



# GLOBAL SENIOR SECURED LOANS

## ABSTRACT

The past two decades were strong periods of growth for senior secured loans in the U.S. and Europe, both in terms of new issuance as well as the number of investors and market makers, resulting in a large and highly developed global institutionalized market. Even though these loans are issued by below-investment-grade companies, they are senior in the company's capital structure and secured by the assets of the corporation. In addition, loans provide further protection to investors through financial covenants, potentially keeping recovery rates high. Loan prices were stable pre-crisis and are less sensitive than other debt instruments to interest rate movements due to their floating-rate coupon payments. Their positive returns through various credit cycles and the characteristics of low volatility and low-to-negative correlation to investment grade credit make loans worthy of consideration for a portfolio allocation.

## GLOBAL SENIOR SECURED LOANS

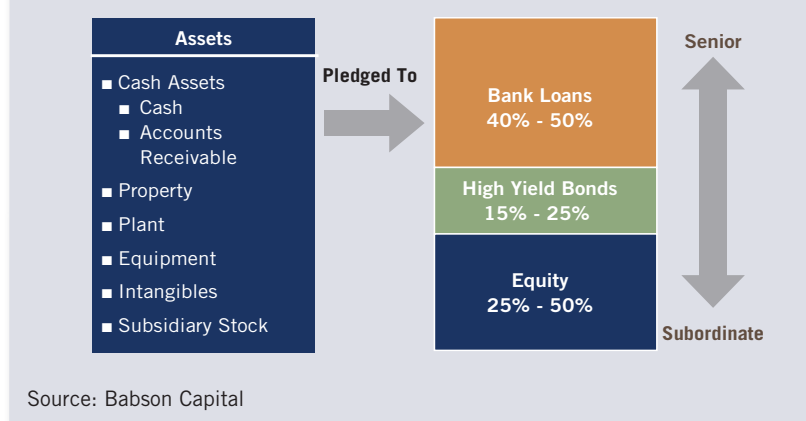
### THOUGH BELOW INVESTMENT GRADE, SENIORITY AND COVENANTS OFFER PROTECTION

Senior secured loans<sup>1</sup> are a unique fixed income asset class. These senior, floating-rate corporate loans are commonly issued by below-investment-grade companies for the financing of acquisitions, capital expenditures, and general operating purposes. Loans are underwritten by a lead bank and syndicated to other banks and institutional investors. They are technically not securities, nor traded on any exchange, but rather traded “over the counter.”

Loans pay a floating rate of interest made up of a base rate (LIBOR), plus an additional fixed coupon called the “spread” or “credit spread” to compensate for credit risk. Interest payments are usually paid quarterly, and in some cases more frequently. In a later section called “*Positive Returns Through Many Credit Cycles*,” we highlight some of the benefits provided by the floating-rate characteristic of loans.

Loans bear the unique combination of seniority, security, and covenants, which helps maintain relatively high recovery rates in the event of default. Loans are typically “senior” in the issuer’s capital structure to other outstanding debt, in that the loan’s interest and principal payment must be paid before the other creditors receive any payment. This seniority also applies to the repayment of the debt in case of default. Additionally, loans are secured by some or all of the borrower’s assets, which means that loans typically have first priority<sup>2</sup> claim on the assets in the event of default. The interests of the investor (also commonly referred to as the lender) are further protected by covenants or contractual restrictions in the credit agreement, which set minimum standards for a borrower’s financial conduct and performance.

FIGURE 1: REPRESENTATIVE CAPITAL STRUCTURE



1. Also commonly referred to as leveraged loans, bank loans, term loans, and high yield loans  
 2. Asset backed loans and revolvers often supersede term loans



Most salient to the lender is the set of financial maintenance covenants stipulating measurable financial variables that must meet certain criteria. These include, among others, limits on the ratio of debt to earnings and minimum levels of interest coverage to be maintained.

Covenants are generally tested quarterly, and if a borrower expects to breach a covenant at some point, he must seek a waiver from the lenders and will most likely be asked for a fee or wider credit spread in return. If a covenant is breached without remedy, senior lenders can demand an accelerated repayment of debt, but in most cases are likely to negotiate an amendment resulting in wider credit spreads or the payment of an amendment fee.

Although contractual maturities are typically five to seven years, the average lives of loans tend to be three to four years due to prepayments. Unlike high yield bonds, which have specific non-call periods, loans are callable at par at any time - although in some cases, terms may include call protection in the form of a call premium.

### **INSTITUTIONALIZED MARKETS WITH ACTIVE SECONDARY TRADING**

The 1990s and 2000s were decades of strong growth and development for the U.S. and European loan markets. They developed into institutionalized markets, with multiple underwriters, third-party credit ratings, and an active secondary market. At its peak in 2008, total U.S. and European institutional loan market size<sup>3</sup> grew to \$1.2 trillion (see Figure 2).

The Loan Syndications and Trading Association (LSTA) was formed in 1995 in the U.S. by industry members to set guidelines for the growing market. As the number of dealers grew in the U.S., the LSTA created a dealer-quote-based secondary pricing system and established standardized settlement procedures which had previously not existed. By 1997, there were two accepted market indices, the Credit Suisse Leveraged Loan Index and the S&P/LSTA Leveraged Loan Index (see Appendix). By 2000, there were two pricing services in the U.S., Loan Pricing Corporation (now Thomson Reuters LPC) and LoanX (now Markit LoanX). Together with the increasing availability of loan ratings for larger U.S. borrowers, the above developments helped improve information transparency and thus liquidity in the secondary market.

Developments in Europe were similar. In 1996, the Loan Market Association (LMA) was formed with the objective of improving liquidity, efficiency and transparency in the loan market and establishing market practice. As of today, the association has grown to over 420 corporate members. Furthermore, European loan market indices were introduced; the main indices being the Credit Suisse Western European Leveraged Loan Index, available from 1998, and the S&P European Leveraged Loan Index (ELLI), first published in 2003 (see Appendix). Similar to the U.S., Thomson Reuters LPC and Markit LoanX provide pricing services for European loans. Although most ratings in Europe are private credit estimates, the availability of public ratings is growing. In line with those developments, transparency and secondary market liquidity have greatly improved over recent years.

3. Institutional loan size does not include pro-rata loans, which include revolvers, that are typically syndicated to banks.



### **A BROAD INSTITUTIONAL BASE, WHICH INCLUDES PENSIONS, ENDOWMENTS AND FOUNDATIONS**

The profile of investors in the global primary market has evolved during the market's growth and development phase over the past 20 years. In the early 1990s, U.S., Asian, and European banks accounted for 71% of all direct purchases in the U.S. primary market (see Figure 3). Now, asset managers account for almost 80% by purchasing loans for CLOs<sup>4</sup>, prime-rate, hedge, and high yield funds.

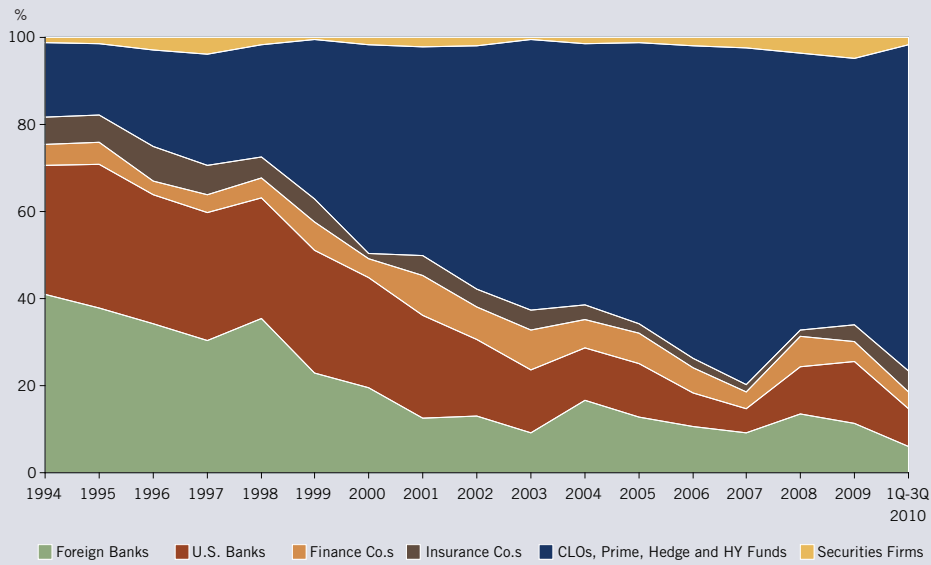
In Europe, the trend was similar with banks accounting for over 88% of primary loan purchases in the late 1990s, dropping to 36% by 2007 in favor of institutional investors, asset managers and CLOs. Although the share of bank investors has grown again after the credit crisis to 67%, institutional investors continue to represent a significant part of the market at over 30% (see Figure 4).

The growing range of investment vehicle options have made loans more accessible to a more diverse institutional investor base including public and corporate pension plans, endowments, and foundations.

4. Collateralized Loan Obligation – a special purpose vehicle that invests in bank loans and issues debt and equity for its capital. See Babson Capital White Paper on CLOs (July 2009)

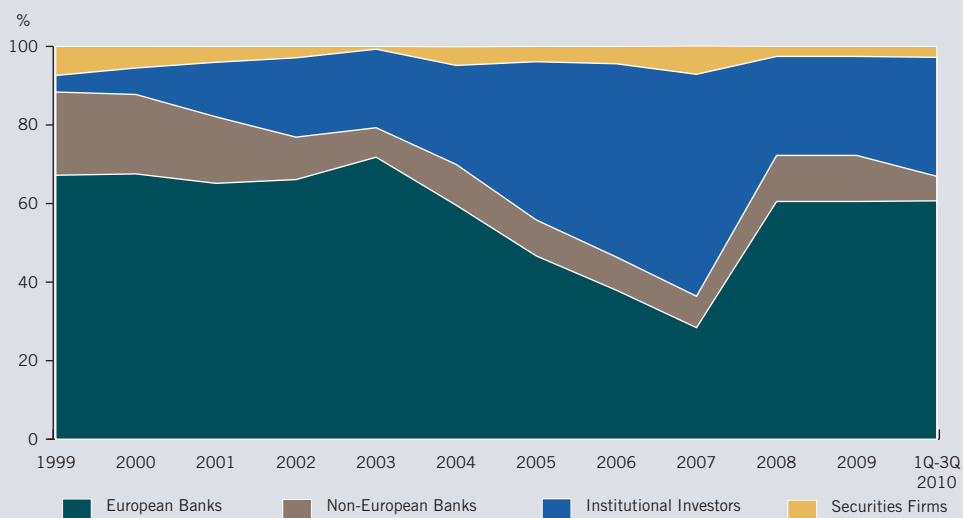


**FIGURE 3: U.S. PRIMARY MARKET BY BROAD INVESTOR TYPE<sup>5</sup>**



Source: S&P/LCD as of September 30, 2010

**FIGURE 4: EUROPEAN PRIMARY MARKET BY BROAD INVESTOR TYPE<sup>6</sup>**



Source: S&P/LCD as of September 30, 2010

5. Investors defined by S&P/LCD as those in the primary market for highly leveraged loans and excludes revolver-only ABL deals  
6. Given the lack of primary issuance, LCD did not track enough observations to compile a meaningful sample for 2009. To create a meaningful chart, we have used 2008 numbers for 2009.

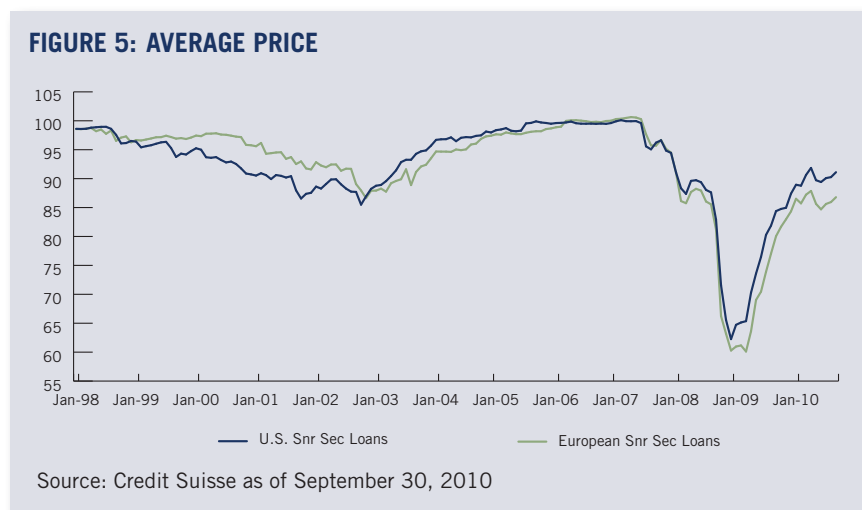


## A “PAR MARKET” PRE-CRISIS, A STABLE MARKET GOING FORWARD

Before the recent financial crisis, performing loans in both the U.S. and Europe generally traded close to or above par and hence the global loan market was known as a “par market.” The financial crisis of 2007-2008 caused a dramatic shift where prices of global loans fell drastically (see Figure 5). The price moves were widespread and did not discriminate between performing loans and those with more significant credit concerns.

While there may have been some fundamental credit concerns, the majority of price moves were driven by market technicals, namely the forced selling of a number of highly leveraged funds, both hedge funds and market-value CLOs. Additionally, the overhang of underwritten loans on bank balance sheets, that we estimate to be approximately \$400 billion at its peak in late 2007 in the U.S. alone, put severe downward pressures on the market. As prices fell, a downward spiral was created, pushing the average price of loans into the 60s in both the U.S. and Europe by the end of 2008.

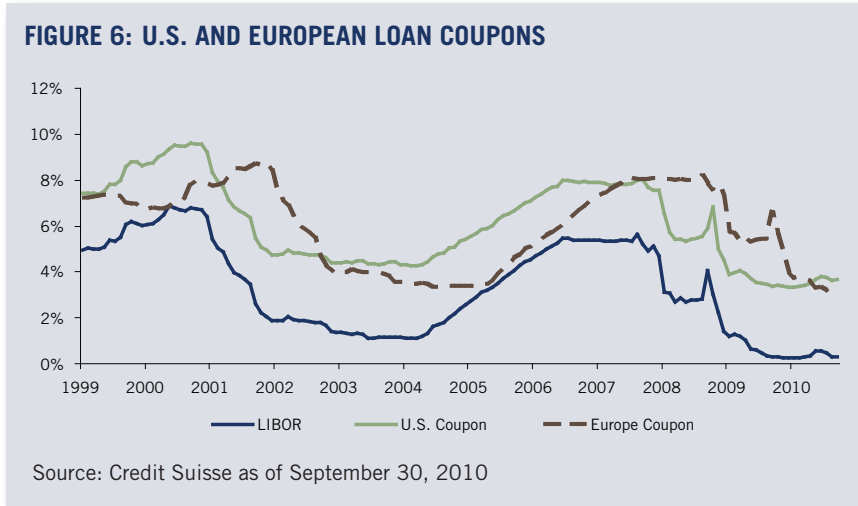
By 2009, the forced deleveraging was nearly complete and investors returned to the market seeking opportunistic gains. The market rebounded strongly and the average price level is now back in the 90s for U.S. loans and in the high 80s for European loans (Credit Suisse Leveraged Loan Index and West Euro Lev Loan Index as of November 10, 2010).





## UNLIKE BONDS, LOAN PRICES ARE LESS SENSITIVE TO INTEREST RATE MOVEMENTS

Due to the floating-rate nature of loan coupon payments, loans do not share the same interest-rate risk (also known as duration risk) as fixed-rate debt instruments. When rates rise, the loan coupon rises along with LIBOR, thus minimizing negative price return associated with the impact of rising rates on fixed income bonds.

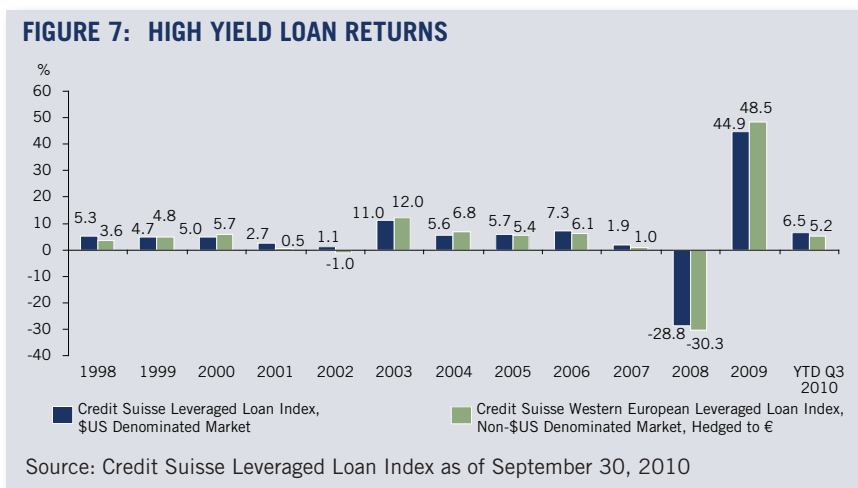


## LIBOR FLOORS PROVIDE MINIMUM YIELDS IN A LOW INTEREST RATE ENVIRONMENT

Critics might say that the currently low LIBOR rates must mean low yields. However, to improve yields and thus attract investors to the primary loan market, the structural feature of LIBOR floors is now being widely used in the U.S. and has also started to gain traction in Europe. According to S&P, nearly every new U.S. loan now carries a LIBOR floor, offering a minimum yield for investors (August 11, 2010). Currently, 25% of the S&P LSTA Leveraged Loan Index by par amount has LIBOR floors, and the average LIBOR floor is 2.02% (S&P LSTA, October 29, 2010) versus the actual three-month LIBOR rate of 0.29% (Bloomberg, October 29, 2010).

## POSITIVE RETURNS THROUGH MANY CREDIT CYCLES

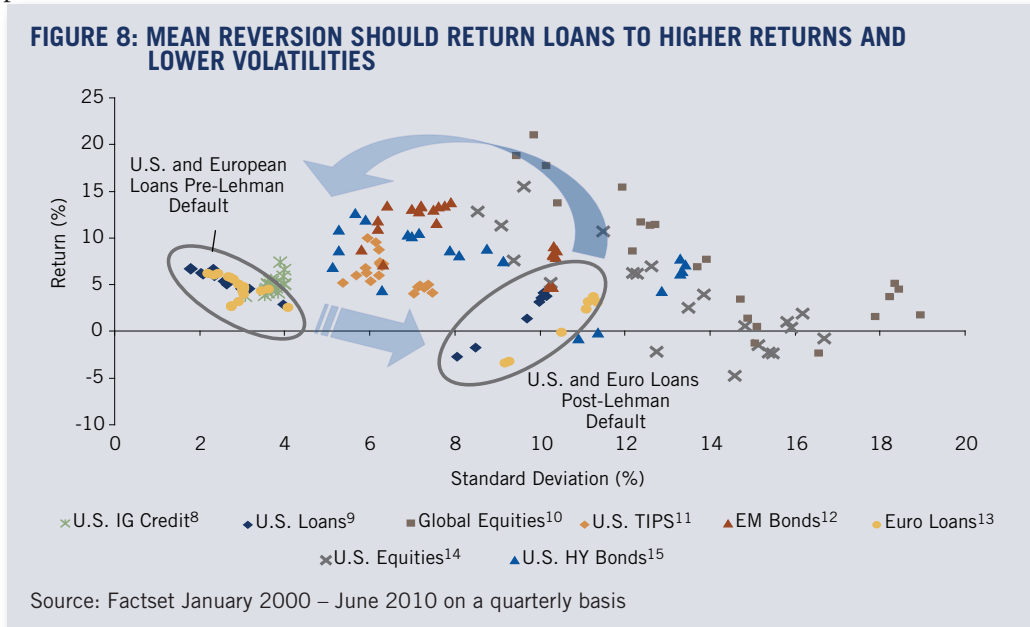
From 1992 to 2007, loans consistently provided positive returns over multiple credit cycles and economic downturns –the Russian Debt Default and LTCM collapse in 1998, the burst of the Dot-com Bubble of 2000, and 9/11 in 2001 (see Figure 7). The unprecedented negative return for U.S. and European loans in 2008 was primarily due to a number of technical issues dislocating the loan market, as previously mentioned in “A Par Market Pre-Crisis...” Both loan markets fell close to 30% in 2008, the worst on record. When investors eventually returned to the loan market to take advantage of the dislocation, the loan markets subsequently experienced record high returns of 44.9% and 48.5% in the U.S. and Europe, respectively, in 2009.





## LOW VOLATILITY + NEGATIVE CORRELATION = DIVERSIFICATION

With historically stable prices (except during the recent crisis), loans globally have exhibited low volatility, thus giving rise to an attractive risk-return profile for the asset class. In the pre-crisis era, both U.S. and European loans generated stable, positive returns while displaying low return volatility in the 2-3% range, lower than the Barclays U.S. Aggregate. Though volatilities shifted up during the financial crisis, we believe some mean reversion will occur returning loans to their pre-crisis risk-return profile.



U.S. loans have also exhibited negative correlation with the Barclays U.S. Aggregate, the broad investment grade credit index (see Table 1), a plus for diversified portfolios in a rising rate environment.

**TABLE 1: GLOBAL CORRELATIONS (LOCAL CURRENCY<sup>7</sup> RETURNS)**

DESCRIPTION	U.S. IG CREDIT	U.S. TIPS	GLOBAL EQUITIES	EURO EQUITIES	U.S. EQUITIES	U.S. LOANS	EURO LOANS	EURO HY BONDS	EM BONDS	U.S. HY BONDS
U.S. IG Credit <sup>8</sup>	1.00	0.79	-0.10	-0.18	-0.07	-0.03	0.11	0.04	0.53	0.17
U.S. TIPS <sup>11</sup>	0.79	1.00	0.00	-0.13	0.04	0.18	0.26	0.16	0.55	0.28
Global Equities <sup>10</sup>	-0.10	0.00	1.00	0.95	0.97	0.54	0.53	0.68	0.57	0.68
Euro Equities <sup>16</sup>	-0.18	-0.13	0.95	1.00	0.90	0.47	0.45	0.62	0.48	0.60
U.S. Equities <sup>14</sup>	-0.07	0.04	0.97	0.90	1.00	0.50	0.49	0.65	0.55	0.66
U.S. Loans <sup>9</sup>	-0.03	0.18	0.54	0.47	0.50	1.00	0.88	0.73	0.52	0.79
Euro Loans <sup>13</sup>	0.11	0.26	0.53	0.45	0.49	0.88	1.00	0.67	0.56	0.67
Euro HY Bonds <sup>17</sup>	0.04	0.16	0.68	0.62	0.65	0.73	0.67	1.00	0.62	0.87
EM Bonds <sup>12</sup>	0.53	0.55	0.57	0.48	0.55	0.52	0.56	0.62	1.00	0.73
U.S. HY Bonds <sup>15</sup>	0.17	0.28	0.68	0.60	0.66	0.79	0.67	0.87	0.73	1.00

Source: Factset 10 Years Ending June 30, 2010

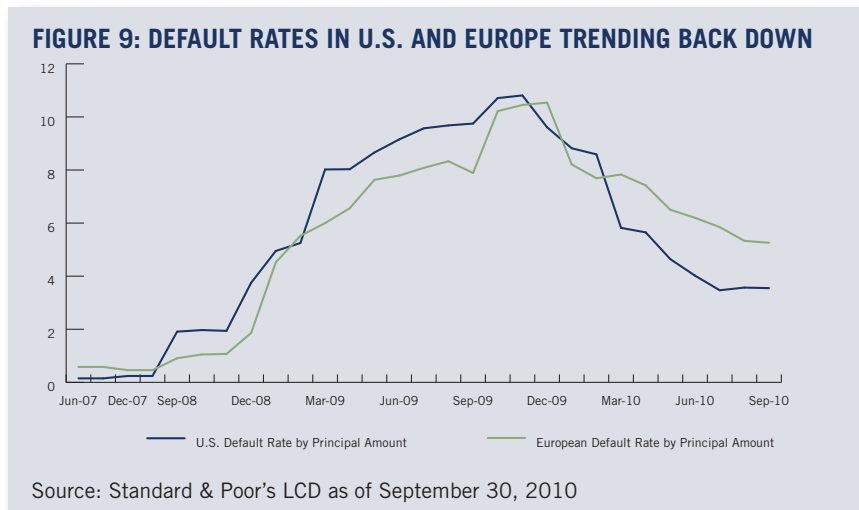
7. For correlations based on USD returns, please see Table 3 in the Appendix.
8. Barclays Capital U.S. Aggregate
9. Credit Suisse Leveraged Loan Index
10. MSCI AC World
11. Barclays Capital U.S. TIPS
12. JP Morgan EMBI Global Diversified
13. Credit Suisse West Euro Leveraged Loan Index
14. S&P 500
15. Barclays Capital U.S. High Yield
16. Stoxx Europe 600
17. BofA Merrill Lynch Euro High Yield



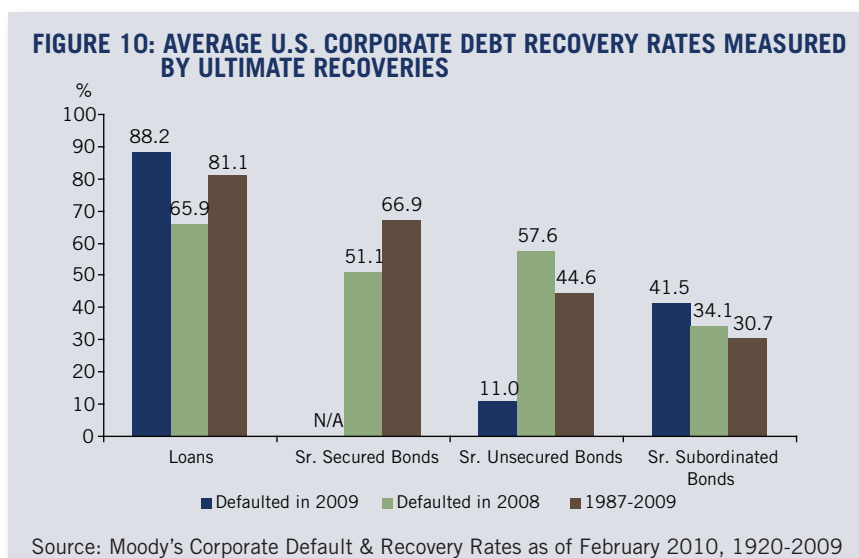
Although not negative, European loans also have low correlation with U.S. investment grade credit. As a component of a broad fixed income portfolio, loans can serve as a diversifier, decreasing overall risk and improving the return profile.

### RISKS: DEFAULT, RECOVERY, LIQUIDITY & PREPAYMENT

**Default risk:** As with all corporate fixed income investments, there is the risk that the company defaults on its payment. Since the companies issuing loans are rated below investment grade, they possess higher probabilities of default than investment grade companies. Default rates are cyclical and generally vary in tandem with the macroeconomic cycle.



**Recovery risk:** If a company defaults, there is also the risk that lenders do not receive a full recovery on their investment or claim. The recovery could vary for a number of reasons, such as a reduction in the entity's enterprise value post-default to below the outstanding senior claim, or the proceeds from liquidating the company not being sufficient to satisfying the claim. Being senior and secured, however, loans tend to have a higher recovery rate than the other debt instruments further down the capital structure. Since 1987, the average annual recovery rate on defaulted U.S. loans has been 81.1% versus 30.7% for subordinated debt (Moody's Corporate Default & Recovery Rates, February 2010, 1920-2009). Recovery data on European loans is limited, but we believe recovery rates for European loans to be 75% on average.





**Liquidity risk:** As with any investment instrument traded over the counter, there is the risk that the loan has no willing buyer. Though the number of market participants and thus market liquidity has steadily grown over time, during the recent financial crisis, there were periods of lower market liquidity for loans. This illiquidity was largely driven by an oversupply issue - the significant overhang of underwritten bank debt on bank balance sheets that has since been unwound.

**Prepayment risk:** Prepayment risk is the risk that all or part of a loan will be paid prior to the scheduled maturity. This is most likely to occur during an environment of falling interest rates and tightening credit spreads, resulting in reduced cash flow for the lender when the redemption proceeds are reinvested at a reduced rate. It is important to note that this risk is more applicable in a “par” market.

#### **SUMMARY: INVESTMENT BENEFITS OF LOANS ARGUE FOR PORTFOLIO ALLOCATION**

The characteristics of senior security, floating interest payments, and covenant protection make loans a unique asset class. The combination of senior security and financial covenants, which differentiates loans from other fixed income asset classes, helps reduce the risk of loss in the event of default by helping to keep recovery rates high. The floating-rate payments of loans can also help offset the effect of falling bond prices attributable to rising rates, within a broader fixed income portfolio. Overall, their historically steady returns, low volatility and low-to-negative correlation with investment grade bonds, could potentially enhance returns while lowering portfolio volatility. The availability of senior secured loans in both the U.S. and Europe means that global investors can also get further country diversification from investing in loans from both regions.



## APPENDIX:

### I. SENIOR SECURED LOAN INDICES

The senior secured loan market is tracked primarily by two indices, both of which are published for the U.S. and the European market: the Credit Suisse Leveraged Loan Index which includes loans from over 1,000 companies in the U.S. and close to 300 issuers in Western Europe, and the S&P/LSTA Leveraged Loan Index which includes loans from close to 700 companies while the S&P European Leveraged Loan Index accounts for approximately 240. Together, these indices capture nearly the entire global senior secured loan universe. These indices provide investors with a level of comfort of the robustness of the market and are frequently used in the industry as benchmarks for portfolio return.

TABLE 2

	S&P / LSTA LEVERAGED LOAN INDEX	CREDIT SUISSE LEVERAGED LOAN INDEX	S&P / ELLI EUROPEAN LEVERAGED LOAN INDEX	CREDIT SUISSE WESTERN EUROPEAN LOAN INDEX, NON-US\$
Market Value	\$513B	\$685B	€135B	€200B
Number of Issuers	692	1148	241	288
Number of Loans	1016	1599	595	698
Inception Date	Jan-97	Jan-92	Jan-03	Jan-98
Loan Types	Fully funded and syndicated term loans with maturities greater than one year and spreads greater than 125bps over LIBOR	Fully funded term loans with maturities greater than one year and spreads greater than 125bps over LIBOR	Term loans syndicated to European loan investors with a minimum initial spread of 125bps over EURIBOR	Investable universe of non-\$US-denominated Western European loan market, with fully funded term loans denominated in Western European currencies, a minimum tenor of at least one year and a Moody's/S&P rating of Baa1/BB+, Ba1/BBB+ or lower; if unrated, the minimum initial spread must be 125 bps over LIBOR (or equivalent)
When Removed	When there is no bid posted on the loan for at least 12 successive weeks, or when the loan is paid out or paid down to a negligible amount	When the loan is upgraded to investment grade, or when the loan is paid out or paid down to a negligible amount	When there is no bid posted on the facility for at least 12 successive weeks, or when the loan is paid out or paid down to a negligible amount; defaulted loans will remain through repayment	When the loan is upgraded to investment grade, or when the loan exits the market (for example, at maturity, refinancing or bankruptcy workout); defaulted loans will remain
Pricing Source	LSTA/LPC leveraged loan pricing data	LoanX / Markit, Credit Suisse leveraged loan trading desk and LSTA/LPC	Markit Partners	Credit Suisse, Markit Partners
Pricing Availability	Daily	Daily	Weekly	Weekly

Source: S&P/LSTA and Credit Suisse as of September 30, 2010



## II. CORRELATION TABLE

**TABLE 3: GLOBAL CORRELATIONS\* (US\$ RETURNS)**

DESCRIPTION	U.S. IG CREDIT	U.S. TIPS	GLOBAL EQUITIES	EURO EQUITIES	U.S. EQUITIES	U.S. LOANS	EURO LOANS	EURO HY BONDS	EM BONDS	U.S. HY BONDS
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Source: Factset 10 Years Ending June 30, 2010

8. Barclays Capital U.S. Aggregate
9. Credit Suisse Leveraged Loan Index
10. MSCI AC World
11. Barclays Capital U.S. TIPS
12. JP Morgan EMBI Global Diversified
13. Credit Suisse West Euro Leveraged Loan Index
14. S&P 500
15. Barclays Capital U.S. High Yield
16. Stoxx Europe 600
17. BofA Merrill Lynch Euro High Yield

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