Feature

KEY POINTS

- Broadly syndicated lending (BSL), dominated by investment banks, and private credit, the province of non-bank lenders, have coexisted and complemented each other over the past decade. However, due to a variety of factors and circumstances, private credit has increasingly seized deals that were traditionally reserved for the BSL market.
- Market reports indicate a growing interest from Wall Street banks in establishing a secondary market for trading private credit loans, which have otherwise been viewed largely as illiquid.
- There is little to no empirical data on how Wall Street banks will approach positions in private credit loans, and so predicting whether banks will trade or hold such positions is speculative, at best. Like with the BSL business model, banks may be incentivised to regularly trade such positions due to their rising cost of regulatory capital.
- Expanding the tradeability and liquidity of private credit may also have a meaningful impact on deal terms, investment upside, competition and the private secondaries market itself.
- From the borrowers' perspective, an expanding market of private loan buyers (similar to, and converging with, the behaviors of the BSL market) may lead to improved pricing and lighter covenant packages but, at the same time, degrade the benefits that a smaller club of relationship lenders afforded, such as direct and easy access and speed of execution.
- Ultimately, lenders and borrowers must consider the differences in transferability of BSL and private credit loans and the impact of merging the two markets, including on commercial and documentary terms.

Authors Daniel Winick, Mark Pesso, Andrew Young and Heba Hazzaa

Wall Street-led secondary trading of private credit loans: considerations for stakeholders

In this article, the authors explore the new trend of Wall Street bank-led secondary trading in private credit and certain considerations for market participants involved.

INTRODUCTION

The well-established advantages of private credit have been tried and tested through challenging market conditions. Among other things, privacy, relationship-based business (buy-and-hold thesis), customised offerings and terms (such as structured equity), and quick and reliable execution are touted as the key reasons borrowers flock to private credit, and alternate lenders are happy to take their business. In exchange, borrowers of privately placed loans (which are loaned and held by alternate lenders) can typically expect to pay a premium above what they would have paid in the broadly syndicated lending (BSL) market – ie an "illiquidity" premium.

Despite perceived competition over market share, private and BSL debt have coexisted and complemented each other over the past decade; with BSL traditionally servicing large cap facilities and private credit targeting smaller or more challenging credits. This symbiotic relationship was facilitated by the sheer vastness of the supply side, with BSL volume growing year-on-year over the past decade to reach nearly $1trn of volume by the end of 2021. Since early 2022, the BSL market has struggled with hung syndications, rising interest rates, and recessionary concerns. As a result, private credit providers have frequently filled the void for transactions which were traditionally reserved for BSL, whether by buying into BSL at discounts, or partnering with sponsors and other private credit lenders to offer a club solution.

From an investment perspective, BSL are unquestionably viewed as more liquid investments given the ready availability of pricing and an established secondary market. From their infancy, large cap loans are arranged by investment banks with an eye to sell down the entire position to myriad financial investors and institutional buyers, and at the same time honoring bank regulatory minimum capital constraints. In addition, secondary market participants can readily purchase and sell positions in BSLs at prices that can be tracked by various publicly accessible quotation services such as S&P Loan and CLO pricing Data and Refinitiv.

Despite historically lacking the benefit of prompt liquidity (compared to BSL), private credit remained an attractive asset class as investors valued the higher yields, historically lower default rates, and lower volatility over other alternative investment vehicles.

Against this landscape, Bloomberg recently reported that certain Wall Street banks are exploring the creation of a market for trading private credit loans. Many Wall Street banks of course already have separate private credit arms, whether as asset managers or otherwise and are already actively invested as limited partners in private credit funds. It is unclear whether the interest in private credit secondaries is intended to piggyback off existing primary positions of such credit arms (ie causing the banks to engage in self-dealing) or to expand investments in unrelated deals through single managed accounts or other vehicles.

Limited partners (LPs) in private credit funds are reportedly welcoming the opportunity for enhanced liquidity. This sentiment may also be shared by certain general partners (GPs) looking to exit investments to stay within the allocation mandates or proactively to diversify holdings.

In this article we explore considerations that various stakeholders should consider as consequential for expanding the investor base for private credit loans through secondary syndication.

LEGAL CONSIDERATIONS FOR DIRECT LENDERS

How will Wall Street bank-led secondaries change the legal terms of private credit deals?

Transferability

The key to an effective secondary market is free alienability, or as close as possible thereto. In BSL, assignment clauses generally allow lenders to freely exit deals subject to limited conditions, including minimum amounts and ineligible assignees, typically including defaulting lenders, natural persons and, in other cases, competitors and blacklisted entities, as well as certain consent rights. The administrative agent and borrowers typically retain the right to consent to new lenders joining a facility, such consent not to be unreasonably withheld or delayed. Indeed, these consent rights are typically not viewed as large obstacles that frustrate liquidity. In the case of borrowers, such consent rights will typically fall away during primary syndication, during an event of default (which is sometimes limited to payment and bankruptcy defaults), or if the borrower fails to respond within five to ten business days.

By contrast, in private credit deals, both lenders and borrowers have a vested interest in keeping tighter control on the lender group. From the borrower's perspective, having an ongoing relationship with one or a small group of lenders is important to manage downturns and other stressors the business may incur. It is not uncommon to see waiver requests for breach of maintenance covenants during rocky quarters. Having to approach a group of hundreds of asset managers and potentially thousands of lenders entails cost and time delays which can impede efficient management of such issues. At the same time, existing lenders traditionally look to preserve their full economics and to prevent non-friendly lenders having any type of blocking position, and, thus, in some cases, may seek protections such as rights to first offer (ROFO) or right of first refusal (ROFR) on assigned loans. Moreover, private credit providers may not adapt well to broadly worded disqualified lender lists (DQ lists) that sponsors looking to control their lender group insist on.

If a secondary market for private credit loans is to develop, attention will have to be paid to the ability of a lender to easily assign its position. Existing constructs in private credit loans around tight controls over assignments, to the ability to preserve ROFO and/or ROFR rights, will have to be revisited for viability. Attempts to transplant DQ lists into private credit loans will have to be viewed against the anticipated demand side participants. As a result, "white lists" used in UK and European transactions may provide a solution to pre-determine an eligible class of potential lenders. In addition, in the US, the seller of a participation, as the lender of record, remains in privity with the borrower prior to an elevation event while transferring the beneficial interest in the underlying loan. As such, participation structures, rather than an outright assignment, should not be overlooked as they may provide an eloquent solution to address any transferability issues.

Impact of enhanced liquidity

One of the hallmarks of the BSL market is price transparency. Individual tranches trade like equities and prospective buyers can see exactly what it costs to play in a certain credit.

On the other hand, pricing for private credit loans has traditionally had limited disclosure. This comes with a number of potentially intended consequences: for starters, private credit loans are not subject to market movement, and as such, are less volatile than BSL. This may be useful from a credit fund's perspective as it does not have to continuously mark its loans to market. Not only does that help smooth fund financial performance, but it may be reason for the attractiveness of the nascent secondaries funds market that has developed since the start of the pandemic, where secondary funds purchase existing interests in primary funds. Currently a small minority of debt funds are secondaries funds, but that number is expected to grow. If Wall Street banks are going to be trading private credit loans, there is going to have to be a way for market participants to have price visibility. With real time price discovery that a syndicated private credit market may bring, private debt funds are going to have to consider the impact that this may have for both harvesting assets (in the traditional sense that they are used to, or by participating in the syndicated market), as well as the impact on raising continuation vehicles or secondaries funds.

Anticipated effects on covenant packages

To date, private credit loans have survived as one of a diminishing pool of non-bank loans that still include one or more financial maintenance covenants. Such covenants serve as early warning signs of financial stress in a business and allow borrowers and lenders to come to the table to achieve what is optimistically a mutually beneficial solution. In addition, private credit loans often have tighter controls around incurrence-based tests used for additional debt, investments and restricted payments. With the exception of strong sponsor backed borrowers, private credit lenders will often look to hard caps on activity such as making acquisitions or incurring incremental debt, rather than wide-open incurrence tests tied to expansive financial covenants, growers, builders and "no worse than" tests. By contrast, BSL are characterised predominantly by covenant-lite financial tests and the sorts of covenant flexibility that has recently led to liability management activity by sponsors.

Private credit lenders should consider the impact that expanding the investor base via

Biog box
Daniel Winick, Mark Pesso and Andrew Young are partners and Heba Hazzaa is an associate in the banking and finance group of Clifford Chance in New York.
Email: daniel.winick@cliffordchance.com; mark.pesso@cliffordchance.com; andrew.young@cliffordchance.com and heba.hazzaa@cliffordchance.com

bank-led syndications would have on their ability to maintain discipline in covenant structures. By the same token, while losing some of the accessibility of private credit lenders to a broadly syndicated group, borrowers may want to exploit a supply and demand reset to push for covenant-lite loans.

Effects on equity kickers

A unique feature of private credit is the ability to present borrowers with hybrid offerings of debt and equity through the use of products like preferred equity interests and warrants. Equity kickers can serve the interest of both borrowers and lenders. Sometimes borrowers use equity kickers as ways of getting more favorable loan terms. It can also be a way of aligning the objectives of management and the lenders to the success of the business. For lenders, it is a helpful way to increase their return on investment. It is difficult to conceive the complexities that would arise if private credit loans syndicated by Wall Street banks sought to preserve equity kickers. Often, equity kickers are not easily transferable and so not ripe for syndication. Trying to sell warrants would result in an unruly outcome for a borrower, and questions of fairness and pro rata allocation would arise if they sought to be preserved for the minority. Faced with such challenges, private credit lenders may need to contemplate foregoing equity kickers in new deals in order to bolster liquidity.

OTHER CONSIDERATIONS

Borrower debt buybacks

To the extent the transferability of private credit is liberated to match the BSL market practice, borrowers may be able to buy back their own debt in the secondary market at a discount. Such flexibility, which could be seen as a liability management tactic, will likely be unwelcomed by private credit providers as it negatively affects their IRR.

Losing privacy and direct access to a limited group of lenders

One of the well documented hallmarks of private credit has been the close working relationship with lenders and the privacy of pricing and borrowers' financial condition. Facilitating a secondary trading market by banks may force disclosure of borrowers' financials and expose borrowers to additional stressors from market forces trading their debt (in addition to the impact that such price discovery would have on lenders as described above).

One thing is certain – the push for enhanced disclosure and transparency in lending, including private credit, is already well advanced. In the US, CUSIP has been a staple in identifying securities for over five decades. In August 2023, the Loan Syndications and Trading Association (LSTA) announced that CUSIP Global Services (CGS) developed the CUSIP Entity Identifier (CEI), a 10-character code, designed to uniquely identify legal entities in the loan market. The original focus of CEI is on modernising the syndicated loan market. However, CEI could also be used to cover any legal entity holding corporate loans including through a private credit loan. By linking the debt to the borrower, it is anticipated that CEI will facilitate secondary trading of private credit loans.

CONCLUSION

Secondary trading in private credit is not new. Private credit agreements allow for assignments and participations. However, private credit is not a transparent or liquid market. Additionally, the bilateral nature of private credit deals ensure private credit loans still enjoy an element of privacy. Secondary trading in BSL, by contrast, relies on a market known for speed and transparency. The increasing interest from Wall Street banks in trading private credit loans in the secondary market may challenge the symbiotic relationship between BSL and private credit and force private credit terms to change.

LPs looking for prompt liquidity have a lot to consider before pushing to facilitate trading of their deals. The advantages of prompt liquidity should be carefully weighed against the cons of eroding yield premium, public debt trading stressors on borrowers and loss of close working relations with repeat players. ■

1 Bloomberg, JPMorgan, 'Goldman Plan to Start Trading Private credit Loans', Lisa Lee and Paula Seligson, 29 March 2023.
2 Stepstone Group, 'Private Debt Secondaries – Moving beyond GP/ LP transactions and into the world of liquidity management', 29 June 2023.

Further Reading:

- Across the pond and back again: what direct lenders should know before deploying historic dry powder (2022) 3 JIBFL 154.
- A wolf in sheep's clothing: are transfers of economic interests undermining privity of contract in the medium-term loan market? (2023) 8 JIBFL 507.
- Lexis+® UK: Banking & Finance: Practice Note: Key issues in loan transfers.