollo to provide firm, executable bids on certain private credit assets for a fund reflects the emergence of an enduring best practice. As mentioned above, the insurance industry will more than likely continue to be the largest purchaser of private credit assets and will have little incentive to deviate from its current buy-and-hold strategy. This will function as a restraining function on the overall level of liquidity within the private credit market.

IV. RISK MANAGEMENT

Risk management in the era of private credit asset-based lending takes on additional dimensions. It's important to distinguish between on balance sheet assets (let's call this ABL) vs. what meets the legal definition of asset-backed securities (let's refer to this as ABS). Even where assets are secured, credit evaluations of ABL necessitate an understanding of the issuer's creditworthiness. This is especially true as insurance regulators become increasingly uncomfortable with significant credit ratings uplift by way of ABL collateral. Navigating the bankruptcy laws upon issuer default is not typically an instantaneous undertaking in the U.S. And where insurance companies are matching expected claims payments to debt maturity, even perfect recovery – years after default – can pose problems for insurers.

Private credit is not a homogenous asset class. We have observed a propensity among some risk managers to draw parallels to the residential mortgage meltdown and corresponding strain on residential mortgage assets (e.g., RMBS, CDOs of RMBS, CDS on RMBS) during the financial crisis. While we do not dispute that some commonalities may indeed be observed (for instance, the possibility of systemic risks emanating from opaque, privately negotiated/bespoke deals) it is nonetheless important to bear in mind that there is a certain mix of sectors within the private credit market. A report by the International Monetary Fund puts technology sector debt at slightly over 40% of private credit assets, healthcare sector debt at around 15% of private credit assets, then consumer discretionary, followed by industrials, etc. To understand the private credit risk within an insurance company's general account or in any private credit fund, it's essential to understand the sectoral makeup of the account or fund and the risks inherent to those sectors.