CLO Coverage

Liquidity Transformed: How Dealer Retrenchment Reshaped Structured Products

Wed 06/25/2025 12:26 PM EDT

Reporting: Sid Punjabi

The increase in risk-based capital charges on banks following the 2008 financial crisis has led to a drawdown in the volume of securitized products held on inventory despite the increase in the overall size of the asset class. Since 2013, the outstanding balance of private-label securitized products has increased by about 140%, but over the same period, broker-dealer holdings have decreased by nearly 50%. This trend has forced investors to shift in how they think about market structure and liquidity.

Single-asset structural drawdowns and increased regulation has caused management at major broker-dealers to pull back trading capital, leading investors to bemoan sporadic client relation service and diminished liquidity. These shifts have slowly changed investor preferences over time, with private market and liquidity tools being used across the structured product landscape to change how capital flows through a number of asset classes.

New tools such as third-party trading platforms, exchange traded funds, private credit and fund finance have proven to investors that an alternative path to deploying capital exists outside of intermediaries.

Regulations and Drawdowns

Over the past decade, a familiar pattern has emerged in structured product markets: As regulation and structural drawdowns drive down trading returns, banks pull back capital, and senior talent exits - leaving markets increasingly fragile. Each new single-asset drawdown reinforces this cycle.

Regulations have changed the nature of trading at major broker-dealers. Basel III and Volcker rules transformed the ability of most major banks to hold inventory on their balance sheets, especially as risk-based capital, or RBC, charges have increased how capital intensive it is to hold most fixed income securities.

“Post Global Financial Crisis, regulators have made it increasingly difficult for dealers to use their balance sheets to provide liquidity to the market,” said Shawn Cooper, portfolio manager at Orchard Global. “With the Volcker Rule and restrictive capital charges now over 10 years old, we have seen a steady move from dealers acting as principals to becoming intermediaries.”

Cooper said that this transformation has had both positive and negative impacts on investment managers.

“On the positive side, dealers often held asymmetric information which disadvantaged investors, and on the negative side, it removed a large block of investors from holding CLOs for extended periods of time,” Cooper said. “It's difficult to conclude the net effect, however, it is certainly a consideration when investing in the CLO market.”

These regulations, coupled with structural corrections in specific asset classes, have caused banks to move to increasingly risk-averse positions with lower capital charges. Commercial mortgage-backed securities were the latest example of how global events such as the Covid-19 pandemic shape return outcomes for trading desks.

“CMBS trading was the latest example of this structural issue,” said Daniel Ezra, founder of Entegra and former global head of securitized products trading at Credit Suisse. “Most banks in the asset class were caught long a lot of private label CMBS risk, which forced them to become net sellers - from a peak of $7.66 billion in December 2022 to $4.88 billion by September 2024, according to Fed data."

Ezra added that as trading volumes decline, dealers retreat from providing two-way markets, compounding the liquidity problem.

"Although CMBS has since rebounded, there is little reason to believe the outcome will be different in the next stress cycle - whether it's in CMBS, RMBS, ABS, or CLOs - unless the model changes," Ezra added.
Ezra argues that the answer is not just more capital, it is a rethinking of the model itself. Rather than forcing desks to internalize risk and compete asset class by asset class, banks could reduce exposure to future drawdowns by bifurcating flow and credit trading. "The current structure forces desks into a defensive posture," Ezra notes. "Without change, they'll remain reactive, not strategic."

Cary Ho, a partner at CVC Partners, believes that there have not been enough historical credit outcomes within the structured product market to determine how liquidity will be shaped in a credit event.

"We have not really seen a true, prolonged credit cycle," Ho said. "While the macro landscape continues to see uncertainty and can be challenging to navigate, the selloff after Liberation Day was still rather orderly. Until we see something definitive and prolonged, the result is just going to be wider bid-ask spreads."

Third-Party Trading

Bids wanted in competition, or BWICs, are a means of transacting on structured products through an auction process with anonymous counterparties that often takes days to close. The process has changed how large investors are able to trade out of their positions by transacting with peers.

"BWICs have become the primary source of liquidity in structured products because the market has lost its dealer backbone," says Ezra. "As balance sheets have shrunk over the past decade, banks have stepped back from making two-way markets, and what's left is an auction process that's manual, time-consuming, and increasingly inefficient."

These auction processes can take hours to complete, and hit rates are often under 10%, according to Ezra. Even when trades occur, sale prices often go undisclosed.

In addition, dealers today only bid selectively - typically when they have an axe (a list of holdings that a dealer has an interest to buy or sell), or a client on the other side - which reduces price tension and results in a wider dispersion of bids. The impact is most acute in lower-rated tranches or impaired bonds, where visibility is already thin.

"For many buyside firms, BWICs aren't just inefficient - they're a barrier to participation," Ezra said.

Entegra's trading as a service, or TaaS, model aims to address this structural imbalance by acting as a third-party trading partner. The firm facilitates deal-specific market-making on behalf of banks using a capital-light model, enabling them to remain active in credit markets without warehousing risk or maintaining full in-house trading infrastructure. The platform runs on a subscription-based model charged per deal and does not take trading commissions.

ETFs

CLO exchange traded funds, or ETFs, saw explosive growth during 2024. The ETFs have brought an example of live liquidity and a retail buyer base to a traditionally institutional and illiquid asset class. Invesco has been part of this market structure change with their ETF, ICLO.

"One driver of the rapid growth in CLO ETFs since 2020 has been the access they provide to an asset class that was previously inaccessible to retail and certain institutional investors," said Ian Gilbertson, portfolio manager and co-head of

U.S. CLOs at Invesco.

Gilbertson said that overall liquidity has improved in tandem with the growth in the CLO market, and noted that ETFs have found a very receptive buyer base.

“Liquidity is a key risk factor that directly influences the credit spreads of CLO tranches, particularly at the senior levels,” Gilbertson said, adding that these fund structures have enhanced price transparency in the secondary market. “Many AAA CLO note buyers - such as banks - tend to buy and hold positions. In contrast, CLO ETFs facilitate more secondary trading of these holdings. Through the creation and redemption process, ETFs are more active in trading the underlying assets versus some more established buyers.”

With total CLO ETF assets now touching over $30 billion in aggregate, the wrappers are expected to have a material impact on how people think about the structured product space, bringing about more accessibility and liquidity to the market.

Private Credit

A significant portion of loan assets have shifted to private credit in the past several years, and offer investors a higher-yielding alternative to holding traditional liquid issues . Investors are able to trust the sponsor to steward their capital, turning away from public markets to trade liquidity for their general partners’ relationships.

The shift to private markets has disintermediated broadly syndicated loan issues and instead allowed sponsors to customize the underlying asset. Despite recent efforts to establish secondary trading of private credit loans, the asset class has not increased traditional liquidity in the sector, but the spread pickup helps investors to get comfortable with the illiquidity from a relative value perspective.

“There is a real attraction for private credit and middle market CLO debt and equity,” said Tracey Jackson, managing director at First Eagle Investments. “Investors can generate further yield on a ratings-equivalent level compared to broadly syndicated loans and CLOs, trading transparency and portfolio loan liquidity for yield.”

This illiquidity in the secondary market provides for an interesting dynamic. Jackson says that private credit CLOs offer reduced volatility in portfolio pricing from short-term technicals relative to BSL CLOs, and that secondary trading of tranches will be influenced more by the track record of the manager.

“Investing in BSL CLO debt, there are two layers of markets that could drive volatility - at the CLO portfolio level and then CLO debt level,” Jackson said. “Loan portfolio performance will drive the CLO MVOC, default rates, and rating composition, all of which could impact the trading level of the CLO debt alone. Layered on the tiering from this portfolio performance, CLO debt and equity secondary trading will tighten or widen with the CLO market environment, as we saw post Liberation Day.”

Illiquidity can serve as both a positive and negative within portfolio construction. For many investors, on one hand, the idea of not being marked at the whims of the market and instead focusing on their lender-borrower relationships are more important than the ability to exit their positions. On the other hand, the natural downside is the difficulty to transact in thin markets.

“Unlike with BSL CLOs, investors in private credit CLOs accept a degree of opacity when making investments,” said Orchard Global’s Cooper. “A key consideration when making private credit investments is if the pickup in spreads over BSL CLOs adequately compensate investors for the lack of visibility and potential for lower liquidity.”

In thinking about which managers to choose, the legal aspect of these deals, such as the covenants and workout teams, have become crucial in differentiating processes across private credit firms.

“Documentation and related lender protections remain a key aspect of private credit deals, particularly lower-middle market direct lending," said Kate Luarasi, partner at Kirkland & Ellis' structured finance group. "In this segment of the market, the relationship with the borrower and sponsor plays a critical role both at the outset of the deal such as getting the allocation, as well as during any times of turbulence, such as covenant default [or] forbearance. Outside of lend-to-control or similar strategies, most middle market direct lenders work actively with their portfolio companies and their sponsors to alleviate present challenges and avoid a workout scenario."

The conflicting ideas continue to factor into the decision-making process of many investors, but the additional spread from the illiquidity premium that is generated from private assets continues to pull capital, and the growth of private credit and middle-market CLOs should continue forward in a meaningful way.

Fund Finance and Rated Feeder Notes

Rated feeder notes and collateralized fund obligations, or CFOs, have emerged as a new means of transacting underlying credit portfolios in private-label credit. While the secondary market for these capital structures are minimal, they have proven to be another private market solution, this time allowing risk-based capital-constrained investors to access equity investments.

CFOs and rated feeders have both proven to be longer-dated, more customizable structures that allow sponsors to bring capital back into their structured credit portfolios by removing the need to raise equity capital - something that is proving to be increasingly difficult to do in an environment where demand for debt outstrips the equity demand.

Adam Risell, partner at Simpson Thacher & Bartlett, believes that the confluence of liquidity preferences has changed how investors approach the market.

"As sponsors continue to face headwinds raising equity capital for structured products issuances, sponsors are turning to traditional high-yield fixed income investors such as hedge funds to fill the gap, many times in the form of a preferred equity investment," Risell said. "This shrinks the requisite equity a sponsor needs to raise and many times sponsors can provide the equity funding themselves when utilizing a preferred tranche."

CFOs are similar in nature to rated feeder funds, with the caveat that rated feeders are generally capital structures built on a singular fund. CFOs, however, are an aggregation of multiple fund stakes, either led by limited partners or GPs.

LPs who raise CFOs often include multiple stakes within the CFO and use the structure as a liquidity tool for their private fund holdings. The liquidity that is provided from existing stakes into these funds can often be used to reinvest in subsequent, newer vintage funds from the same GPs. GP-led CFOs are often more concentrated either by fund or strategy and are predominantly used as a fundraising tool by the GPs. Both LP- and GP-led CFOs are proving to be a new form of structured credit and an alternative form of moving fixed income liquidity in the market.

"We see more potential in the near term for rated note structures that include securitization-like components like collateralized fund obligations to potentially have secondary liquidity," said Kirkland & Ellis' Luarasi. "Some of the standardization and development of 'market' terms for these interests could facilitate increased liquidity options. At least with help from sponsors or managers or market participants, such as banks or structuring and placement agents."

Rated feeder funds are capital structures that are built on top of new funds. The capital structure is handled in a separate entity that feeds into the main fund that is being raised by the GP. The traditional LPs still have direct fund participation, but the insurance companies get their debt commitments to the rated feeder rated by the ratings agencies in order to gain RBC-friendly participation.

"Rated feeder notes have been adopted by insurers as an asset class," said Pramit Mukherjee, managing director at SLC Investments, who adds that without the insurance, capital cannot meaningfully participate given high capital charges for LP investments.

"When you think about rated feeders, insurers are able to consider both horizontal and vertical participation, with horizontal strips being more favorable given that they are considered rated debt tranches, and therefore carry more favorable capital charges," Mukherjee said. "It will be interesting to see how the asset class evolves over time."

Secondary liquidity in the rated feeder space, however, is less likely given how the product is structured.

"For single vehicle, closed-end rated note feeders such as a single feeder investing in a single closed-end private fund, transfers are strictly restricted and subject to prior consent and investor eligibility requirements, both qualifications and deliverables," said Luarasi, who added that the intent at signing is that the investor commits to hold until maturity.

"Investors looking to exit early to address a change in liquidity or portfolio rebalancing needs may not have access to interested institutional buyers with the same or similar risk-return profile," Luarasi continued, adding, "In certain cases, an investor looking to exit may have the added complexity of coordinating a sale of a pro rata portion of each tranche in a vertical strip."

Luarasi noted that unless the investor, the sponsor or an intermediary is successful in finding a buyer, the expectation is that they will hold to maturity.

While the fund finance products do not share the same prominence as traditional CLOs or ETFs, players in the industry believe that these products will become a mainstay but will evolve with regulations as the structures become more mature.

"You think about CLOs 15 years ago, and they were considered risky investments that were not suitable for insurance balance sheets," said SLC's Mukherjee. "These rated feeders and CFOs are similar in a way - once there is more transparency and a true ratings methodology from the rating agencies and the NAIC, I think they will prove to be a growing and defensive asset class."

Luarasi said that regulations have a direct, material and continuous impact in capital structures. She told Octus, formerly Reorg, that she believes that the National Association of Insurance Commissioners has been one of the driving forces in the evolution of the fund finance and rated feeder markets.

"In the context of rated notes and similar products, the continuing evolution of these structures is a result of a confluence of ongoing triggers and developments and not the direct result of a single regulator or market participant nor any single event," Luarasi said.

"As the number of rated note structures and insurance company investors grew, so too did the regulatory scrutiny, guidance and attendant limitations, in turn prompting further evolution in structuring and legal documentation to address regulator concerns while still allowing insurance companies the ability to participate within the framework," Luarasi noted.

"Ultimately, the regulators are protecting their constituencies and it is incumbent on legal advisors and other market participants to generate innovative solutions and optimize technology for managers and investors within the established regulatory framework and guardrails," Luarasi added.

KBRA has rated over $37 billion in CFOs and over $2 billion in rated feeders, with the expectation that they will continue to be a stronghold in private markets. These innovative structures will likely continue to gain popularity as an alternative means of transacting private-label structured products, especially as secondary liquidity becomes increasingly peer based.
