



Portfolio Finance: An Opportunity for Enhanced Spreads Through IG Credit

INSIGHTS

Portfolio finance offers a number of potential benefits for insurers seeking to generate enhanced spreads at scale in a growing market.



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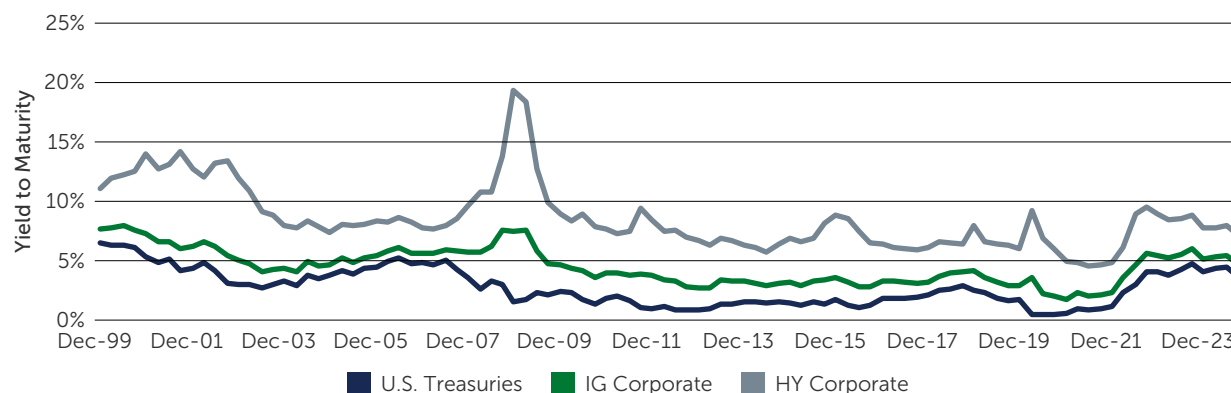


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Yields across fixed income are elevated, but many insurance companies are struggling to generate attractive spreads through traditional investment grade (IG) and high yield markets. This challenge is perhaps most evident in IG corporate credit, where current yields remain high relative to the past 25 years (Figure 1), while spreads are exceptionally tight.

Figure 1: Yields Remain Elevated Across Fixed Income



Sources: Barings, Refinitiv DataStream. As of September 30, 2024.

With spreads across public fixed income markets at or near historical tights, insurers seeking to provide more competitive pricing are increasingly looking to private markets for solutions. This is where portfolio finance comes in—little-known and less-understood, the asset class is garnering increasing attention from insurance investors for its ability to offer enhanced spreads through IG-rated investments.

Supporting the Expansion of Private Markets

Private markets have expanded rapidly over the last decade, and that momentum looks set to continue given the widespread benefits they provide—not only for investors, but also from a socioeconomic standpoint. Indeed, while private markets offer investors a source of potentially enhanced returns, they also have become an important source of capital for the development of critical infrastructure, as well as a key driver of economic growth.

As private markets continue to grow—and as managers expand their capabilities across the spectrum, from private debt to private equity—there will be (and, in fact, already is) a significant need for capital to provide leverage to those managers. There are two distinct ways that fund or portfolio financing, which provides loans to private market funds, can address this growing need:

1. **Subscription Line Financing** refers to loans that are provided to a general partner’s (GP) private market fund and backed by recourse to undrawn limited partner (LP) commitments. These financing facilities typically provide short-term working capital to GPs, offering them an efficient way to draw capital and make investments as their fund ramps.
2. **Portfolio Finance** refers to loans that are provided to a GP’s private market fund to support the long-term capital and liquidity management of the portfolio. These loans are typically cross-collateralized by the fund’s underlying investments. They also provide longer-term capital at prudent Loan-to-Value (LTV) ratios and can typically achieve investment grade ratings.

Portfolio Finance: A Broad & High-Quality Opportunity Set

Many investors associate fund or portfolio financing with providing leverage to private equity (PE) funds. That association is not incorrect—PE funds do make use of fund financing, a practice known as NAV lending, to raise debt against their portfolios. The debt can be used for a number of reasons, such as for further investment into their portfolio or for paying out cash to LPs while holding companies mature. It is a significant part of the fund financing market as well, and one we expect to require over \$75 billion of funding annually. However, it does not tell the full story—and there is, in fact, a wide opportunity set beyond NAV lending.

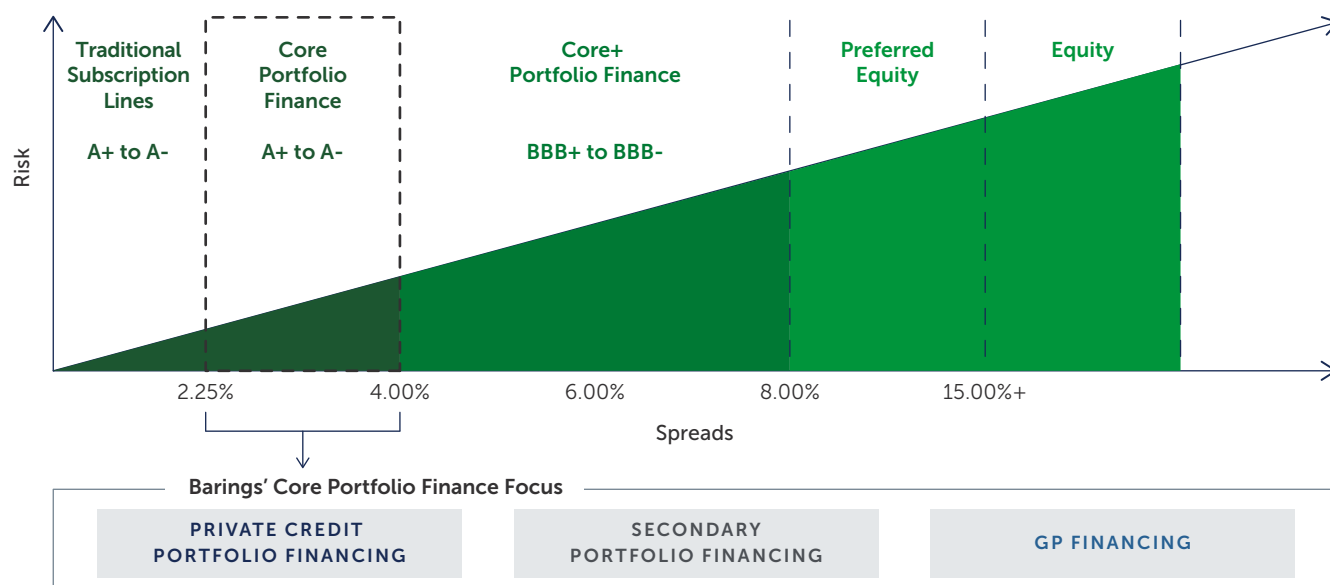
Specifically, there are a range of lending strategies that have been in existence for over a decade and have grown in parallel to private markets more broadly. These strategies span the spectrum of private markets, from infrastructure debt to direct lending, and origination styles, including both primary and secondary funds.

Across both NAV and more diversified strategies, as mentioned, portfolio finance loans that maintain

prudent LTV ratios typically are assigned investment grade quality ratings. The credit quality of the individual loans largely depends on the diversity, quality and certainty of the underlying investments. All else being equal, loans secured by private credit or diversified pools of secondary LP interests typically receive higher credit ratings than those secured by private equity. For this reason, we refer to private credit, secondary and similarly focused strategies as the ‘core’ segment of portfolio finance. Similarly, we refer to higher-risk (though still IG-rated) strategies, such as NAV lending, as the ‘core+’ segment of the market.

In terms of spread enhancement, we expect core portfolio finance to offer spreads in the range of 225–400 basis points (bps), while core+ loans typically offer spreads in the range of 400–600 bps.¹ Although there are a range of strategies that can deliver higher returns by allocating on an opportunistic basis, we expect the majority of investor demand and the fund financing market to focus on core and core+ loans.

Figure 2: Core Portfolio Finance Offers Exposure to Varying Risk-Return Profiles & Market Segments



Source: Barings. As of September 30, 2024.

1. Source: Barings. As of September 30, 2024.

Breaking Down Core/Core+ Portfolio Finance

PRIVATE CREDIT PORTFOLIO FINANCING

Private credit portfolio financing is the financing of a cross-collateralized portfolio of private credit assets. This type of financing is used to tailor a private credit strategy to suit an investor's unique needs, from specific investment goals to return targets. For instance, if an investor likes an asset manager's direct lending strategy but requires higher returns, this type of financing allows for a separately managed account (SMA) or levered sleeve, offering the potential to achieve the desired returns without altering the underlying strategy's risk profile. Given the rapidly rising popularity and growth of the private credit market, there is robust growth potential within this area.

SECONDARY PORTFOLIO FINANCING

The financing of private market secondary portfolios has existed since the early 2000s, and typically involves lending against a cross-collateralized portfolio of LP interests in funds. These loans benefit from the significant diversity of the portfolio's underlying assets, which can number in the hundreds or even thousands. LPs' motivations for selling their interests in funds can vary, and they often include portfolio management goals—like managing exposures to different vintages, styles, and managers—or freeing up capital to invest in new vintage funds. Regardless of the motivation, secondary portfolio financing can help close the bid-ask spread between buyer and seller to make such transactions possible. It is also increasingly used as a portfolio management tool by secondary PE asset managers to smooth distribution profiles, refinance deferred consideration, or help bring the fund closer to being 100% invested.

GP FINANCING

GPs are typically required by LPs to invest their own capital in their funds, with this "skin in the game" helping to ensure GP-LP alignment. But as asset managers grow and raise additional funds, they may not have as much capital readily available to invest. When combined with longer hold periods, continuation vehicles, and strategic growth initiatives, there is a growing need for capital to help GPs further align themselves with LPs. GP financing can be an effective solution, allowing managers to continue investing alongside LPs in their own funds, without being forced to raise dilutive equity capital. This type of financing can also help GPs invest in the growth and expansion of their own platforms, manage succession planning, and engage in other activities that require additional capital.

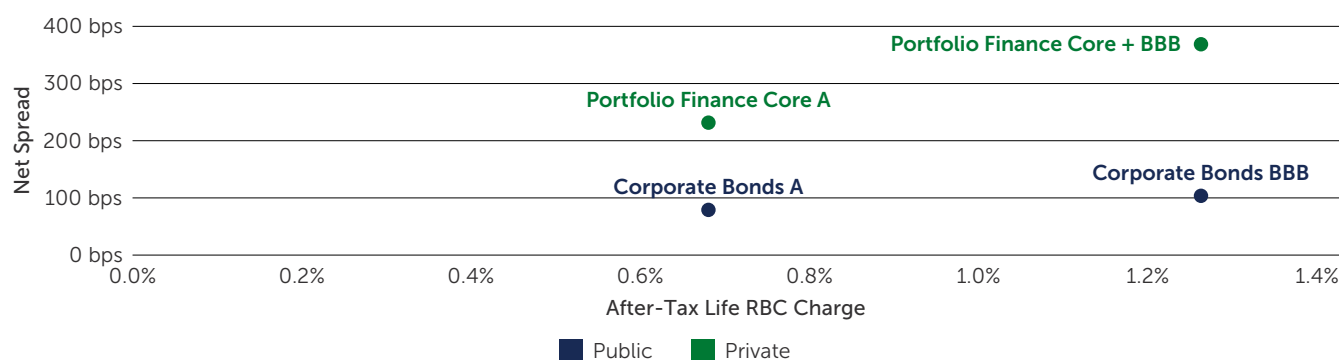
“Across both NAV and more diversified strategies, portfolio finance loans that maintain prudent LTV ratios typically are assigned investment grade quality ratings.”

Portfolio Finance: The Advantage to Insurance Investors

Portfolio finance, through its combined offering of investment grade ratings and enhanced spread potential, is a particularly compelling option for fixed income investors seeking to reduce risk while maintaining spreads or enhance spreads while maintaining risk. For liability-driven investors such as insurance companies and mature defined benefit pension schemes, there are additional benefits—insurance companies, in particular, benefit from the significant increase in spreads while incurring no additional capital requirements.

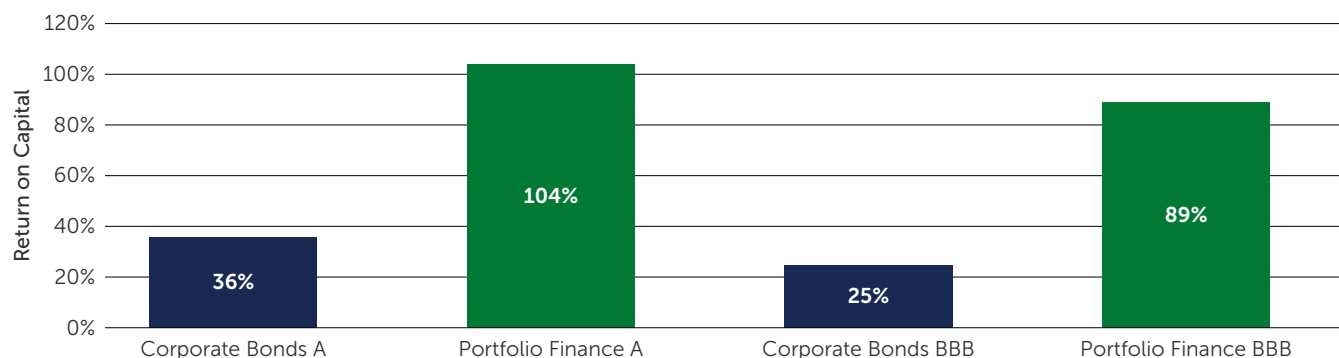
This stems from the fact that under U.S. Risk-Based Capital (RBC), there is no penalty from a capital perspective for investing in illiquid credit. The result is a higher potential return on capital for portfolio finance loans when compared with liquid credit of similar credit quality. Like all bonds and loans, portfolio finance loans attract a spread charge based on their rating. At Barings, our portfolio finance loans receive a rating from an external credit assessment institution, which results in favorable capital treatment and therefore a high return potential on capital (Figures 3, 4).

Figure 3: Portfolio Finance vs. Public Assets: Estimated Net Spread and Life RBC Charge



Source: Barings’ assumptions, ICE Bank of America U.S. Corporate Bond Index, National Association of Insurance Commissioners (NAIC). As of November 12, 2024. Barings’ interpretation of NAIC’s U.S. Life RBC. Net spreads include adjustments for estimated losses from defaults and estimated fees. Assumes a tax rate of 21%.

Figure 4: Return on Capital for Portfolio Finance vs. Liquid Credit for a Typical Insurer



Source: Barings’ assumptions, ICE Bank of America U.S. Corporate Bond Index, NAIC. As of November 12, 2024. Barings’ interpretation of NAIC’s U.S. Life RBC. Return on capital is defined as net spread (net of estimated losses from defaults and estimated fees) over the estimated additional capital that a life insurer will need to hold to support that investment (after-tax life RBC factor * target RBC ratio * covariance adjustment), using the average life insurance industry RBC ratio and a covariance adjustment of 75%. Assumes a tax rate of 21%.

An allocation to portfolio finance can also generate significant yield enhancements. **Figure 5** highlights the potential benefits of the impact of repositioning investments in public IG corporate bonds to portfolio finance. Our analysis shows the impact of increasing allocation in portfolio finance from 0% to 20% and the associated pickup in spread. Notably, because the U.S. RBC regime imposes the same capital factors for both liquid and illiquid credit, insurers have the opportunity to increase spread without additional capital requirements.

Figure 5: Improving Expected Return with Portfolio Finance

	Current Portfolio	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4
IG Credit	100%	95%	90%	85%	80%
A Rated	60%	57%	54%	51%	48%
BBB Rated	40%	38%	36%	34%	32%
Portfolio Finance		5%	10%	15%	20%
Core A Rated	-	3%	6%	9%	12%
Core+ BBB Rated	-	2%	4%	6%	8%
Summary					
Net Spread	91	100	110	120	130
After-tax RBC Charge	92	92	92	92	92
Increase in Spread	-	10	20	30	40

Source: Barings' assumptions, ICE Bank of America U.S. Corporate Bond Index, NAIC. As of November 12, 2024. Barings' interpretation of NAIC's U.S. Life RBC. Assumes a tax rate of 21%.

Finally, portfolio finance loans are typically floating rate, which is also beneficial for insurers. For liability backing portfolios, a simple interest rate swap overlay can be implemented to support asset and liability management (ALM) requirements. As such, insurers can make use of the high spread potential available through portfolio finance to fund liabilities with capital efficiency.

In addition, the floating-rate nature of portfolio finance is beneficial for insurance companies seeking the certainty of fixed income without duration. This is particularly important for surplus investments, where there are no ALM considerations. An allocation to portfolio finance will not introduce duration to the balance sheet.

There is a further key benefit to insurance companies beyond risk, return and capital arguments: enhancing deployment. Given the scale and diversity available in the private markets, portfolio finance provides insurance companies an opportunity to reduce the time to deploy capital into private credit through a diversified and capital efficient portfolio.

Key Takeaway: Sizing Up the Opportunity

The rising demand for tailored investments, the expanding secondary market, and the growing need for GP capital should provide a tailwind for continued growth in the portfolio finance market in the coming years. And, while the scale of the market opportunity is difficult to quantify, we estimate it will be significant—and is perhaps being overlooked. Current forecasts, as mentioned, call for growth to roughly \$75 billion per year by 2028. However, most focus almost exclusively on PE buyout NAV lending and largely disregard core portfolio finance strategies. This suggests that the total size of the opportunity could be much greater—to the tune of over \$200 billion per year. We break this down [here](#).

Against this backdrop, and considering the ongoing expansion of private markets, the increasingly sophisticated financing needs of asset managers, funds, and asset owners, and the structural shift away from traditional bank capital, portfolio finance presents an increasingly significant opportunity. The potential to meaningfully improve returns, enhance capital efficiency, and reduce risk makes portfolio finance particularly compelling for insurers looking to enhance deployment within IG private credit—and we expect it to become a staple in strategic asset allocations going forward.

Barings' Portfolio Finance Platform

EXPERIENCE & SCALE

\$41+ B executed since inception of strategy in 2017

ALIGNMENT OF INTEREST

Investing alongside our parent company

IG RATING

External credit ratings supporting capital efficiency

INSURANCE SOLUTIONS

Taking a solutions mindset to our borrowers and investors

REPORTING

Customized reporting to meet our insurers' needs

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