

**Loan Syndications and Trading:  
An Overview of the Loan Syndications & Trading Association  
and the Leveraged Loan Market**

**by Bridget Marsh and Ted Basta<sup>1</sup>**

The business of corporate loan syndications, trading, and investing has changed dramatically over the past 15 to 20 years. Up until then, banks made loans to their corporate borrowers and typically held those loans on their books. It was never contemplated that loans would be traded and managed by investors like stocks and bonds in a portfolio. Eventually, however, investors were drawn to the attractive features of loans – unlike bonds, loans were senior secured debt obligations with a floating rate of return – and, over the years, a full institutional asset class emerged.<sup>2</sup> Today, such loans are not just held by banks but typically sold to other banks, institutional investors, mutual funds, insurance companies, structured vehicles, pension funds, and hedge funds. Consequently, the past 15 years has witnessed an explosion in the volume of loans being issued in the primary market and traded in the secondary market.

Amidst these developments, loan traders recognized a need to develop best market practices and standard documentation that would allow them more easily to trade with each other. In 1995, certain institutions joined together to establish the Loan Syndications & Trading Association, Inc. (the “LSTA”). From its inception, the LSTA has played a prominent role in the development of such standards and has spearheaded efforts to increase the liquidity, efficiency, and transparency of the loan market.

This article will: (i) provide a general overview of the LSTA, our mission, and our goals, (ii) highlight some of the more recent developments in the leveraged loan market, in particular the volatility of the past six to eight months, and (iii) review some of the legal initiatives undertaken to help our members cope with such a market.

The Loan Syndications & Trading Association

The LSTA is a not-for-profit organization dedicated to promoting the orderly development of a fair, efficient, liquid, and professional trading market for corporate loans. We seek to enhance public understanding of the corporate loan market and serve the public interest by encouraging adherence to the highest ethical standards by all loan market participants. The LSTA is active in both the primary market, where agent banks originate syndicated loans, and the secondary trading market, where bank loan traders effectively buy and sell pieces of such syndicated loans. Unlike other trade associations, the LSTA’s membership consists of both buy-side institutions (*e.g.*, insurance companies, hedge funds, prime funds, CLOS, *etc.*) and sell-side institutions (the agent banks and dealers) as well as law firms (which are the LSTA’s largest constituency) and vendors in the market.

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<sup>1</sup> The authors are employees of the LSTA. Bridget Marsh is Senior Vice President and Assistant General Counsel, and Ted Basta is Vice President, Market Data & Analysis.

<sup>2</sup> Please see “An Introduction to the Loan Asset Class” by Scott Page and Payson Swaffield in the LSTA’s “Handbook of Loan Syndications & Trading” by Allison Taylor and Alicia Sansone.

The LSTA's focus is attuned to the distinctive structural features of the loan market which stem from the fact that corporate loans are privately-negotiated debt obligations that are issued and traded subject to voluntary industry standards. No regulatory authority oversees or sets standards for the trading of loans. Instead, the LSTA acts as a forum for the analysis and discussion of issues and developments relating to the loan market. Through our involvement and guidance, loan market participants adhere to a unique consensus-building process to develop and ultimately adopt a set of market standards and legal documentation applicable to the primary market and the secondary market. Because of the diverse nature of the loan market, we have never sought to dictate specific policies or procedures; rather, we have expressed general principles and guidelines that are relevant to all market participants.

The LSTA undertakes a wide variety of activities which foster the development of trading policies and standards designed to promote just and equitable market practices and to encourage cooperation and coordination with firms facilitating transactions in loans. Those activities are pursued through several different channels – legal, analytical, and educational. First, the legal role of the LSTA is critical. The establishment of best market practices and the production of standard documentation, all of which are negotiated and vetted by LSTA members, for use in the primary market (*e.g.*, commitment letters, funding letters, and model credit agreement provisions) and in the secondary market (*e.g.*, trading documentation, purchase and sale agreements, and participation agreements) have contributed significantly to the liquidity of the market. The LSTA is also an advocate of the asset class, stepping in where necessary to file *amicus* briefs to support parties involved in litigation the outcome of which could influence the market. We are also willing to protect the interests of our members by lobbying for legislative change whenever necessary.<sup>3</sup>

Second, the LSTA's market data and analysis team serves as a critical resource for members, providing quantitative and qualitative proprietary statistical studies and analytical deliverables covering key topics confronting industry participants (*e.g.*, secondary market performance, trade volume, liquidity, settlement, and mark-to-market price accuracy). The team also manages third party relationships and data distribution from Reuters Loan Pricing Corp. (LPC) and Standard & Poor's Leveraged Commentary and Data Division (LCD). Since 1999, LPC, under license from the LSTA, has facilitated the daily mark-to-market process between bank loan dealers and investors through the creation of the LSTA/LPC Mark-to-Market Pricing Service, the first independent third-party provider of daily secondary mark-to-market prices of loans. Additionally, the LSTA, in conjunction with LCD, developed the S&P/LSTA Leveraged Loan Index. Prior to 1999, there was no mark-to-market service available to the buy-side. Without a third party pricing source for loans, many institutional investors were unwilling to invest in loans. Shortly after the introduction of the Service, the market saw a dramatic shift in the type of entity that started to invest in loans. Nonbank lenders, more comfortable with the asset class, began to enter the market in significant numbers.

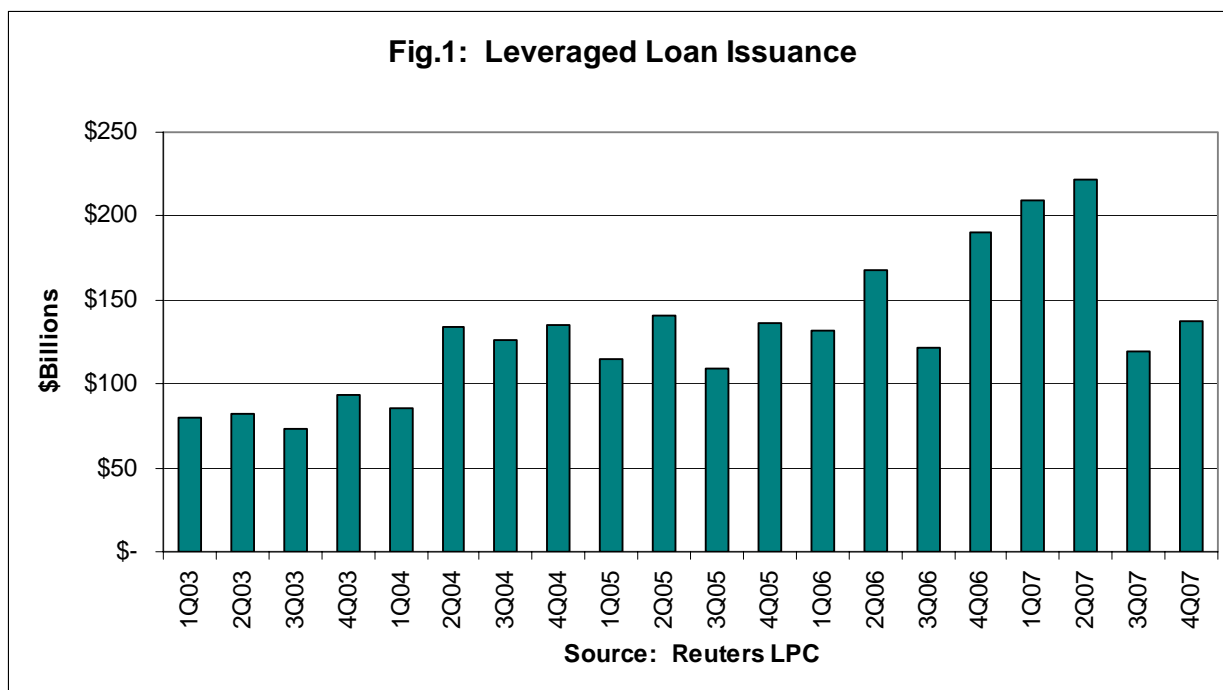
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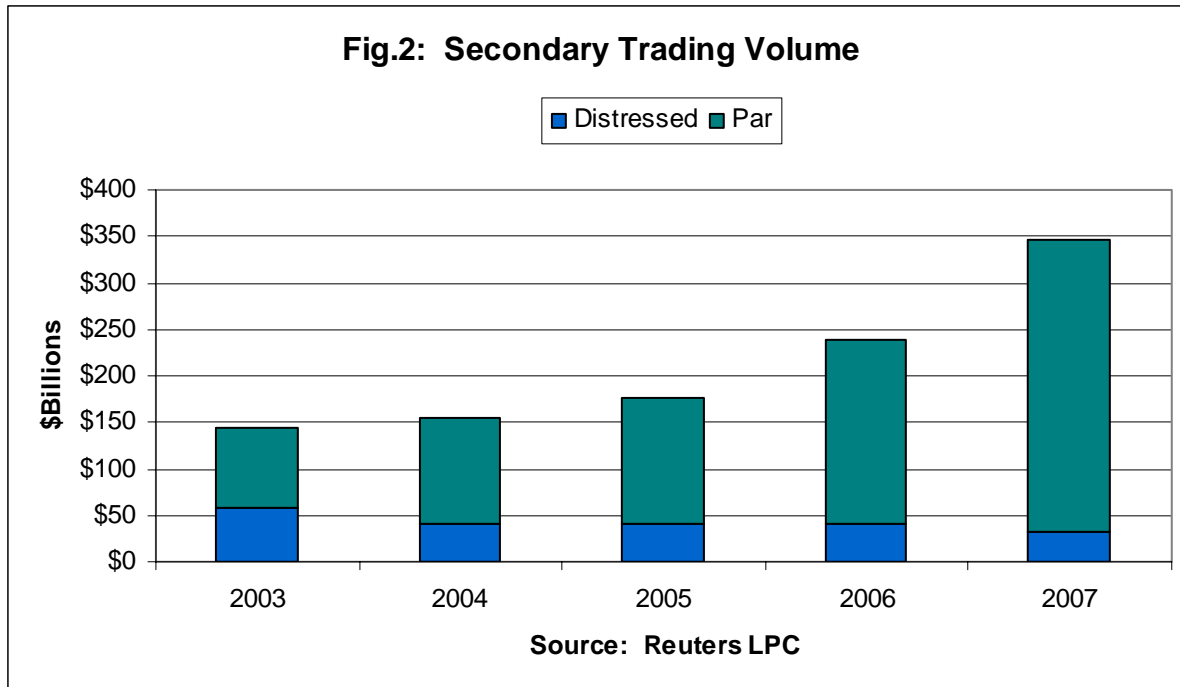
<sup>3</sup> In October 2002, as a result of the LSTA's lobbying efforts, the New York legislature passed a law exempting loan trading from the Statute of Frauds in New York.

Finally, the LSTA has actively advanced the asset class through its educational endeavors. By regularly hosting conferences, seminars, and roundtables throughout the U.S., Europe, and Asia, the LSTA successfully promotes the loan market and helps to broaden its appeal to a larger investor base. One of our most significant accomplishments in this area has been the publication of the only comprehensive textbook on the syndicated loan market. In 2006, we published the “The Handbook of Loan Syndications & Trading,” a complete guide to the primary and secondary market.

### The Leveraged Loan Market

Over the past 20 years, the U.S. leveraged loan market, consisting of an efficient primary market and a liquid transparent secondary trading market, has become one of the most innovative and expanding sections of all U.S. capital markets. In the new millennium, the leveraged loan market has continued to develop and attract a new and diverse group of institutional investors, who appreciate the high risk-adjusted returns of the asset class and find trading in the secondary market to be a useful tool in managing credit risk and increasing portfolio diversification. In particular, between 2003 and 2005, there was a dramatic increase in demand for the loan asset, largely as a result of an increase in collateralized loan obligation (“CLO”) issuance. By the end of 2005, such issuance began to feed an already-forming supply and demand imbalance. From 2005 to 2007, the market underwent a period of rapid development and structural changes which enabled massive growth in both leveraged loan issuance (**Figure 1**), and secondary market trading (**Figure 2**). An elongated positive credit cycle coupled with this level of demand served as the backdrop for an extended rally in secondary market loan prices which continued through the first half of 2007.





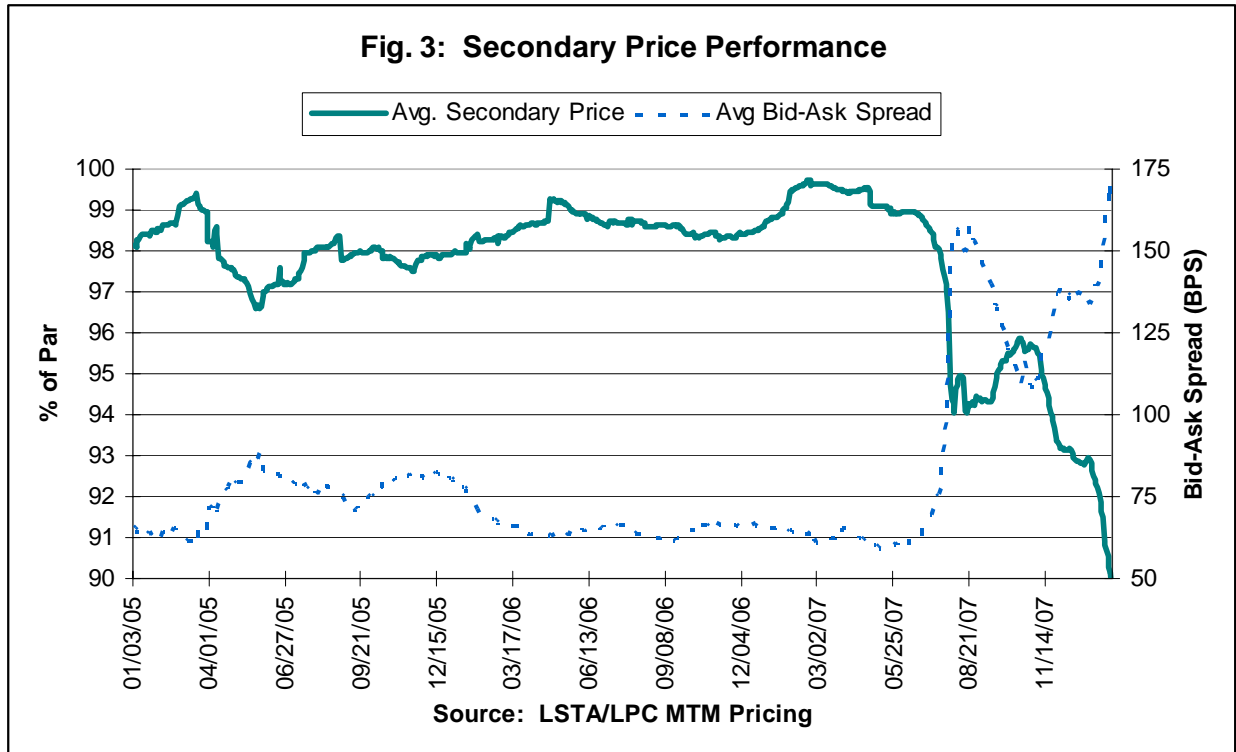
During the first half of 2007, leveraged loan issuance was poised to exceed the record levels of 2006,<sup>4</sup> while the overwhelming majority of loans traded at a premium to par in the secondary market. As CLO demand continued to reach record levels,<sup>5</sup> new issue supply changed accordingly – deals became larger and coupons trended lower. Loan structures loosened as covenants were relaxed, and, in some cases, removed entirely.

By the beginning of the third quarter of 2007, the subprime mortgage meltdown precipitated a credit crunch that spread across all structured finance and impacted the CLO sector. The aftereffects of the contagion, including the reassessment and re-pricing of credit risk, triggered a shutdown of CLO issuance. Meanwhile, however, syndicators had committed to a record number of large deals. Confronted by the absence of CLO issuance and the massive amount of new issue supply, the primary market became stalled. Coupled with a weakening economy, these factors meant that secondary market prices were poised to plummet. Thus, by mid-July 2007, bids began to fall in the secondary market, which suddenly became less liquid but considerably more volatile.

From month-end June to July 31, 2007, 96% of the LSTA market dataset (U.S. term loans priced in the secondary market by three or more trading desks) recorded mark-to-market losses on an advancer/decliner ratio of 1:65. The mean price fell 363 basis points to 95.06 as its average bid-ask spread widened to 140 basis points, from 66 basis points at the end of Second Quarter 2007. **(Figure 3).**

<sup>4</sup> According to Reuters Loan Pricing Corp. leveraged issuance totaled \$431.5 billion in the first half of 2007.

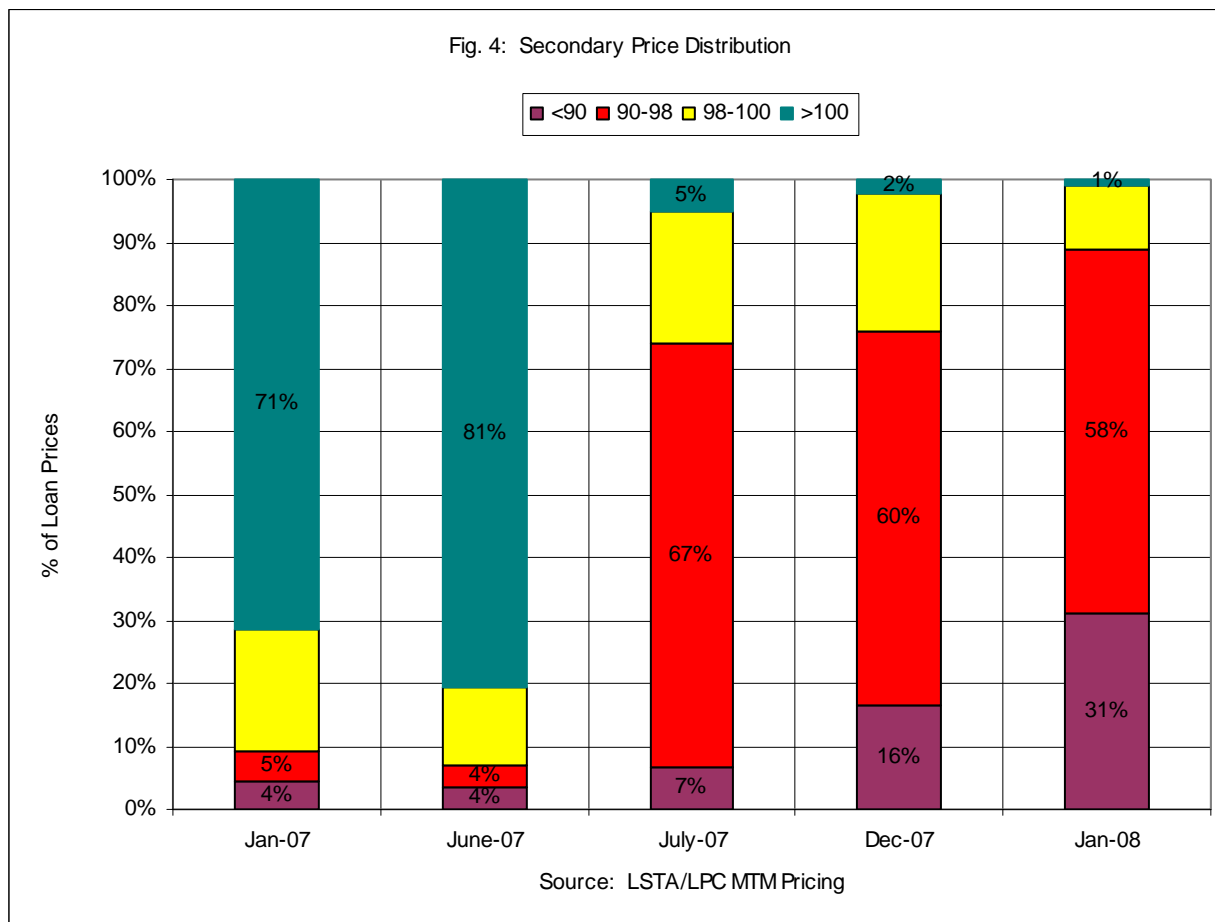
<sup>5</sup> According to the S&P LCD 1H07 CLO issuance totaled \$57.6 billion, on 2Q07's record \$32.8 billion.



**This abrupt correction caused a plunge in the percentage of loans priced above 100 to 5% of the market dataset – as compared with 81% just four weeks earlier – while the percentage of loans priced between 90 and 98 grew to 67% from 4%. (Figure 4).** Moreover, the prospect of rising mortgage default rates and rating agency downgrades on these structured assets heightened concerns regarding credit market stability. A number of leveraged deals were either postponed or downsized due to their inability to clear market. On the demand side, new CLO issuance remained mostly scarce. According to S&P LCD, the CLO market share of primary issuance fell to less than 25% from approximately 60% since the beginning of the third quarter of 2007. Conversely, the market share of hedge, high yield, and distressed funds in the primary market more than doubled to approximately 60% from less than 25%. Taking advantage of the lucrative yields available in both the primary and secondary loan markets, such non-traditional lenders filled a sizable portion of the vacated CLO market share and provided much needed liquidity to the market; however, their participation was short-lived and the resulting rally brief. Reversing a two-month trend of rising prices and tighter bid-ask spreads, the secondary market recorded its worst month of 2007 in November.

As the year 2007 came to a close, loan market supply and demand in both the primary and secondary markets entered into a period of flux, as issuers and lenders carefully evaluated the future. With the investor base no longer dominated by the prominent CLO community, adjustments were made to the manner in which loans were structured, priced, and subsequently traded in the secondary market. New deals were downsized and once again included more aggressive covenant packages and higher coupons. Despite such higher coupons, to make new loan issuances more attractive to lenders, such loans were sold at deep discounts to par in the primary market (thereby increasing the yields on those loans) in order to clear the substantial new issue overhang. Within the secondary market, liquidity suffered as prices declined and

volatility increased to historical highs. By the end of 2007, the mean price had fallen 594 basis points (6%) to 92.77, while the average bid-ask spread, commonly used as a measure of liquidity, widened 71 basis points to 136 basis points. **As bid levels continued to drop, the percentage of loans priced above par fell to 2%, while the 90 to 98 range grew to 60% from an average of 4% in the first half of 2007.**



Despite the Federal Reserve Bank's multiple rate cuts during January, the equity market tumbled, loan returns suffered as LIBOR rates were slashed, and prices in the secondary market once again retreated. The lower loan yields made loans less desirable to certain crossover lenders such as hedge funds and high yield accounts, which returned to higher yielding fixed income bonds. In addition to the lack of liquidity, the market suffered from a lack of leverage, with banks, dealing with their own balance sheet issues, less willing or less able to offer leverage. In January, mean prices fell an additional 315 basis points, ending the month at a record low of 89.62, while the average bid-ask spread widened to 174 basis points. The percentage of loans priced between 98 and 100 fell to 10%, while the percentage of loans priced between 90 and 98 fell to 58%. At the time of writing this article, these loans – which had previously been priced between 90 and 100 – have now migrated down into the below-90 range (which now comprises 31% of the LSTA market dataset).

## Legal Challenges arising out of the Current Market Volatility

The recent volatility of the market raises a litany of new legal issues with which the LSTA must now contend. We are working to create new standard documents to help streamline the trading process and further refining the terms of trading documents. Recently, we published a new Distressed Participation Agreement and Collateral Annex (where an assignment is not possible, parties are required to settle via a participation). And efforts are already underway to draft a Par Participation Agreement. In addition, we are revising our Par/Near Par Trade Confirmation and Distressed Trade Confirmation,<sup>6</sup> to address issues arising out of the market volatility. For example, we are reexamining the existing buy-in/sell-out provisions to allow them to be effectively used by parties and revisiting the LSTA's corresponding arbitration provisions.

Most recently, the LSTA was called upon to help the market cope with one particular aspect of the unprecedented pricing of performing loans. With a significant number of performing loans priced well below 90, loan market participants are uncertain whether to trade such loans on par documentation or distressed documentation. We recently issued guidance on this topic, highlighting that although a price may be an important indicator of the likelihood of default, a price can be indicative of many other factors and therefore should not, in itself, be determinative of whether distressed or par/near par documentation is appropriate.

For use further ahead in the credit cycle, we are preparing a form of a Proceeds Letter, a complex standard which is intended to be used in instances where settling a distressed trade does not occur until after confirmation and the effective date of a borrower's Chapter 11 plan. (Once the borrower's plan has gone effective, settlement can no longer result in transfer of the traded loan, which will have been restructured and discharged by the plan but only in the transfer of the proceeds under the plan of the loan and the related claim.)

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Today's market certainly looks much different from one year ago and represents a new and more challenging period for not only investors, but also the LSTA. Loan prices are now said to be closely correlated to, and no longer shielded from, the daily price fluctuations of other asset classes. While the risk-adjusted returns of leveraged loans are still advantageous, today's returns come with not only a higher level of volatility, but also an apprehension of rising default rates. In this environment, the LSTA remains committed to promoting a fair, efficient, and liquid market for loans and maintaining its position as the market's principal advocate. We know that we will be called upon to address issues raised by our membership as a result of the market volatility and to help effectively and promptly resolve those issues to ensure the market continues to operate smoothly and efficiently. In all our pursuits and efforts to resolve those issues, we will continue to work efficiently – mindful of both buy-side and sell-side constituents – as we strive to resolve market challenges.

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<sup>6</sup> The Par/Near Par Trade Confirmation sets out the standard terms and conditions of a trade involving a performing loan. The Distressed Trade Confirmation sets out the standards terms and conditions of a trade involving a loan of a borrower in financial distress.