DEMYSTIFYING LOANS
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UNLOCKING THE POTENTIAL OF LOANS

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LOW INTEREST RATES AND A LACKLUSTER RISK-RETURN PROFILE IN EQUITIES PROVIDE INCENTIVES TO SEEK VALUE IN ALTERNATIVE INVESTMENTS.

Historic low yields on traditional fixed-income products are driving institutional investors to the loan market in search of better risk-adjusted returns. There are a few ways in which they could potentially gain exposure to loans, but to execute a successful strategy, they must be aware of the nuances of the asset class across multiple jurisdictions.

The global financial crisis has had a lingering effect on the investment environment and the choices available to institutions such as pension funds, hedge funds, insurance companies and private equity firms. Volatility in the equities markets, which reached an all-time high in October 2008, has decreased significantly during 2012. Despite major gains in key indexes, volumes have declined as investors re-evaluate the risk-return profile of the asset class.

Value is also hard to find in the fixed income market. Interest rates in investment grade bonds are extremely low, although rates on high yield bonds are more attractive. Meanwhile, the European sovereign debt crisis has taken a toll on confidence.

To this end, institutional investors are increasingly diversifying, trying to generate alpha and funding their exposures by holding baskets of assets that include various types of loans.

Secured, investment grade bank loans are bilateral agreements between lenders and the borrowers. Sub-investment grade leveraged loans are usually syndicated bank loans that make up the balance of a private equity purchase of a business. Senior secured bonds and floating rate notes share in the same security pool as the senior secured lenders, do not incorporate maintenance covenants, and do not have standard wording for the intercreditor agreement. Common in the U.S., covenant-lite loans have similar recovery characteristics to senior secured high yield bonds. Finally, Collateralized Loan Obligations (CLOs) are special purpose vehicles backed with receivables from loans.

Loans may offer a higher risk-adjusted return compared to high yield bonds. They usually have a lower default rate and a higher recovery rate. Importantly, in the event of bankruptcy, the borrower will typically repay lenders before bondholders.

HIGHLIGHTS OF U.S. LOAN PERFORMANCE

- 2012 U.S. CLO issuance: $53.5 billion
- Institutional pro rata spreads: LIBOR plus 290 to 315 basis points
- December 2012 S&P/LSTA Leveraged Loan Index: $543 billion, a 38-month high
- Expected loan bids by year-end 2013: 97.5+
- Expected 2013 average default rate: 1.75%

Source: Loan Syndications and Trading Association (LSTA) and BNY Mellon

BUOYANT U.S. PERFORMANCE

2012 was a positive year for the U.S. loan market. By August, CLO issuance was higher than the last three years combined. Institutional spreads contracted 60 basis points, and bid levels in the secondary market were already higher than anticipated. By year end, issuance already had exceeded expectations for 2013.

The supply of loans has increased; in fact, the S&P/LSTA Leveraged Loan Index reached a 38-month high in December 2012. Demand has remained robust leading to heavily oversubscribed new issues and loans bidding higher in the secondary market. Restructures and amendments on loans also have played a significant role as many corporations amended their loan maturity dates, amongst other provisions.

Meanwhile, default rates on syndicated loans remain at modest levels. Along with growth in the CLO segment of the market, BNY Mellon has seen larger flows into loans from traditional pension and government entity clients through unlevered loan portfolios.

THE ATTRIBUTES OF INVESTING IN LOANS

- Inflation protection through a floating interest rate (returns increase as interest rates rise); U.S. loans often have LIBOR floors
- Direct, secured exposure to corporate credit—an easily understood, traditional asset class
- Access to assets via a deep pipeline of primary assets and an established secondary market
- The opportunity to diversify exposure by issuer, industry and geography

THE U.S. VS. THE EUROPEAN LOAN MARKET

Today many asset managers are seeking global opportunities. As such, they should be aware of the differences between the two major loan markets in the U.S. and Europe.

The International Capital Market Association (ICMA) European Repo Council estimates that the European bank loan market was worth approximately €7 trillion as of January 2012. This figure includes syndicated, bilateral and club loans. According to Credit Suisse's *2013 Leveraged Finance Outlook and 2012 Annual Review,* the size of the European Leveraged Loan market was estimated at about €410 billion as of the end of September 2012.

The characteristics of the European loan market tend to favor larger institutions that understand the complexities of working in multiple jurisdictions. The market is dominated by a few banks, and the secondary market is not as liquid as in the U.S. Traditionally, there has been relatively more activity in high yield bonds than syndicated loans.

The U.S. loan market is larger and more liquid than in Europe, driven by a number of factors. For example, U.S. loans are typically publicly rated, making it easier for investors to find out information about the assets.

Significantly, in the U.S. a recent structural improvement for investors is the inclusion of LIBOR floors, which are not common in the European loan market. As an example, let's say LIBOR is 0.5%, the margin on the loan is 400 basis points over LIBOR, and the agreement includes a 2% LIBOR floor. Rather than the borrower paying 4.5% (LIBOR plus the margin), they will pay 6% (LIBOR floor plus the margin). LIBOR floors have allowed CLOs to recover much of the ground lost during the peak of the financial crisis through improved over-collateralization (OC) ratios and excess spread. This applies to many existing CLOs that issued floating rate liabilities.

U.S. and European loans have different governing documentation. Specifically, existing European credit agreements will not allow electronic signatures. Also under LMA standards in Europe, the agent bank typically is required to obtain the borrower's consent to transfer lenders, whereas this is not always the case under LSTA standards in the U.S. This affects settlement times and liquidity.

Finally, the borrowing process varies across Europe. While some investors find the diversification of the funds attractive, they must be aware of the nuances in each jurisdiction.

U.S. MARKET:

- Large, liquid market
- Publicly-rated loans
- LIBOR floors
- LSTA documentation
- Electronic signatures allowed

EUROPEAN MARKET:

- Diverse market
- Favors larger institutions
- Dominated by a few banks
- Limited secondary market
- More high yield bonds than syndicated loans
- LMA documentation
- Electronic signatures not allowed
- Practices vary across jurisdictions

THE NUANCES OF THE LOAN MARKET

Specialized investment managers and credit hedge funds with around $10-20 billion in AUM are the dominant players in loans. These firms tend to have a corporate credit team with expertise in products such as CLOs, knowledge of certain industries and the ability to manage the recovery process. With banks deleveraging, there are plenty of opportunities for new entrants that understand the following market characteristics and practices:

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Irregular Cash Flows: A loan may be structured so the initial payments are made quarterly, but then they might switch to semi-annually, weekly or even daily. The terms of a loan may be amended to help a borrower get through the period of stress, and then the loan reverts to the original terms. Moreover, a loan may be renegotiated to extend the maturity and realign the repayment schedule with the borrower's anticipated cash flow. The ability to amend and extend benefits the borrower and ultimately reduces the default rate.

Long Settlement Cycle: In the U.S., the mean settlement cycle under LSTA is around T+16, and in Europe, the mean under LMA is around T+20. The industry is working with DTCC and Euroclear to compress the time frame, therefore allowing investors more flexibility.

Fragmentation and Paper-Based Processes: Around 300 agent banks globally act as issuing agents and registrars for the loans. There is no central clearinghouse, so lenders must work with this large network of agent banks, each with its own systems and processes. Loans are traded through the execution of physical documents. The investor's position is then recorded on the agent bank's books and records. Straight through processing is limited, so transparency suffers as a result, and errors may creep into the process at peak times.

That said, there are efforts to move to a paperless environment. Agent banks in the U.S. allow for electronic signatures on credit agreements. European banks still require a physically signed document, but the governing documentation has been amended on a "go forward" basis, so a primary issuance may collect electronic signatures. The LMA is working with the agent banks to permit documentation on existing loans to be signed electronically as well.

DTCC and Markit have a combined offering that automates loan trade settlement by electronically managing the workflow, legal requirements and ownership transfers that are central to loan transactions. Using DTCC's Loan/SERV or Euroclear's LoanReach™, lenders may reconcile with the agent banks electronically, verify that the client owns the position, and settle the payments associated with the transaction akin to delivery vs. payment.

Opacity: Leveraged Loan Finance has been restricted to a relatively small number of institutions that have good access to information and borrowers and have little to gain by sharing their knowledge. The borrowers do not necessarily want transparency either. The financial information they supply to lenders is sensitive, so they often feel more comfortable borrowing from a club of banks. Further, only a few firms—including Markit, Reuters and Bloomberg—provide pricing on loans.

FUTURE TRENDS

In the near term, the market will likely migrate toward centralized clearing with the majority of loans serviced through either DTCC's Loan/SERV or Euroclear's LoanReach™. In the longer term, the loan market will become partially dematerialized, which will improve liquidity, transparency and the settlement process.

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The ICMA European Repo Council launched an initiative to allow loans to be used as eligible collateral in repurchase agreements (repos), where securities are used as collateral for short-term financing. However, privacy hurdles must be overcome before this is possible. Companies do not want their competitors to buy their syndicated loans because they would have access to confidential financial data that may not be in the audited financial statements. A borrower typically must approve the lender in the transaction. A Know Your Customer process must be performed each time an investor buys and sells a loan, and that may take three to seven days depending on the agent bank. The industry is working to insert language in both loan and repo documentation to facilitate this process, therefore enabling loans to be used as collateral in repo transactions.

Finally, the LMA is working to make loans compliant with the Undertakings for the Collective Investment of Transferable Securities (UCITS) Directive. UCITS are public limited companies that coordinate the distribution and management of unit trusts among countries within the European Union. UCITS have not been allowed to invest in loans because of the lack of liquidity and transparency associated with the asset class, but the LMA is working to change this.

PARTNERING WITH AN EXPERT LOAN ADMINISTRATOR

Clearly institutions could potentially benefit from investing in loans. Since loan structures may be complex, there is significant benefit to partnering with an independent administrator that fully understands and is plugged into the agent bank process and network. Importantly, the administrator will know how to restructure a loan and comprehend the upstream and downstream implications of doing so.

In addition, the administrator will have the technology necessary to warehouse, track, monitor and value the assets. Ideally, it will have a master database covering all available loans in the market. When there is a new issue, the administrator creates a global record that models the terms of the loan from the original loan documentation. When an investor buys a loan (becomes a lender), the administrator only needs the administration agreement for the loan and the buy and sell ticket. A good master database makes the process less labor intensive.

The administrator will likely take a consultative approach and provide innovative solutions comprising an array of services including:

- **Syndicated Loan Services (Buy Side):** Automated feeds on rollovers, interest rate changes and other loan data, and provide a comprehensive reporting package to investors.
- **Alternative Investment Services (AIS)–Independent Verification:** Accounting, servicing and reporting for investors in the hedge fund that owns the loan.
- **Warehousing (Buy Side):** Loan administration, custody services and reporting around the warehousing of the loan prior to the launch of a CLO or new fund.
- **Financial Reporting:** Accounting reports to help managers comply with FAS 167, which requires some companies and investment managers to consolidate CLOs onto their balance sheet.
- **Regulatory Reporting:** In Europe, certain structures issue debt to the market and qualify as Financial Vehicle Corporations (FVCs). The issuer must produce jurisdiction reports and comply with the filing requirements of the appropriate National Central Bank, which in turn reports to the European Central Bank in accordance with regulation (EC) No.24/2009. In the U.S., FATCA requires that certain information be collected and shared. The administrator's service offering will be able to navigate through FATCA, the tax implications and the agent networks. The administrator will play a key role particularly in jurisdictions that do not have Intergovernmental Agreements (IGAs).
- **Facility Agent (Sell Side):** The ability to act as an independent borrower's agent in a syndicated loan. Notably, when a borrower gets into difficulty, and there are different tranches of loans, the mezzanine tranche often is split out.

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Investors should partner with an administrator that has the resources to monitor the loans and act on their behalf. A good administrator will shadow the agent on each loan to ensure all information pertaining to principal payments, interest, roll periods and payments in kind are processed correctly. Similarly, they will support investors so they do not miss the opportunity to vote on a loan restructure, for example, or a payment. Moreover, it will catch errors such as when an agent bank inadvertently deletes the investors from its system, requiring the investors to prove ownership of a position.

Finally, the administrator will have a pan-European view. This will be key for large investors who want to invest in different jurisdictions using various investment strategies. For example, a Kapitalanlagegesellschaft (KAG) is a regulated German Capital Investment Company, and SIFs and SICAVs are open-ended collective investment schemes common in Luxembourg. Ireland has Qualified Investment Funds (QIF), and France has a securitization vehicle known as the Fonds Commun de Titrisation (FCT). These structures are increasingly being used to invest in loans, but they all have their own nuances and tax implications that must be fully understood and navigated.

By partnering with an expert administrator and custodian that understands the asset class, the process and technology systems, investors should be well positioned to reap the potential benefits

CONCLUSION

Loans are garnering attention for reasons including the risk-return profile, low volatility and high recovery rates. Traditionally, the high degree of specialization has been a barrier to entry for new participants who are not familiar with loan characteristics, market practices and trading procedures. By partnering with an expert administrator and custodian that understands the asset class, the process and technology systems, investors should be well positioned to reap the potential benefits.

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