# THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING

Second Edition

Edited by
Lee M. Shaiman
Bridget K. Marsh
Loan Syndications and Trading Association

## Praise for *The Handbook of Loan Syndications and Trading*

"This handbook is a wealth of important information for all who regularly navigate the U.S. loan market, compiled by some of the industry's leading experts. From the basics of market structure, to some of today's more complex topics, it's all in here."

—**Jeff Bakalar**, Senior Managing Director, Group Head and CIO of Voya Investment Management

"This is a fantastic resource that explains the intricacies of the growing U.S. corporate loan market—from the primary market where the loans are originated to the secondary market where they are actively traded. Everything is explained in one easy to use source."

—**Andrew Sveen**, Vice President of Eaton Vance Managing Director of Morgan Stanley, Director of Bank Loans

"This book captures all the loan market's developments since the Global Financial Crisis—it's an amazing resource for new entrants to the market, seasoned professionals, and investors!"

—**Scott Baskind**, Head of Global Senior Loans and Chief Investment Officer of Invesco

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Editors:

**LEE M. SHAIMAN**

**BRIDGET K. MARSH**


New York Chicago San Francisco Athens London
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# ACKNOWLEDGMENTS

Sixteen years ago, I helped the Loan Syndications and Trading Association (LSTA) by reviewing articles that had been submitted for the first edition of *The Handbook of Loan Syndications and Trading*. I learned a lot from that exercise. Until then, as a finance attorney, I had not fully appreciated the importance of certain provisions tucked away at the back of every credit agreement nor their significance to the growing loan market. Once I was in-house counsel to the LSTA, those provisions took on a much greater importance to me as I learned more about origination practices, secondary market trading, loan assignments, and the settlement of loan trades.

Perhaps I was an unusual choice—a lawyer—to be an editor of the second edition. Over the past year, I've had the pleasure of working with the book's authors, the majority of whom have not been lawyers, and through the editorial process, I have developed a deeper understanding for other loan market–related (nonlegal) topics such as loan trading strategies, ESG and the loan market, and portfolio management.

The book provides an overview and history of the U.S. loan market. It examines the primary market where loans are originated and the second loan trading market, which continues to break records for trading volumes. It provides insights on trading strategies, portfolio management techniques, and key provisions of credit agreements. It also tackles the latest trends, including the cessation of LIBOR, the emergence of ESG, and the globalization of the loan market.

The first edition was published shortly after the LSTA celebrated its 10th anniversary. The second edition will be published after the LSTA's 26th anniversary. During that time, the LSTA has grown enormously—membership is now close to 600 entities (which includes an impressive 25,000 individuals), although the LSTA, itself, remains streamlined with 16 full-time staff. Together the LSTA staff covers all disciplines within the loan market—the loan origination; trading and settlement of loans; the legal, regulatory, and advocacy side of the loan market; and the market's practices and operations—we cover it all while working to educate our membership on the market, its activities, and trends.

As the loan market has evolved, so too has the LSTA's profile and prominence. Our Executive Director, Lee Shaiman, our General Counsel and Co-Head Public Policy Group, Elliot Ganz, and EVP of Research and Co-Head Public Policy Group, Meredith Coffey, all work to promote the loan market in Washington, DC and may be found, from time to time, in the halls of Congress testifying, educating, and meeting staff there. Ted Basta, EVP of Market Analytics and Investor Strategy, is synonymous with the secondary loan market; he knows everyone and everything about it. My colleague and EVP of Public Policy and Associate General Counsel, Tess Virmani, has worked tirelessly for the past few years on the market's transition away from LIBOR, on the growth of ESG, and of course on her day job involving the LSTA legal work. Ellen Hefferan, EVP of Operations and Accounting, continues tirelessly to fight hard to move the ball forward in the tricky area of loan operations. Lisa Schneider, EVP of Membership, works hard both to grow our membership and keep in contact with our existing members. Together we are a formidable and talented team.

I would like to thank my colleagues for their valuable contributions to the book. Lee has updated the first chapter on the overview of the entire market. Meredith and Elliot have teamed up to write the regulatory chapter. Elliot has written the ever-important "loans are not securities" introduction. Tess has written the ESG introduction. Meredith and Tess together tackled the transition away from LIBOR chapter, and Meredith and Elliot wrote the regulatory chapter. Ted has updated the entire chapter on the secondary loan market and created many charts in this book. Ellen has written the primary market delayed compensation article and been incredibly helpful on the accounting chapter.

I would like to thank all my LSTA colleagues for their time, effort, and articles. They have all contributed immensely to the Handbook's successful completion. I would also like to thank all of the authors of the first edition of the Handbook. Some of the articles from that first edition have been used here but all of them have been incredibly useful. Finally, I would like to give a very special thank you to my colleague, Margarita Valdes, Administrative Assistant, who has worked tirelessly with me, the authors, and McGraw Hill to help pull this enormous project over the end line. She is a true professional who has done an excellent job.

Whether you are a newcomer to the market, a seasoned professional, or someone who is merely interested in learning more about the corporate loan market, I hope you find the book a useful guide. Take it, read it, and join us on our quest to continue to make the corporate loan market a fair, orderly, efficient, and growing market.

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# PREFACE

The corporate syndicated loan market, indeed the entire leveraged finance marketplace, has changed and developed significantly since publication, in 2007, of the first edition of *The Handbook of Loan Syndications and Trading* (the "Handbook"). The syndicated loan market has more than quadrupled in size over nearly 15 years in spite of the Global Financial Crisis (GFC) and COVID-19 pandemic. Today's market is stronger and has more diverse ownership than it ever has had in its history. The investor base still includes the banks and mutual funds, who were early investors, but those early pioneers are overshadowed by collateralized loan obligations (CLOs) and other structured vehicles, pension funds, international banks, insurance companies, sovereign wealth funds, exchange traded funds (ETFs), and hedge funds.

Average leveraged loan issuance over the last 10 years, according to Refinitiv LPC, has been $864 billion, up significantly from the period prior to the GFC of 2008–2009. Recovery from the GFC demonstrated the resilience of the asset class, encouraging investors that the credit risks were reasonable, while low absolute level of interest rates provided further encouragement with significant returns. With overall growth in the market came improvements in trading and liquidity. Total trading volume for 2019 was $743 billion. The pandemic shadowed 2020, but the market still registered $772 billion of loans changing hands, with first quarter volume alone witnessing over $250 billion of trades, as some investors exited risk-based assets and others repositioned portfolios.

The first edition of the Handbook was written over 15 years ago, with the help of nearly 50 participants within the loan market. The Handbook has been a useful tool and reference for financial professionals and students, seeking to understand the many nuances of what was then a relatively new segment of the broader capital markets. Times change, markets develop, documentation evolves, and market practices are refined. The Handbook needed updating to reflect all those trends. With this second edition we are confident that readers will continue to rely on the Handbook as they consider the corporate loan market or look to negotiate its nuance.

## THE LSTA

The Loan Syndications and Trading Association (LSTA) was founded by a group of market participants in 1995, over 25 years ago, to advance the interests of the marketplace and to promote the highest degree of confidence for investors in floating rate corporate loans. The LSTA's mission is to foster cooperation and coordination among all loan market participants, facilitating just and equitable market principles, and inspiring the highest degree of confidence among investors in the corporate loan asset class.

## FULFILLMENT OF THE LSTA'S MISSION

Loans are not securities! As a result, no single regulatory authority oversees and sets standards on how loans are to be structured, sold, and traded among the various parties and counterparties. Following the GFC, Congress created, through the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Financial Stability Oversight Council within the Treasury Department. The Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) have regulatory oversight for the banking system. The Securities and Exchange Commission (SEC) has regulatory authority over markets, investment companies, and investment managers. Through joint rule making, these agencies have an ability to regulate the loan market, which, to this writing, has been limited. That said, the development of market standards and documentation has largely been left to the self-determination of the market. The LSTA has since its inception been focused on the consensus building necessary to solving

problems, improving market practices, and developing efficiencies that have led to the market's growth.

Today the corporate loan market is well established as a large and mature market. While its growth has been gratifying to the many participants who have dedicated their careers to it, the loan market continues to present many challenges. Its virtue as a flexible provider of capital to help American companies grow is also a principal source of those challenges. Terms and conditions are dynamic, and documentation must accommodate that variability. The flexibility provides further stress on trading, settlement, and liquidity. Structuring, trading, and management of loans and loan portfolios is a specialized area of finance. The LSTA seeks to educate both new investors as well as veterans as we grow the market, streamline processes, improve documentation, and increase the transparency and competence of all market participants.

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*Executive Director*
*Loan Syndications and Trading Association*

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CHAPTER 1

# An Introduction to the Loan Asset Class

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# An Introduction to the Loan Asset Class[1]

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The bank loan asset class has enjoyed significant growth, in issuance by borrowers, and broad acceptance by investors, achieving "core-plus" status within traditional fixed income allocations. In 2007, when the first edition of the *Handbook* was published, corporate bank loans were considered an exotic or alternative asset class, not quite in the mainstream. It is instructive to review the history and unique characteristics of the asset class as a way of explaining how these changes have taken place in the capital markets.

Historically, markets develop at the intersection of supply and demand. Acceptance of higher levels of financial leverage on corporate balance sheets, both by corporate managements and investors, converged with the needs of banks to distribute or syndicate credit risk as a tool to optimize use of bank capital. To meet these diverse requirements, a floating rate, term loan market developed, which, over time, has produced modest, though solid, risk-adjusted returns with lower correlations when compared to other major asset classes.

## A SHORT HISTORY OF BANK CREDIT RISK SINCE THE 1980s

### Commercial Bank Credit Culture

Pioneering loan market participants learned their craft in highly formalized training programs designed by large commercial banks. Such programs were conducted at great expense to develop hundreds of trainees who learned to evaluate creditworthiness from scores of dedicated instructors. Course materials included an intensive indoctrination in accounting, risk analysis, cash flow

[1] We would like to thank Scott Page and Payson Swaffield, authors of "An Introduction to the Loan Asset Class," which was in the first edition of this book. Portions of that article have been used here.

projections, legal ramifications, and many other topics that institutions deemed young analysts must know before being deployed in a lending department of a bank.

Each of these departments created commercial loans, the large majority of which were expected to be held to maturity or repayment by the lending bank. The loans were sometimes syndicated, usually to other banks, and typically through a corresponding banking unit. Such syndication was a laborious and rudimentary process compared to today's practices. Syndicate lenders had no expectation that the loans would trade or even be assigned a market-determined value. Corporate loans are now, and have always been, private, customized contracts between a lender (or lenders) and a borrower. Prior to the advent of a robust syndicated market, banks were expected to hold credit risks on the balance sheet, often with large undiversified exposures, driven by customer relationships, profit centers, excess capital, and other business considerations having nothing to do with portfolio management techniques associated with securities such as stocks and bonds. Despite the best efforts of credit-risk management departments and pedantic credit evaluation, relationship banking has been blamed for repetitive and noteworthy credit debacles in real estate, oil and gas, sovereign debt, and ill-conceived leveraged buyout (LBO) loans. The cumulative effect of such lapses on banking practices and capital created conditions that led to a significant restructuring of bank lending through mergers, consolidations, outright bank failures, and the development of nonbank institutional lending, along with repeal of the Glass-Steagall provisions of the Banking Act of 1933, which separated commercial and investment banking.

## High-Yield Bonds Emerge as an Asset Class

Prior to the 1980s advent of the high-yield bond market, underwriting and trading of corporate credit was largely the purview of investment banks and focused on raising money for investment grade–rated transportation, utility, and a few financial corporations. The now defunct Drexel Burnham Lambert started a revolution by trading fallen angels, companies whose credit ratings had fallen from investment-grade to speculative ratings in the late 1970s and early 1980s. Seeing success in secondary trading of these risky credits, investment banks began underwriting new bond issues. The emergence of the high-yield market changed everything, filling

a vacuum that had defied nature for far too long. There can be no doubt that the emergence of a robust high-yield market acted as a catalyst for change in corporate finance generally, and for the emergence and growth of the bank loan asset class. Although both asset classes began to grow dramatically into the turn of the next century, by 2013 institutional syndicated loan issuance was eclipsing high-yield bond issuance.

Prior to the formation of the high-yield bond market, credit risk was something to be avoided, not something to be managed. The banking system—investment or commercial—rarely created noninvestment-grade securities. In the case of commercial banks, loans were relationship-driven and held on balance sheets, and no one even considered external ratings profiles or other risk labels. In secondary markets, the noninvestment-grade bonds that did exist were mostly the unfortunate products of downgraded fallen angels to be shunned by the majority of banks and investors. With the growth of the high-yield market, skills learned and honed to avoid credit risk were employed to structure around and manage deep credit risk. Portfolio management tools such as diversification were implemented such that no single credit failure or industry distress would destroy returns.

## The Credit Buy-Side Emerges

To our knowledge, the first explicit application of basic portfolio management techniques to credit-risk assets on any scale was performed by Drexel's investor clients: savings and loan institutions; insurance companies; and, most important, the mutual funds that came to dominate the market as consumers of high-yield bonds. Credit portfolio management principles require that credit selection be based on objective credit analysis, and portfolio construction considers diversification by both issuer and industry. High-yield bond investors founded credit-risk portfolio management, creating an investor base, to which the bank loan asset class also appealed. When Drexel unraveled in 1990, most of its competitors rushed, somewhat ironically, to fill the void. Commercial and investment banks recruited teams of former Drexel bankers, establishing or fortifying their own high-yield practices. After a few lean years in the early 1990s, the high-yield bond market recovered from the excesses of the 1980s, and leveraged finance conferences once again filled resort venues as investor interest grew stronger each year.

At many of these conferences, generally taking the form of one or two panels in a small conference room, a market began to gather and take form for *syndicated loans*, in addition to bonds.

## LEVERAGED LOANS AS AN INVESTMENT ASSET CLASS

There is no clear history of what single loan, made to which individual borrower, and syndicated to what group of nonbank lenders can lay claim as being first in establishing the syndicated loan market. In truth, capital markets innovations rarely work that way. The spark that ignited today's institutional leverage loan market was generated because it fulfilled multiple aims and goals of its various participants. Borrowers sought flexible term financing for mergers, acquisitions, or general corporate purposes, whereas banks looked to meet their customers' needs while at the same time managing their own risks and the limits of their own capital. Institutional asset managers and their clients were comfortable evaluating and assuming the credit-risk transfer for a short-duration asset that could further limit risk through diversification. It was an idea whose time had come! Institutional investors looked at various investment vehicles and structures to best package loan portfolios in a manner that fit investors' risk appetite. Initially, two broad classes of investors emerged as lenders: structured vehicles, primarily in the form of collateralized loan obligations (CLOs), which are generally sold to institutions, and mutual funds, which were primarily sold to individual investors. By the early 2000s, foundations, endowments, and sovereign wealth funds began to allocate to separately managed accounts or unlisted funds, followed later by public and private pension funds. Managed funds could be structured with or without the use of financial leverage, which increased returns at the cost of some additional risk of loss.

In those early days, there were many challenges to developing and marketing these vehicles beyond the initial group of investors. A principal shortcoming was the limited data available on the risk-and-return profiles of bank loans; the components and structuring features that are taken for granted today were still under development, being tested through educated trial and error. There was no market pricing or pricing service; no standardized settlement procedures, or even documentation; and no agreed-upon procedures for structuring and capitalizing CLOs. Loan trading, when

a loan did trade hands, was "by appointment." There were no ratings of bank loan instruments. Many banks that originated loans were wary of the developing market and were at times reluctant to show new investors any loans other than their riskiest, least attractive assets. Borrowers, accustomed to dealing with their bank, or banking relationships, were skeptical of this new class of lender.

As noted earlier, this market developed to serve many needs; the largest and most influential banks recognized the mutual benefit for many parties, not least of which the impact distribution of risk had on the banks' own balance sheets. Banks such as Manufacturers Hanover, Bankers Trust, Chemical Bank, Continental Bank, Chase Manhattan, Citibank, and a number of other important institutions, whose names are today unfamiliar, embraced the development of institutional investor-lenders such as mutual funds and CLOs that provided the balance sheet but did not have, or want, the borrower relationship. With time, new investor-lenders and larger capital pools invested in leveraged loans, and most large banks became confident and more competent, viewing leveraged loans as a capital markets' product, to be distributed to customers, not retained on the balance sheet.

Financial regulations served as another catalyst in the growth of the institutional loan market. In the wake of the 1987 stock market crash and the failure of several highly leveraged companies, Washington pushed regulations limiting the ability of banks to lend in highly leveraged transactions. The so-called HLT regulations of the early 1990s were a reaction by the Federal Reserve Bank to limit commercial bank involvement in the high-yield excesses of the time. The new rules made holding high-yield loans more expensive, in terms of regulatory capital, making it difficult for banks to make and hold such loans. In response, the B term loan was created, a crucial innovation favored by issuers that relaxed the high levels of amortization generally required by commercial banks. Many commercial banks would not, or could not, hold B term loans (due to capital requirements), despite their popularity with borrowers, and this void increased the market's further reliance on nonbank institutional investors, as lenders, to successfully syndicate transactions.

As the 1990s passed, each year saw the development and refinement of the numerous components required for a full institutional asset class. The Loan Syndications and Trading Association (LSTA) was formed as the forum in which important operational and

structural issues regarding the loan market—documentation, pricing, trading standards, settlement, etc.—were debated and decided. With time, additional infrastructure developed. The Loan Pricing Corporation, which began providing rudimentary pricing for a select number of issues, refined and built its pricing model in conjunction with the LSTA. As CLOs became important structures for holding loans, rating agencies, agent banks, and issuers slowly embraced the concept of assigning ratings to single-name bank credit risk.

Major commercial banks and investment banks evolved under the forces of changing financial markets, regulations, and macroeconomic forces. The second half of the 1990s witnessed a winnowing of banks as major players merged: New York-based Chemical Bank merged with Manufacturers Hanover, and then with The Chase Manhattan Bank (and later with JP Morgan). Bankers Trust merged into Deutsche Bank. Los Angeles-based Security Pacific Bank and First Interstate Banks, respectively, merged into West Coast rivals, Bank of America and Wells Fargo. Charlotte-based NationsBank acquired Bank of America (changing its name to Bank of America), followed by the merger of its neighbors, First Union and Wachovia. The Global Financial Crisis (GFC) further changed the landscape as JP Morgan absorbed Bear Stearns, Bank of America took over Merrill Lynch, and Washington forced Goldman Sachs and Morgan Stanley to become banks under Federal Reserve control. Throughout this period the syndicated bank loan market sometimes survived, sometimes prospered, but ultimately grew to more than $1 trillion in par value outstanding by 2020.

## Risk, Returns, and Bank Loans

Today, as at the beginning, investor and asset allocators have been attracted to leveraged loans based on three key features: seniority, security/collateral, and the floating rate nature of loan returns. The first two components mitigated credit risk, and the third virtually eliminated interest rate risk. Compared to high-yield bonds, another deep credit-risk asset class (instruments that are generally unsecured and that came with fixed interest rates), bank loans exhibit lower risk of loss given default and have virtually no interest rate duration. But the question today is the same as it was in the early days: How much lower risk? After all, leveraged bank loans are, like high-yield bonds, rated noninvestment grade, so how defensive could they be? In the early days, it was hard to say with any

precision. Without data, institutional investors mostly shunned the asset class, causing a "chicken-and-the-egg" dilemma that is probably common to all new investment categories. But retail investors, stretching for yield most vigorously, pursued the opportunity through broker-sold mutual funds, not analysis-driven institutional investors, who were limited by lack of data. Twenty years on, several investment cycles have generated reams of data comparing the performance of loans to high-yield bonds and other asset classes. Although loans have generally underperformed high-yield bonds (63% of the time) since 1997 from an annual total return perspective, they have, in fact, been an outperformer during periods of rising interest rates, more of a worry than a fact over the past 20 years. With the growth of the asset class and armed with data supporting loans as a core-plus allocation to fixed income, institutional asset allocators are the dominate end-investor in leveraged loan strategies and through CLO tranches.

## Default versus Recoveries

Credit-risk studies by rating agencies and academics primarily focus on one key event: default. Although credit risk can be categorized differently, most credit analysts focus on predictions and probabilities of loss given events of *default*—the inability of a company to meet the terms of its debt obligations. The bursting of the tele-technology investment bubble of the early 2000s and defaults experienced through the GFC provided both the impetus for serious predictive analysis and the data to support it. However, an analysis of recoveries is critical because of the simple equation that credit losses equal the incidence of default multiplied by one minus the recovery rate.

The treatment of the separate phenomena of default and recovery is an issue that rating agencies continue to wrestle with. Until CLOs, with their arcane collateral quality tests, became the dominant holder of senior secured bank loans, few investors really cared if a borrower defaulted as long as the investor recovered all principal and was paid full interest in the process. The degree of added safety, created by seniority and security, was the subject of debate as the asset class took full form. Data tracking recoveries today are generally better than they were for early investors in loans. What defines a recovery remains heavily reliant on investor experience and anecdotes, and definitions often are dictated by intervals or

moments in time. The degree of defense offered by a bank loan's seniority, security, and other protective features relies heavily on the loan documentation—the credit agreement—that forms the essential contract between lenders and borrowers. And even then, outcomes are likely to vary based on actions taken and the timeliness of those actions. Early investors in the asset class were experienced in and optimistic about the advantages of seniority and security in default recoveries. Understanding of credit markets and default–recovery cycles has only improved from those early days, and investors have no less reason to remain optimistic about the performance of the loan asset class.

## Enterprise Value, Hard Collateral, and Bankruptcy

One of the most significant questions investors in bank loans raise concerns the treatment of senior secured classes in bankruptcy and reorganization. Such treatment in bankruptcy weighs heavily on recovery values and, therefore, investment outcomes. Bankruptcies and out-of-court restructurings are a part of the normal functioning of companies and corporate financial outcomes. The growth in capital available for riskier credits and higher leveraged companies made the likelihood for an increased number of bankruptcies inevitable. The default cycle of the late 1980s produced little transparent information about bank loan default and recovery; nonbank institutional lenders were too few, and banking institutions controlled the workout process and had little reason to publicize discrete information on debt recoveries.

Leveraged lending differed from traditional bank lending in the determination of creditworthiness. Loans were structured as both senior and secured by all, or substantially all, of the borrower's assets, but the amount of credit extended was no longer limited to the value of hard assets—accounts receivable, inventory, property/plant/equipment—but to the more abstract assessment of enterprise value, such as capitalization of cash flow or earnings value. Enterprise value of firms in the growing service economy had never been tested on a large scale as collateral in the courts, particularly from the early 1990s through the first decade of the 2000s. The law gives bankruptcy judges considerable discretion in consideration of this form of collateral. The value of seniority and security in many loan agreements could have been greatly

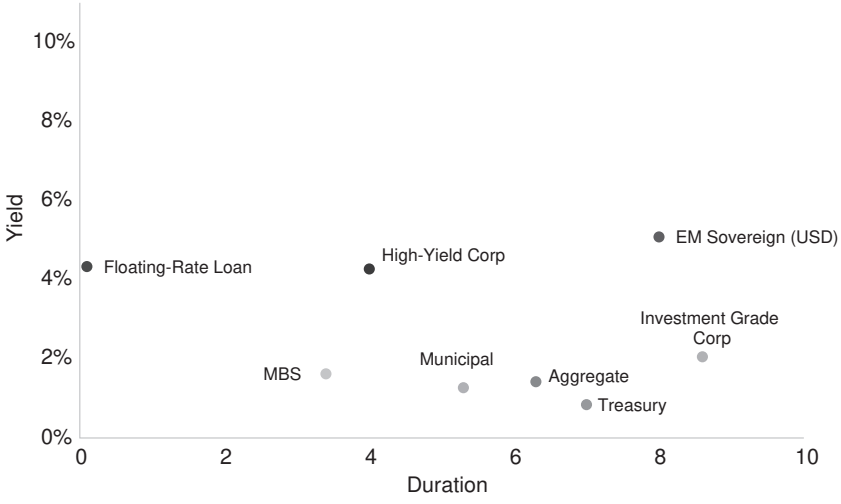
diminished, and the advantages of this asset class would have been diluted. But the law looks for outcomes that favor a way for the concern to reorganize and potentially prosper, setting the stage for enterprise value (or the value of a going concern) to be deemed highly significant in bankruptcy and restructuring situations. Such treatment resulted in better recoveries and greater investor confidence in spite of increased levels of price volatility through time.

## RISK AND RETURN IN BANK LOANS: A HISTORICAL REVIEW OF THE NUMBERS

*Conclusion:* The bank loan asset class has earned its place among investors, serving a core-plus role in fixed income allocations. Its attributes are: modest but solid risk-adjusted yields, lower volatility than high-yield bonds or emerging market debt, and a lower loss-given-default rate when compared to high-yield bonds. Borrowers see virtue in the flexibility and bespoke nature of this privately placed capital source. See Exhibits 1.1 and 1.2.

**EXHIBIT 1.1**

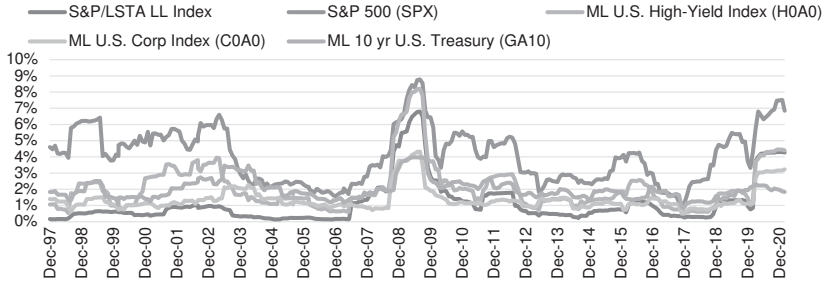
Cross Asset Yield & Duration.




*Source:* Eaton Vance.

**EXHIBIT 1.2**

Average 12-month Lagging Standard Deviation of Returns.




*Source:* S&P Global Market Intelligence.

*Conclusion:* As an asset class, bank loans have lower correlations with most other major investment asset classes, creating a powerful instrument for dampening volatility in broader portfolios. See Exhibit 1.3.

**EXHIBIT 1.3**

Bank Loans: Correlation with Other Major Asset Class Indices. 1997—Feb-21

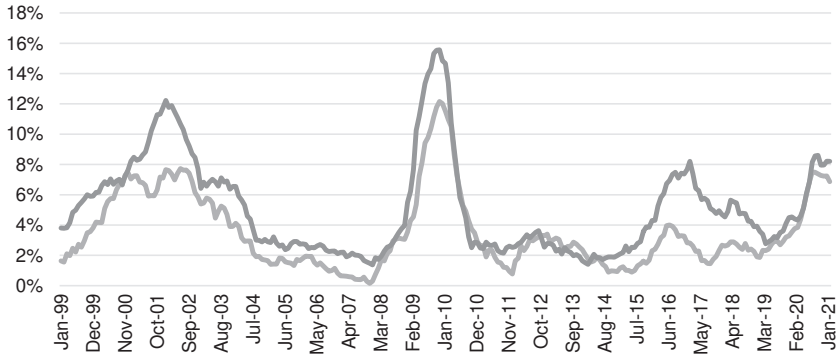
| Asset Class | S&P/LSTA LL Index | High-Yield | 10yr Treasury | S&P 500 | High Grade Corp |
|---|---|---|---|---|---|
| **S&P/LSTA Leveraged Loan Index** | 1.000 | 0.791 | -0.358 | 0.491 | 0.426 |
| **Performing Loans Index** | | 0.785 | -0.360 | 0.489 | 0.422 |
| **ML U.S. High-Yield Index** | | 1.000 | -0.175 | 0.649 | 0.583 |
| **ML 10 yr U.S. Treasury Index** | | | 1.000 | -0.283 | 0.555 |
| **S&P 500** | | | | 1.000 | 0.275 |
| **ML U.S. Corp Index** | | | | | 1.000 |

*Source:* S&P Global Market Intelligence.

*Conclusion:* Defaults tend to occur in waves, concentrated with regard to both time and industry, because they usually follow a severe recession. Average default rates are not as meaningful as peak default rates. In general, the episodic nature of credit losses and recoveries wreaks havoc with investment statistics, numbers that require higher-than-normal caution when being interpreted. See Exhibits 1.4 and 1.5.

**EXHIBIT 1.4**

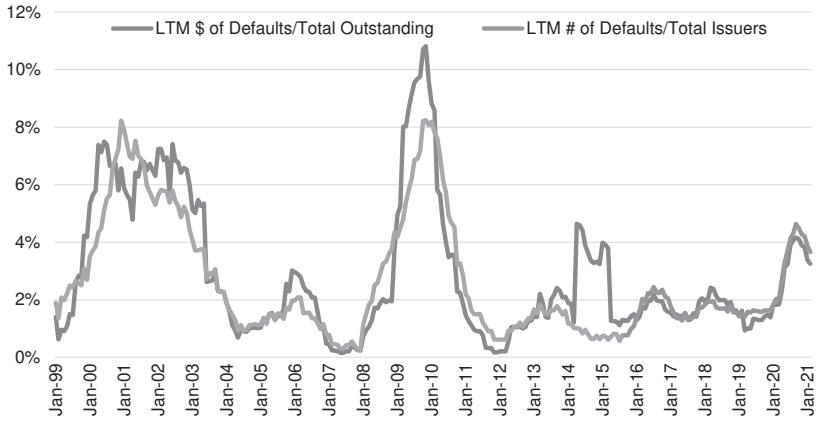
Speculative Grade Issuer Default Rates.




*Source:* Moody's.

**EXHIBIT 1.5**

S&P/LSTA Leveraged Loan Index Default Rates.

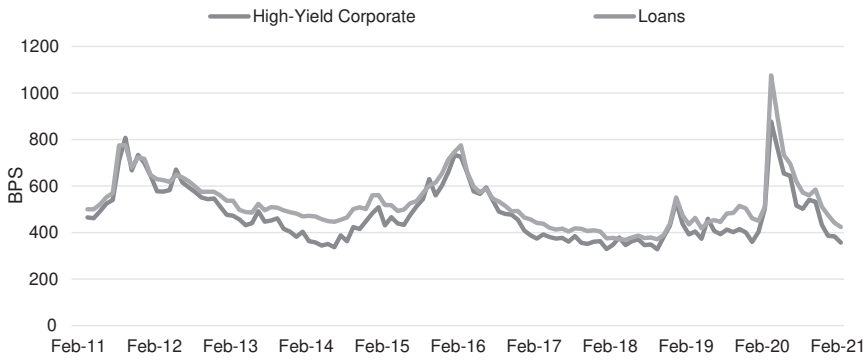



*Source:* S&P Global Market Intelligence.

*Conclusion*: Credit spreads in the bank loan market ebb and flow but vary within a much narrower range than spreads in the high-yield bond market. See Exhibit 1.6.

**EXHIBIT 1.6**

Bank Loan and High-Yield Bond Spreads.




*Source:* S&P Global Market Intelligence, JPM.

*Conclusion*: There are numerous ways of measuring and estimating annual credit losses in this asset class. The exact numbers depend on management style and skill, market entry and exit timing, and a number of other factors. When the actual credit experiences of a variety of public mutual fund managers, measured over various periods, are averaged into theoretical estimates from rating agency default/loss data and idealized loss studies, we believe that the best overall average estimate is approximately 60 basis points of annual credit loss. Variations from this point estimate can be considerable, driven most powerfully by market timing and investment style, but this estimate provides a starting point on which to base expectations. Of course, the future could be very different, but that's the basic experience so far.

*Observation:* The advantages of seniority and security are significant, but the statistics supporting this conclusion are weak. We have seen all kinds of numbers over the years, but reliability is difficult given measurement errors, apples and oranges-type data sets (e.g., senior secured securities, such as first mortgage bonds, versus senior secured bank loans), varying definitions of recovery, and other suspicious flaws in data. There may be clean numbers out there, but from what we have found thus far the results are

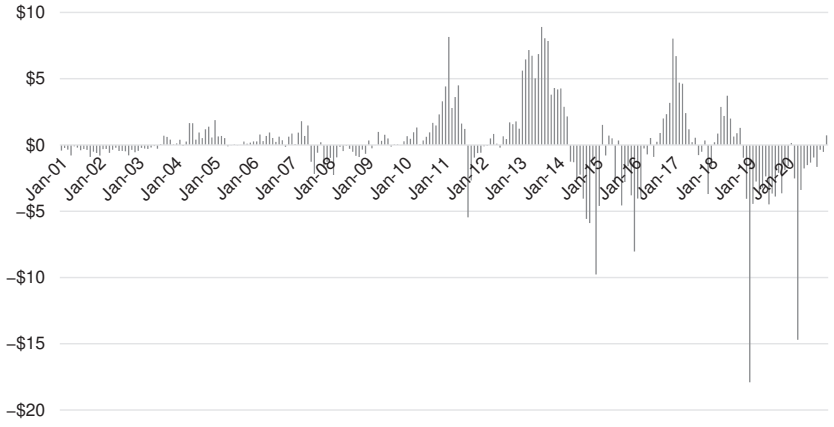
inconclusive. We have seen some studies that claim that recoveries are 100% and others that claim 50%. Based on our experience, we believe that senior secured recoveries applicable for the relevant range of bank debt used in most mutual funds and CLOs vary between 60% and 80%, with the best estimate of recoveries through a full cycle being approximately 70%.

*Observation*: Default probabilities increase geometrically as ratings decline into B/B2 and B/B3 territory (or further), and generally there is not sufficient additional coupon to compensate for the much higher default risk *unless* (1) recoveries in the event of default are strong and/or (2) investors hang tight through a downturn to experience the rebound on the other side. Interpreting the data supporting this observation is complex, and this is perhaps the most central debate among investors in all high-yield instruments (both bonds and bank loans). It is beyond the scope of this section to resolve this debate, other than to point out our belief that in the bank loan universe, at the very least, enhancing stability achieves more than chasing yield. Most investors prefer the rolling, gentle, more predictable statistical topography of the more stable end of the bank loan asset class than the sudden, sharp peaks and valleys of the more aggressive end. But the debate is a worthy one, and in the end it remains a matter of investor preference. A talented credit manager or an investor with market-timing skills and some guts can do well in the riskiest loans, evidenced perhaps best by the very strong results experienced by distressed bank loan investors in 2009.

*Observation*: Various investment managers with public track records have approached this asset class quite differently, with results that vary widely. In the mutual fund arena, defensive managers who have moderate volatility relative to the index have better long-term results on a risk-adjusted basis. Mutual funds experience withdrawals during market declines, and aggressive funds that perform poorly in bear markets experience greater withdrawals. These withdrawals can negatively affect an investor's experience through the usual whipsaw of buy high and sell low. See Exhibits 1.7, 1.8, 1.9, and 1.10.

**EXHIBIT 1.7**

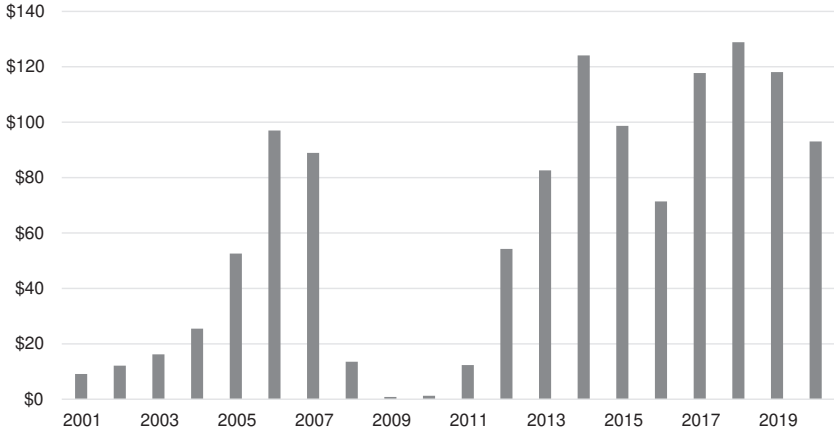
Loan Mutual Fund Flows ($ Billions).




*Source:* Refinitiv LPC, Lipper.

**EXHIBIT 1.8**

CLO Issuance ($ Billions).

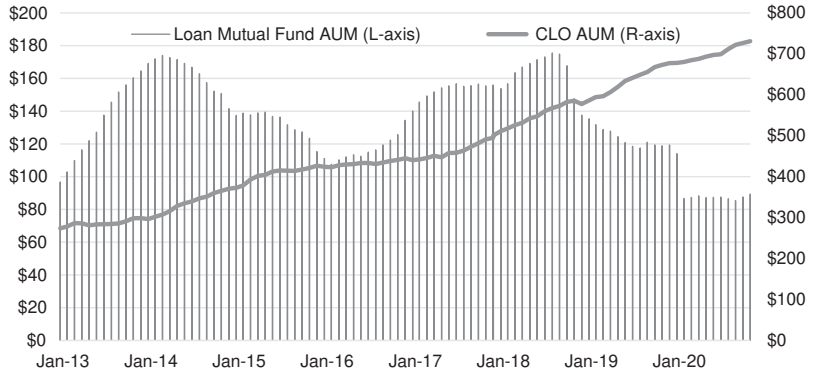



*Source:* LPC Collateral.

*Observation*: The measurement techniques used by Lipper and Morningstar in the mutual fund arena, which highlight returns more clearly than risk, may push managers into taking greater credit risks. The episodic nature of credit risk, with short but intense down cycles and declining mutual

**EXHIBIT 1.9**

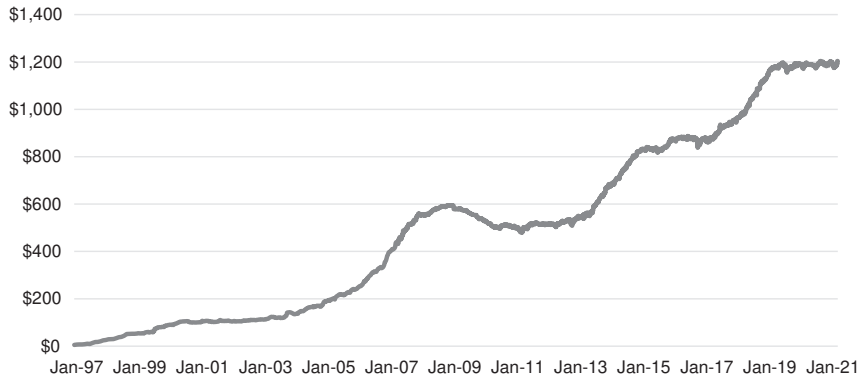
CLO & Loan Mutual Fund AUM ($ Billions).




*Source:* Refinitiv LPC.

**EXHIBIT 1.10**

S&P/LSTA Leveraged Loan Index Outstandings ($ Billions).

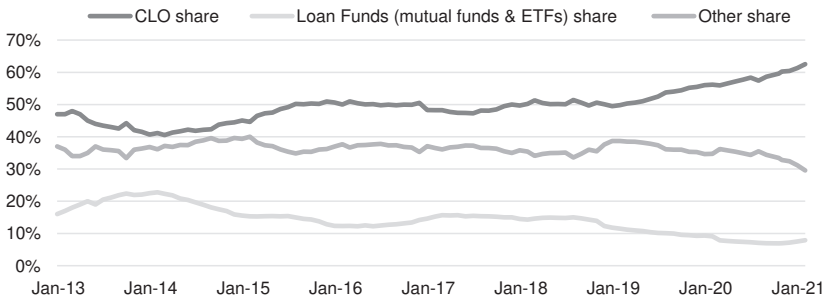



*Source:* S&P Global Market Intelligence.

fund net asset values (NAVs), combined with the usually much longer bull or calm portions of the credit cycle, has a tendency to tempt many risk managers to take on greater risks. In other words, credit conditions are typically stable most of the time, and a manager will seek to gain yield and total return by taking on more risk, even unreasonable risk, which will move the manager up in Lipper's quintile

**EXHIBIT 1.11**

Investor Share of Institutional Loan Outstandings.




*Source:* LPC Collateral, Refinitiv LPC, Lipper.

rankings and gain Morningstar stars. These rankings will face sharp reversals during credit downturns, and some investors will suffer even more because of the whipsaw effect of fearfully withdrawing funds at market bottoms.

*Observation*: CLOs are generally structured to survive market declines, and most of them survived the sharp downturn in 2001 and 2002, as they did again following the GFC of 2008–2009 and the COVID-19–induced recession of 2020. Because investors cannot withdraw funds from CLOs during market declines unless structures are breached—a rare occurrence—and because CLOs are a significant and growing percentage of the asset class, the presence of CLOs is a stabilizing influence on the asset class, particularly during market declines. See Exhibit 1.11.

## RISK AND RETURN IN BANK LOANS: THE NARRATIVE

The economic development of nearly every major civilization—east, west, north, or south—has depended on a form of lending practices to provide capital to business and agriculture. During the Renaissance era in Europe, informal practices developed into more complex banking systems, first in Italy as banks fueled the growth of the first mercantile societies of Western Europe. It is no surprise, then, that the advantages of seniority, security, flexible terms, and the floating rate interest profile proved attractive

to borrowers and institutional lenders, whose end-investors are nonbank institutions and individuals. Although leveraged lending carries greater credit risk than lending to investment grade–rated borrowers, the asset class has proven to be attractive, especially when compared to high-yield bonds. The asset class has survived and thrived through several trials through the mid-1990s, several industry-specific downturns through the early 2000s, during the GFC of 2008–2009, and again during the early months of the COVID-19 pandemic in 2020.

## The Timeline of Risk and Return in Bank Loans

The early 1990s were characterized by high interest rates and a number of lagging credit defaults resulting from credits weakened by the late 1980s LBO binge. Most of the ensuing credit losses were suffered by banks, the institutional market not yet having developed to hold significant exposures to those troubled companies. Subsequently, regulatory restrictions limiting exposure to HLT lending and other excesses having passed to history, credit defaults were extremely low, and the period proved an attractive one for nascent bank loan investors. The slow and relentless decline in interest rates, which progressed in fits and starts across the decade, although attractive to borrowers, made investing in loans somewhat unattractive when compared to fixed rate bonds. (Loan returns are a function of a base interest rate, initially a published bank prime rate, "Bank Prime" or "Prime," and later the London Interbank Offered Rate [LIBOR], plus a credit spread. In those early years the base rate comprised more than half the total return available from a loan.)

A global boom in new and capital-intensive telecommunications and technologies businesses intersected with yield-hungry investors, fueling a new bubble beginning in the late 1990s. Investors were willing to obtain large exposures to credits with great long-term promise but no available, or often negative, cash flow and overstated collateral valuations. Enthusiastic lending to fiber-optics and Internet strategies fueled overbuilding of infrastructure to the point of excess capacity, making debt service, let alone repayment, impossible. True to Murphy's law, which states that anything that can go wrong will go wrong, overextended emerging markets in Asia and Latin America began suffering large defaults. Soon easy credit terms were responsible for overcapacity in other

capital-intensive sectors such as nursing homes and hospitals, adding to investor woes. By early 2001, overleveraged technology and telecommunications companies began defaulting in significant numbers on bonds and loans, creating a default–loss cycle larger than anything seen since the Great Depression. This difficult period was followed quickly by large fraud-related defaults, most of which were by investment-grade companies (Enron, WorldCom, and so on), that tested liquidity across debt markets and compounded the difficulties created by the technology and telecommunications defaults.

## The First Credit Test

The technology crash of 2000 is mostly viewed as the bursting of a stock market bubble, which was true: the Nasdaq composite stock market index lost 78% of its peak valuation by October 2002. But, with increasing defaults, this period was also the first real test for the bank loan market, which this time was dominated by mutual funds and CLOs. Loan losses piled up and the loan mutual funds most aggressively positioned, particularly with tele-tech exposures, had the largest NAV declines and experienced the largest withdrawals. Still, even the most aggressively positioned bank loan funds suffered significantly lower losses than those experienced by high-yield bond funds. More conservatively managed funds weathered the downturn with positive total returns throughout.

CLO vehicles, though 8 to 12 times leveraged, are also required to be highly diversified, and so largely survived the downturn. Although market-value funds experienced some instability as the market struggled to find levels at which to price risk during the cycle, cash flow CLOs that did not have market-value tests survived the period. The strength of CLOs during this period stood in stark contrast to the experience of investors in collateralized bond obligations (CBOs), vehicles that invested primarily in high-yield bonds. CBOs were not structured to survive a severe credit downturn, and many did not. Those that survived did so with significant damage to investors. Similar experiences played out broadly during the GFC, where both market and corporate liquidity, or lack of it, played a broader role. Market-value CLOs became a victim of the extreme loan price volatility suffered through the GFC.

## The Rebound of 2003

Following the downturn, 2003 was an extraordinary year in the bank loan market. Although many of the technology and telecommunication loans created realized losses that would never be recovered, the overall market, which had traded down in sympathy, did recover. Aggressively positioned bank loan mutual funds, many of which became even more aggressive as they met redemptions, snapped back and provided annual returns in 2003 that in some cases exceeded 20%. More conservatively positioned funds enjoyed less robust snapbacks, but they had not experienced as much of a decline in 2001 and 2002. Perhaps the most important development during the 2001–2003 period was the success of investors in distressed bank loans. Distressed loan investors, through dedicated private funds or general credit hedge funds, were aggressive buyers of senior secured bank loans during 2001 and 2002, and their investments provided a handsome return during 2003. These funds bet on the advantages of seniority and security, and these successful and often debt-financed bets were the cornerstone of many of the legendary hedge fund returns experienced in 2003. It was hoped that the success enjoyed by distressed investors coming out of the dotcom bust would be reflected in better secondary market support for bank loans during the next credit decline; it didn't work out that way the next time.

## The Global Financial Crisis (GFC) of 2007–2008

The causes of the GFC of 2007–2008 have been well covered, and there is little debate that, once again, plentiful credit and relaxed lending standards, this time centered in housing markets, were the initiate of what became a multinational financial crisis and the deepest economic recession since the Great Depression of the 1930s.

By the summer of 2007 financial markets around the world were showing signs that a reckoning was in process. Less than a year later several major financial institutions had failed or were forced to merge with better capitalized institutions. What began as problems in housing and real estate finance quickly spread and began to choke credit across the global financial system. In leveraged finance markets, high-yield bond spreads widened, pulling loan credit spreads with them, and average bid prices of loans fell below 90. Daily liquid loan mutual funds experienced demands

for redemptions as investors exited risk-based assets such as leveraged loans. Loan performance following the rebound from the tele-tech bust discussed earlier, encouraged hedge funds, using prime leverage to enhance returns, to become significant investors in loans, and they were forced to post additional collateral or sell-out positions against margin calls. Although most CLOs had long-term capital, a bull-market creation known as the market-value CLO failed leverage tests, and those CLOs were forced to sell into a collapsing market. This was the final straw for the market-value CLO. New CLO creation became impossible as structured finance investors, typical investors in the senior CLO tranches, were suffering losses in residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and mortgage and other subprime collateralized debt obligations. At the center of this whirlwind were the banks, investment banks, insurance companies, and other systemically important financial institutions. Many of these banks had further extended already stressed balance sheets by originating firmly underwritten commitments to large leverage buy-out transactions. Loans backing these LBOs were intended to be distributed to the very mutual funds, hedge funds, and CLOs that were now net-sellers into a declining market. The financial crisis quickly turned into an economic crisis as job losses and foreclosures mounted. The Federal Reserve Bank had to step in, shoring up money markets as a liquidity crisis began to develop. Loan investors saw prices of par loans of performing credit trade into the low 60s as the once stable asset class suffered enormously from volatility and loss of investor confidence.

## Economic Recovery and a Way Forward

The financial crisis and ensuing economic recession were so pervasive that central banks globally stepped in, expanding their own balance sheets to liquefy a frozen market. But the damage was so deep that central banks alone proved inadequate to the scope of the task and were joined by the full force of governments. In the United States the Federal Reserve Bank ("the Fed") responded beginning in early 2008 with a two-track effort to support market liquidity and function and pursue macroeconomic objectives through monetary policy. The Fed expanded its balance sheet through a number of programs, but neither leveraged loans nor CLO liability tranches were eligible for acquisition by any of those programs.

Loan markets continued to suffer through most of 2008, ending the year at an average bid price of 64 with a bid/offer spread of 315 basis points. Loans closed 2008 with the S&P/LSTA Leveraged Loan Index (LLI) declining a record 29.1% on the year, the first negative return year for the asset class. A recovery in the loan market was to be dependent on broader financial and economic recovery. The conventional view held that such recovery could not happen until governments intervened with stimulus and support. In the United States taxpayers stepped up in late 2008 with a $168-billion stimulus package in the form of the Economic Stimulus Act of 2008, and again with the Emergency Economic Stabilization Act of 2008, which included the $700 billion in funding for the Troubled Assets Relief Program (TARP). Further economic stimulus came in early 2009 with passage of a $787-billion package called the American Recovery and Reinvestment Act. The impact of all these programs began to take effect as the economic recession officially ended in the second quarter of 2009. By April, the secondary loan market broke through following on gains made earlier in the year. Distressed and opportunistic investors began to selectively buy loans, and secondary loan volumes increased by nearly 25% measured against trading volumes recorded in the first quarter. Importantly, bid/offer spreads, a measure of market liquidity, narrowed considerably.

The credit arms of several large private equity firms raised multibillion-dollar pools of capital among their base of mostly institutional limited partners (LPs) aimed at acquiring large pools of heavily discounted loans, particularly loans made as commitments to those large LBOs that remained on the balance sheets of many banks.

It has been well documented that the economic recovery was a long and shallow slog, likely the shallowest, in terms of gross domestic product (GDP) growth rates, on record. Recovery in terms of market prices, trading volumes, and ultimately the return of significant levels of primary issuance was reflective of general economic conditions. For the loan asset class, a number of specific challenges needed to be overcome for the market to return to prosperity. Among them were the steep decline of prices in the secondary market; the concomitant decline in net assets allocated to loan strategies; the volume of rating downgrades, bankruptcies, and financial restructurings, and the impact of those actions on CLOs in particular; and the overhang of loans held by banks and other opportunistic or nontraditional holders; to name a few.

The continuation of the Federal Reserve's low interest rate policy, called quantitative easing, served to reduce investor interest in loans through much of the period as interest rates remained near zero for much of the elongated recovery. Likewise, recovery in CLO issuance rates proceeded slowly in 2010 and 2011 as the Nationally Recognized Statistical Rating Organizations (NRSROs) revamped and reevaluated CLO structure and criteria into what became commonly referred to as CLO 2.0.

## Regulation of the Syndicated Loan Market

As we will discuss in a later chapter, significant legislation directly affecting loans and the loan market was passed into law in the wake of the GFC. In 2010, as the economy generally and loan market returns and conditions were improving, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Two parts of Dodd-Frank, Section 619, often referred to as the Volcker Rule, and Section 941, the Risk Retention Rule, weighed heavily on the loan market's continued recovery. Since the New Deal, Congress had increasingly delegated significant authority to federal regulatory agencies in interpreting laws. Few pieces of legislation have vested greater powers of interpretation and implementation of financial regulation than has Dodd-Frank. The banking agencies along with the Securities and Exchange Commission imposed significant restrictions and obligations on loan market participants that had very material implications for the syndicated loan market. The regulators released rules implementing Volcker that impacted CLOs, specifically dictating how they were to be organized and the composition of underlying assets, and at the same time issuing leveraged lending guidance that appeared to change lending standards. It is interesting to note that the most significant result of the 2013 guidance was to accelerate the growth of direct lending by institutions organized on an asset management model rather than on a banking model. Ultimately, the most restrictive provisions imposed on the loan market by the 2013 agency guidance were overturned by challenges from Congress itself. The Risk Retention Rules, which equated CLO management to sponsorship, thus requiring the manager/sponsor to hold a portion of the CLO risk (through ownership of a portion of its capitalization) was successfully challenged by the LSTA and overturned by the DC Circuit Court of Appeals. Congress rebuked the administrative branch for

its overzealousness in attempting to enforce leverage lending guidance as a rule without properly seeking approval from the legislative branch; the agencies demurred, restating that guidance was guidance and would not be strictly enforced.

## COVID-19 and the Pandemic Recession

By late 2019, the loan market was already experiencing a peaking bull market for loans. Performance of the S&P/LSTA LLI remained positive, having returned 3.12% for the full year with a market par value of $1.2 trillion. While macroeconomic trends were pointing to a cooling of the U.S. economy, and the Fed took a pause in recent moves to tighten monetary policy, the economy was still robust. By January 2020, interest rate expectations were flat to slightly lower, causing some investor interest in floating rate loans also to cool. News of the spread across Asia and some early reported cases of a "new strain" of SARs virus was causing ripples across global financial markets. Stock markets experienced reversals in mid-February, and by March the loan market, along with other risk assets, was in full retreat as mutual fund and exchange traded fund (ETF) investors liquidated positions for the "safety of cash." As the sell-off accelerated, dealers performed a yeoman's service in matching sellers with buyers, albeit at declining prices, but meeting the liquidity needs of panicked investors. Prior to the sell-off, loans were trading in a mid-97 context at the beginning of March, after suffering a 150-basis point decline during the last week of February. But by mid-March, the secondary loan market traded down to levels not seen since the height of the GFC. From March 16th through the 23rd, trade prices fell an additional 14 points, to a sub-78 context, before rallying back to the high 80s by the months end. Total secondary trading volume for March was a record $119 billion. Loan settlement times, always a point of contention in the loan market, actually compressed as operations groups, largely working remotely or from home, were the unsung heroes as the market cleared tens of thousands of individual trades, expeditiously providing settlement liquidity for redeeming funds.

The voluntary lockdown of the broad economy, globally, immediately moved the economy from prosperity to recession. The closing of national borders and curtailment of domestic travel quickly impacted airlines, tour, travel, and hospitality industries. As the virus spread, hospitals and healthcare facilities were cleared

of profitable elective surgeries and other procedures to create capacity for gravely ill victims of the virus. Credit concerns dominated the market, accelerating selling and further depressing asset values. The NRSROs very quickly began to downgrade the credit ratings of hundreds of borrowers in the leveraged loan markets. These downgrades took an air of procyclicality in that they immediately impacted CLO collateral quality tests, increasing CCC-rated assets above threshold levels and causing collateral managers to reduce risk or deleverage structures by either selling low-rated assets at a loss or diverting income, expected to be distributed to tranche holders, to acquiring additional assets.

Both the Fed and Congress stepped in quickly, first to support market liquidity needs, and then to provide financial support to employees and businesses where revenues had dried up and payrolls could not be met. On March 27, 2020, then-President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), injecting a historic $2.2 trillion of economic stimulus into the economy.

Through the CARES Act, Congress directed the U.S. Treasury to fund programs such as the Paycheck Protection Program (PPP) through the Small Business Administration and the Main Street Lending Program (MSLP) through the Fed to provide loans and grants to businesses in need of emergency capital. In most cases the programs created under the CARES Act were designed not to support large and mid-cap leveraged businesses. The immediate effect of the CARES Act was to provide a psychological salve to panicked financial markets, and the PPP program quickly provided cash to small businesses and select nonprofits sufficient to meet some payroll and other expenses. The $600-billion MSLP, like the PPP, was structured not to support the type of companies that were traditional borrowers in the leveraged loan market. Although some business types, such as some fast-food and casual-dining franchisees, were able to access PPP, most borrowers in the leveraged loan market were not directly assisted by the stimulus and support programs. Nonetheless, the CARES Act and other programs, such as the Term Asset Leverage Facility, stood up by the Fed provided a strong underpinning for financial markets that ultimately provided investor confidence, renewed liquidity, and prompted general price recovery that accelerated through the first quarter of 2021, even while the pandemic continued its disruptive effect on commerce.

## The Current Market

Bank loans, as an investible asset class, survived both the GFC of 2007–2008 and the COVID-19 epidemic. Although the pandemic and the attendant societal restrictions on commerce have stressed corporate credit across most industries, economic stimulus and plentiful liquidity have both helped to keep borrowers solvent. These same forces have pushed yield-seeking investors to reconsider leveraged finance, concluding, based on fund flows, that risks and rewards are balanced. The S&P/LSTA LLI, as measured in par outstanding, was larger than the ICE BofA US High Yield Index. Even though we have witnessed several significant periods of price volatility and credit concerns, including increased bankruptcies and lower recoveries, investors continue to see loans as a core-plus asset serving a specialized supporting role in the fixed income portfolios of institutional and individual investors. Sharpe ratios after the GFC and COVID-19 are not as compelling as they once were, and correlations with other assets, particularly during periods of global panic, are far more correlated. Bank loans serve a useful role by driving risk-adjusted returns and reducing exposure to volatile interest rates. A broader number of institutions, particularly long-term investors such as pensions, endowments, and sovereign wealth funds, have taken notice, and have increased their exposure to this investment class through CLOs, other leveraged vehicles, and separately managed accounts. An increasing portion of that investor base is also making the trade-off between liquid credit strategies, choosing to allocate toward direct lending. Although retail investors, mostly investing through mutual funds and ETFs, have maintained their interest in this asset class, inflows and outflows have been more volatile. Daily liquid mutual funds, which dominated the nascent loan market, as of this writing, represent significantly less than 20% of all institutional investors.

Increased acceptance of bank loans has come at a cost, however. Spreads today have narrowed across the risk spectrum and are at historic lows. Although spreads now are only modestly below the levels experienced during the early and mid-1990s, they are significantly below the unusually wide spreads seen during earlier periods. Even more concerning has been the continued degradation of other terms and conditions or protective covenants in modern loan documentation. Although loans remain senior and secured, the relaxation of restrictions on the borrower as well as the reduction

of remedies available to lenders have led to abuses and increased concerns over recoveries in the event of default. Although it may be difficult to distinguish the normal ebb and flow of both monetary and nonmonetary terms through a credit cycle from a potential secular decline in such terms caused by greater familiarity with and interest in the asset class, there is probably an element of the latter. Once again, investment managers' ability to draw the line on risk is likely to be tested, and those results and additional lessons will be learned in the next credit cycle.

## CHAPTER 2

# The Primary Market

### Introduction to the Primary Market

**Ralph Hinckley**
Vice President and Portfolio Manager
Eaton Vance Management

### Information in the Loan Market: Material Nonpublic Information and Confidential Information

**Robert Scheininger**
Partner
Reed Smith LLP

**Elizabeth Grzywacz**
Senior Counsel
PNC Bank, National Association

**Jon Mooney**
Managing Chief Counsel
PNC Bank, National Association

### Settling Primary Allocations

**Ellen Hefferan**
Executive Vice President of Operations and Accounting
Loan Syndications and Trading Association

### Bringing Benchmarks to the Complex Realm of Loan Covenants

**Steven Miller**
Chief Executive Officer
Covenant Review, a Fitch Solutions Service

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# Introduction to the Primary Market[1]

**Ralph Hinckley**
Eaton Vance Management

In the primary market for syndicated loans, issuers and investors come together to price, structure, and invest in one of the oldest of financial instruments—bank loans. Although parts of the loan market have evolved significantly over the past few decades and now resemble the markets for other fixed income products more closely, the primary market for syndicated loans retains some unique attributes that are distinct from those of other debt markets. Some of those distinguishing attributes are set forth here:

- *Flexible structuring.* Loans remain one of the most customized credit products in the capital markets, with highly negotiated packages of covenants and other structural elements. Arrangers compete by creating unique structures, and investors are willing to accept these unique structures as long as they believe that the structures represent an acceptable risk. The primary market for loans accommodates this structural flexibility with highly negotiated term sheets and documentation.
- *Revolving loans.* Unlike other fixed income markets, the loan market as a whole remains heavily weighted toward revolving loans. Nearly every company has at least some amount of unfunded revolving loan in its capital structure that allows it to manage the fluctuations in its cash levels caused by working capital and other needs. The need to accommodate requirements for revolving credit is a structural challenge that is unique to the loan market.
- *Floating rate/callable.* Loans are generally floating rate instruments, and as such do not have the interest rate and inflation risk inherent in fixed rate debt. In addition, because loans are priced on a floating rate basis, generally at a spread over the 30- to 90-day London Interbank Offered

[1] We would like to thank Barry Bobrow, Mercedes Tech, and Linda Redding who were the authors of this article as it appeared in the first edition. It has been updated here.

Rate (LIBOR) index, loans do not have the same prepayment breakage costs as fixed rate debt, where pricing is based on longer-term Treasury rate indices. For this reason, loans are generally callable at par at any time. Most loans feature soft call protection, which features the payment of a fee, typically 1%, if the loan is refinanced at a lower spread above LIBOR within the first 6 to 12 months of the life of the loan. This is still very different from the bond market, where the debt generally has a lengthy noncall period and prepayment penalties designed to discourage early termination.

- *Relationship underpinnings.* Much of the loan market is still made up of relationship-oriented banks making loans to their corporate clients and may or may not hold those loans on their balance sheets (in the leveraged loan market, the banks arrange but typically do not hold the loans on their own balance sheets). Because corporate issuers expect their core relationship banks to provide credit in order to be eligible to provide other products, banks are critical investors in the loan market. This is in contrast to other fixed income markets, where investment decisions are made purely on a risk-and-return basis, and issuers are not reliant on their investors for other financial services.
- *Public and private markets.* Investors may participate in the market on a public basis or a private basis, with an increasing number of institutional investors participating in the loan market on a public basis. Private-side investors in the loan market receive more information than is typically available for public securities, including detailed historical analysis and projections. Private investors are not permitted to actively trade other securities of the issuer while they are in possession of the private offering materials. In addition, the principal regulatory oversight comes from bank regulators such as the Office of the Comptroller of the Currency. There is no direct Securities and Exchange Commission (SEC) regulation, because bank loans are not securities.

## LOANS: A BRIEF HISTORY

Until the mid-1980s, loans to corporate borrowers were made almost exclusively by banks. These loans held the first-priority position in the issuer's capital structure, and the credit exposure