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LSTA ADVANCING THE CORPORATE LOAN MARKET

LMA Loan Market Association

APLMA Asia Pacific Loan Market Association

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Loan Syndications and Trading: An Overview of the Syndicated Loan Market

Loan Syndications and Trading Association

Bridget Marsh

Tess Virmani

During the past few decades, the art of corporate loan syndications, trading and investing has changed dramatically. There was a time when banks lent to their corporate borrowers and simply kept those loans on their books, never contemplating that loans would be traded and managed by investors like stocks and bonds in a portfolio. In time, however, investors became 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, an institutional asset class emerged. Today, such loans are not only held by banks but are also typically sold to other banks, mutual funds, insurance companies, structured vehicles, pension funds and hedge funds. This broader investor base has brought remarkable growth in the volume of loans being originated in the primary market and subsequently traded in the secondary market. The syndicated loan market represents one of today's most innovative capital markets.

In 2023, total corporate lending in the United States exceeded US$2.1 trillion,[1] a 13.5% decrease from the prior year's volume. This figure encompasses all three subsectors of the syndicated loan market: the investment grade market; the leveraged loan market; and the middle market. In the investment grade market, total lending was about $1.1 trillion in 2023. Most lending in the investment grade market consists of revolving credit facilities to larger, more established companies. The leveraged loan market, where loans are made to companies with non-investment grade ratings (or with high levels of outstanding debt), represented $737 billion.[2] Leveraged loans are typically made to companies seeking to refinance existing debt, to finance acquisitions or leveraged buyouts, or to fund projects and other corporate endeavours such as dividend recapitalisations. Leveraged loans comprise the overwhelming majority of loans that are traded in the secondary market. Then there is the middle market. As traditionally defined, middle market lending includes loans of up to $500 million that are made to companies with annual revenues of under $500 million.[3] For these companies, the loan market is a primary source of funding. In 2023, overall middle market lending totalled $121 billion (this includes the traditional middle market and the larger middle market loans).[4]

Of these three market segments, it is the leveraged loan market that has evolved most dramatically over the past 30–35 years. Attracted by the higher returns of the loan asset class, the investor base expanded significantly starting from the mid-1990s and has grown increasingly more diverse. This, in turn, fuelled demand for loans, leading to a commensurate rise in loan origination volumes in the primary market. For the loan market to grow successfully, for the loan asset class to mature, and to ease the process of trading and settlement, the new entrants to the market in the 1990s needed uniform market practices and standardised trading documentation. In response to these needs, the Loan Syndications and Trading Association ("LSTA" or "Association") was formed in 1995, and its mission since inception has included the development of best practices, market standards and trading documentation. The LSTA has thus successfully spearheaded efforts to increase the transparency, liquidity and efficiency of the loan market; in turn, this more standardised loan asset class has directly contributed to the growth of a robust, liquid secondary market.

The LSTA's role has expanded to meet new market challenges, assuming more prominence in the loan market generally and, particularly since the global financial crisis, the LSTA has regularly engaged with the U.S. government and its regulatory bodies on legislative and regulatory initiatives. Policymaking in the wake of the financial crisis had included sweeping changes to the financial industry, including to the loan market, even though the regulatory impact on the loan market was sometimes an unintended by-product of reform legislation aimed somewhere else. The LSTA has, therefore, dedicated substantial time and energy over the past 15 years to building awareness amongst regulators about the loan market and how it functions, seeking to distinguish it from other markets and, at times, persuading policymakers to exempt the loan market from particular legislative measures. Having established a more mature regulatory outreach programme, the LSTA now maintains a dialogue about the loan market with regulators and promotes the many benefits of a vibrant leveraged loan market for U.S. companies.

This chapter examines: (i) the history of the leveraged loan market, focusing on the growth and maturation of the secondary trading market for leveraged loans; (ii) the role played by the LSTA in fostering that growth through its efforts to standardise the practices of, and documentation used by participants active in, the secondary loan market to bring greater transparency to the loan asset class; and (iii) the regulatory and other challenges faced by the loan market.

Growth of the Secondary Market for Leveraged Loans

The story of the leveraged loan market starts more than 35 years ago in the United States, with the first wave of loan market growth being driven by the corporate M&A activity of the late 1980s. Although a form of loan market had existed prior to that time, a more robust syndicated loan market did not emerge until the M&A deals of the 1980s and, in particular, those involving leveraged buy-outs ("LBOs"), which required larger loans with higher interest rates. This had two significant consequences for the loan market. First, because banks found it difficult to underwrite very large loans on their own, they formed groups

of lenders – syndicates – responsible for sharing the funding of such large corporate loans. Syndication enabled the banks to satisfy market demand while limiting their own risk exposure to any single borrower. Second, the higher interest rates associated with these large loans attracted non-bank lenders to the loan market, including traditional bond and equity investors, thus creating a new demand stream for syndicated loans. Retail mutual funds also entered the market at this time and began to structure their funds for the sole purpose of investing in bank loans. These loans generally were senior secured obligations with a floating interest rate. The resultant asset class had a favourable risk-adjusted return profile. Indeed, a non-bank appetite for syndicated leveraged loans would be the primary driver of demand that helped propel the loan market's growth.[5]

Although banks continued to dominate both the primary market (where loans are originated) and the secondary market (where loans are traded), the influx of the new lender groups in the mid-1990s saw an inevitable change in market dynamics within the syndicated loan market. In response to the demands of this new investor class, the banks, which arranged syndicated loans, began modifying traditional deal structures, and, in particular, the features of the institutional tranche or term loan B, the portion of the deal of which would typically be acquired by the institutional or non-bank lenders. The size of these tranches was increased to meet (or create) demand, their maturity dates were extended to suit the lenders' investment goals, and their amortisation schedules tailored to provide for only small or nominal instalments to be made until the final year when a large bullet payment was scheduled to be made by the borrower. In return, term loan B lenders were paid a higher rate of interest. All these structural changes contributed to a more aggressive risk-return profile, which was necessary in order to still attract more liquidity to the asset class.

A true secondary market for leveraged loans in the United States emerged in the 1990s. During the recession of the early 1990s, default rates rose sharply, which severely limited the availability of financing, particularly in transactions involving financing from regional and foreign banks. Interest rates to non-investment grade borrowers thus increased dramatically. Previously, banks had carried performing loans at par or face value on their balance sheets, while valuations below par (expected sale prices) were only generally assigned to loans that were in or near default. During the credit cycle of the early 1990s, however, a new practice developed in the banking industry. As banks in the U.S. sought to reduce their risk and strengthen their balance sheets, they chose to sell those leveraged loans which had declined in value since their syndication, rather than hold the loans until their maturity date as they had in the past. In so doing, a new distressed secondary market for leveraged loans emerged, consisting of both traditional (bank) and non-traditional (non-bank) buyers. Banks were not simply originators of these loans but now were also loan traders, and thus, in their role as market makers, began to provide liquidity for the market.

Although leveraged lending volume in the primary market had reached approximately $100 billion by 1995, trading activity was still relatively low, standing at approximately $40 billion.[6] The early bank loan trading desks at this time initially acted more as brokers than traders, simply brokering or matching up buyers and sellers of loans. As liquidity improved and the lender base expanded, investors began to look to the secondary market as a more effective platform from which to manage their risk exposure to loans, and eventually active portfolio management through secondary loan trading was born. With the advent of this new and vibrant secondary loan market, there naturally was a greater need for standard trading documents and market practices which could service a fair, efficient, liquid and professional trading market for commercial loans – a need reflected in the LSTA's creation in 1995. (The LSTA and its role in the development of a more standardised loan market are discussed more fully below, under "The Standardisation of a Market".)

Around the same time, the loan market acquired investment tools similar to those used by participants in other mature markets, for example, a pricing service, bank loan ratings and other supporting vendor services. In 1996, the LSTA established a monthly dealer quote-based secondary mark-to-market process to value loans at a price indicative of where those loans would most likely trade. This enabled auditors and comptrollers of financial institutions that participated in secondary trading to validate the prices used by traders to mark their loan positions to "market". Within a few years, however, as leveraged lending topped $300 billion and secondary trading volume reached $80 billion, there was a need to "mark-to-market" loan positions on a more frequent basis.[7] In 1999, this led to the LSTA and Thomson Reuters Loan Pricing Corporation (now known as the LSTA/LSEG Mark- to-Market Loan Pricing Service) jointly forming the first secondary mark-to-market pricing service run by an independent third party to provide daily U.S. secondary market prices for loan market participants. Shortly thereafter, two other important milestones were reached, both of which facilitated greater liquidity and transparency. First, the rating agencies began to make bank loan ratings widely available to market participants. Second, the LSTA and Standard & Poor's together created the first loan index, the S&P/LSTA Leveraged Loan Index ("LLI") (now known as the Morningstar LSTA Leveraged Loan Index), which has become the standard benchmarking tool in the industry. Just as the market's viability was on the rise, so was its visibility. In 2000, *The Wall Street Journal* began weekly coverage of the syndicated loan market and published the pricing service's secondary market prices for the most widely quoted loans. All these tools – the pricing service, the bank loan ratings, the loan index, and the coverage of secondary loan prices by a major financial publication – were important building blocks for the loan market, positioning it for further successful growth.

At about this time, the scales tipped, and the leveraged loan market shifted from a bank-led market to an institutional investor-led market comprising finance and insurance companies, hedge, high-yield and distressed funds, loan mutual funds, and structured vehicles such as collateralised loan obligations or "CLOs". Between 1995–2000, the number of loan investor groups managing bank loans grew by approximately 130% and accounted for more than 50% of new deal allocations in leveraged lending. By the turn of the millennium, leveraged lending volume was approximately $310 billion and annual secondary loan trading volume exceeded $100 billion. With these new institutional investors participating in the market, the syndicated loan market experienced a period of rapid development that allowed for impressive growth in both primary lending and secondary trading.

Unfortunately, as the credit cycle turned and default rates increased sharply in the early 2000s, there was a temporary lull in the market's growth, with secondary loan trading stalling for a number of years. By 2003, however, leveraged lending (and trading) volumes quickly rebounded as investor confidence was restored.

Even the most bullish of loan market participants could not have predicted the rate of expansion that would take place over the next four years. Once again, this growth was driven by M&A activity and large LBOs. Increasing by nearly 200% from 2003–2007, leveraged loan outstandings were more than half a trillion

dollars and secondary trading volumes reached $520 billion. Although hedge funds, loan mutual funds, insurance companies and other investor groups played a large part in this phase of the loan market's expansion, the growth had only been possible because of the emergence of CLOs. This structured finance vehicle changed the face of the leveraged loan market and was also responsible for its revival after the Global Financial Crisis.

The 2008 Global Financial Crisis led to a recession in the United States, a contraction of global supply and demand, and record levels of default rates. Several years passed before leveraged lending issuance was restored to pre-crisis levels, finally reaching $665 billion in 2012. Although secondary trading activity had been in steady decline from 2008 through 2012, the asset classes' investment thesis (senior secured, floating rate, high risk-adjusted return) coupled with the investment tools put in place years earlier and the standardisation of legal and market practices helped the market to expand further during its next phase which began in 2013. Since 2013, annual secondary loan trade volumes have grown, reaching a record $824 billion in 2022, but then pulled back in 2023 and volume declined 13% to $715 billion, representing the lowest in six years.

The Standardisation of a Market

No regulatory authority directly oversees or sets standards for the trading of loans in the United States, although, of course, loan market participants themselves are likely to be subject to other governmental and regulatory oversight. Instead, the LSTA leads the loan market by developing policies, guidelines and standard documentation and promoting just and equitable market practices. 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. Because the LSTA represents the interests of both the sellers and buyers of leveraged loans in the market, it serves as a central forum for the analysis and discussion of market issues by these different market constituents and thus is uniquely placed to balance their needs and drive consensus.

Loan market participants have generally adopted the standardised documents and best practices promulgated by the LSTA. The LSTA is active in the primary market, where agent banks originate syndicated loans, and in the secondary market, where loan traders buy and sell syndicated loans. The LSTA has an ever-growing library of documents for use in the primary market, all of which are generally used by market participants. Over the years, the Association has published a suite of standard trading documents: "trade confirmations" are available to evidence oral loan trades made by parties and form agreements are available to document the terms and conditions upon which the parties can settle those trades. The universal adoption of the LSTA's standard trading documents by US loan market participants has directly contributed to the growth of a robust, liquid secondary market.

It is customary for leveraged loans to be traded in an over-the-counter market, and, in most instances, a trade becomes legally binding at the point the traders orally agree the material terms of the trade. Those key terms are generally accepted as including the borrower's name, the name, facility type, amount of the loan to be sold, and the price to be paid for the loan. For commercial reasons, most U.S. borrowers choose New York law as the law governing their credit agreements, and for similar reasons, the LSTA has chosen New York as the governing law in its trading documentation. Since 2002, loan trades agreed over the telephone, such as agreements relating to derivatives contracts and certain other financial instruments, have benefitted from an exemption from a New York law which would otherwise require them to be set forth in signed writing to be enforceable. Because of the LSTA's lobbying efforts, the applicable New York law was changed in 2002 to facilitate trading. Thus, provided both parties have traded together previously on LSTA standard documentation, even if one party fails to sign a confirmation evidencing the terms of the trade, the loan trade will be legally binding and enforceable if it can be shown that the parties orally agreed the material trade terms. This was a critical legislative reform that contributed to legal certainty in the loan market and harmonised its status with that of other asset classes.

After agreeing the essential trade terms, loan market practice requires that parties then execute a form of LSTA trade confirmation (the legislative change discussed above merely makes it possible legally to enforce an oral trade even if a confirmation has not been signed). Loans can be traded on what is referred to as par documentation or on distressed documentation. Two forms of trade confirmations are available for this purpose and the choice of which one to use is a business decision made at the time of trade. Performing loans, where the borrower is expected to pay in full and on a timely basis, are typically traded on par documentation which means that the parties evidence their binding oral trade by executing an LSTA Par Confirmation and then settling the trade by completing the form of Assignment Agreement provided in the relevant credit agreement (the term par is used because performing loans historically traded at or near par). Alternatively, where a borrower is in, or is perceived to be in, financial distress or the market is concerned about its ability to make all interest payments and repay the loan in full and on a timely basis, parties may opt to trade the borrower's loans on distressed documentation (in recent years, a market practice has emerged where dealers often elect not to trade a loan on distressed documents until a borrower has filed for bankruptcy). In this case, the trade is documented on an LSTA Distressed Confirmation, and the parties settle the transaction by executing the relevant assignment agreement and a supplemental purchase and sale agreement. The LSTA has published a form agreement for this purpose which has been refined over the years and is used by the market. This agreement includes, amongst other provisions, representations and warranties, covenants and indemnities given by the seller and buyer. The adoption of standard documents in this regard, particularly for distressed debt trading, significantly contributed to a more liquid loan market for market participants knowing that an asset being traded repeatedly on standard documents can then uniformly price the loan and more efficiently settle the trade.

When a loan is traded, the existing lender of record agrees to sell and assign all of its rights and obligations under the credit agreement to the buyer.[8] In turn, the buyer agrees to purchase and assume all of the lender's rights and obligations under the credit agreement. The parties must then submit their executed assignment agreement to the administrative agent which has been appointed by the lenders under the credit agreement. The borrower's and agent's consent is typically required before the assignment can become effective. Once those consents are obtained, the agent updates the register of lenders, and the buyer becomes a new lender of record under the credit agreement and a member of the syndicate of lenders.[9] If, for some reason, the borrower does not consent to the loan transfer to the buyer, the parties' trade is still legally binding under the terms of the LSTA's Confirmation and must be settled as a participation.[10] The LSTA has published a standardised form of par participation agreement and of distressed participation agreement which may be used to settle par and distressed trades, respectively, where loan assignments are not permissible. Under this structure, the seller sells a 100% participation interest in the loan to the buyer and retains bare legal title of the loan. Although the seller remains

a lender of record under the credit agreement and the borrower will not typically be aware that a participation interest in the loan has been sold, the seller must pass all interest and principal payments to the buyer for so long as the participation is in place. The transfer of a participation interest on LSTA standard documents is typically afforded sale accounting treatment under New York law. Thus, if the seller of the participation becomes a bankrupt entity, the participation is not part of the seller's estate, and the seller's estate will have no claim to the participation or the interest and principal payments related thereto.

The LSTA continues to expand its suite of trading documents and has increasingly played a more active role in the primary market and has published complete credit agreements and term sheets. The LSTA has most recently published an Emerging Business Credit Agreement with supplements for financial performance covenants, security, and agency terms. Finally, the LSTA continues to expand its suite of documents for making, trading, and settling loans to borrowers domiciled in four jurisdictions in Latin America: Chile; Colombia; Mexico; and Peru, and these forms are being updated in 2024.

The Final Word

The corporate loan market faced numerous policy matters in 2023, not least from the continued work of an activist U.S. Securities and Exchange Commission ("SEC"). Despite these travails, two important issues that had been hanging over the loan market for years were successfully resolved. The first issue came from the courts in the now seminal case *Kirschner v. JPMorgan Chase, N.A.* when Marc Kirschner, litigation trustee for borrower Millennium, raised the question of whether syndicated institutional term loans (commonly referred to as term loan Bs or TLBs) were subject to the federal securities laws – a determination which would fly in the face of decades of market understanding and practice. The second issue was the U.S. dollar LIBOR transition endgame ushered in by the cessation of panel LIBOR after June 30, 2023. A high-level look at these two issues is set forth below.

The *Kirschner* case

Easily the issue that dominated most conversations in the loan market this year – TLBs subject to the federal securities laws – the loan market faced a final showdown on its most existential question. In August 2023, the Second Circuit said "No", affirming the district court's decision in *Kirschner v. JPMorgan Chase, N.A.*[11] that TLBs are not subject to the federal securities laws. Both courts recognised that (at least) three out of the four *Reves* factors – the applicable test – weighed in favour of treating TLBs as distinct from securities.[12] To wit, TLBs are not offered or sold to a broad segment of the public, lenders could not have a reasonable belief that loans are securities, and the application of the securities laws is unnecessary in light of TLBs being secured by borrower collateral and subject to prudential regulator oversight.

It was not always clear that the loan market would see this result, however, after the Second Circuit threw a judicial curve ball in March 2023. Shortly after hearing oral arguments the Second Circuit asked the SEC to weigh in with any views it wished to share on whether the loans in the *Kirschner* case are securities under the *Reves* test. Fearing that the SEC may see this invitation as an opportunity to draw loans into their fold, the LSTA actively engaged with the SEC and the banking agencies to impress upon them the legal reality and congressional intent that loans are distinct from securities and, importantly, how any view to the contrary would be massively disruptive to a decades-old market. Ultimately, despite having kept interested parties in suspense for months, the SEC declined to weigh in.[13] The Second Circuit's decision affirming the district court's holding the syndicated TLBs are not securities swiftly followed.

The *Kirschner* decision now serves as a roadmap for maintaining the distinction between TLBs and securities and favourably (and appropriately) answers a question that had not been asked in 30 years. Upon further appeal to the Supreme Court, the Court denied Kirschner's petition for *certiorari* in February meaning that the question may well not be asked again for 30 years!

Bye, bye LIBOR!

The day for which loan market participants had been actively preparing for five years came about in 2023. A day both longed for and feared – the cessation of the LIBOR panel. Much like the oft-given analogy of Y2K – June 30th's final panel LIBOR publication proved mercifully anticlimactic. There had been a material ramp up in LIBOR transition amendments between May and June of last year, with LevFin Insights, a Fitch Solutions Company, tracking more than 300 amendments completed in that time. That last flurry of amendments together with hardwired fallback amendments saw the share of loans referencing SOFR jump in July. According to J.P. Morgan research, the share of SOFR loans in CLOs hit 63% by early July, up from 41% a month earlier.

That is not to say that *all* the work was completed come July. In the weeks that followed the cessation of the LIBOR panel, amendments to LIBOR credit agreements continued where the borrower had locked in a LIBOR rate before the end of June. Momentum continued and, by autumn, 76% of the loans in the J.P. Morgan loan index referenced SOFR. In the CLO space, J.P. Morgan research recorded 99% of floating rate CLO liabilities referencing SOFR. (For the sake of completeness, it is worth noting that there continue to be a few credit agreements that are using the synthetic versions of U.S. dollar LIBOR that will be available at least through September 2024. Those credit agreements were of an earlier vintage and are expected to terminate or be refinanced at some point in the next few months (if they haven't already).)

To cap off the successful transition, the Alternative Reference Rates Committee ("ARRC"), which had been at the helm of the transition for cash products since 2018, dissolved. In doing so, the ARRC released its final reflections memorialising the hard won knowledge and incredible efforts of the thousands of individuals and organisations that delivered an orderly transition.[14] Let us all hope it is knowledge that is never called upon again!

Conclusion

The U.S. corporate loan market continues to evolve and expand, continually adapting to new challenges, including legal, regulatory and economic challenges. In this environment, the LSTA remains committed to promoting a fair, efficient and liquid market for loans and maintaining its position as the voice of the corporate loan market.

Endnotes

1. *LSEG PLC.*
2. *LSEG PLC.* "Leveraged" is normally defined by a bank loan rating by Standard & Poor's and/or Fitch Ratings of BB+ and below (by Moody's Investor Service, Ba1 and below) or, for non-rated companies, typically an interest rate spread of LIBOR + 125 basis points.
3. For a more detailed description on the loan market, see Lee Shaiman, "An Introduction to the Loan Asset Class",

in *The Handbook of Loan Syndications & Trading*, page 3 (Lee Shaiman and Bridget Marsh, 2nd ed., 2022); and Ralph Hinckley, "The Primary Market", in *The Handbook of Loan Syndications & Trading*, *supra*, 31.

4. *LSEG PLC.*
5. For a more detailed description of the history of the loan market, see Lee Shaiman, "An Introduction to the Loan Asst Class", in *The Handbook of Loan Syndications & Trading*, *supra*, 3.
6. *LSEG PLC.*
7. *LSEG PLC.*
8. For a detailed comparison of assignments and participations, see Michael Bellucci and Jerome McCluskey, *The LSTA's Complete Credit Agreement Guide*, 2nd ed., at 541–542 (McGraw-Hill 2016).
9. For further information on the structure of assignments, see *id.* at 543–561.
10. For further information on the structure of participations, see *id.* at 561–567.
11. *Kirschner v. JPMorgan Chase Bank, N.A.*, 2020 WL 2614765 (2020), *aff'd*, 2023 WL 5437811 (Aug. 24, 2023), *cert. denied* 601 U.S. 23-670 (Feb. 24, 2024).
12. The U.S. Supreme Court in *Reves v. Ernst & Young* (494 U.S. 56 (1990)) identified the four factors of the "family resemblance" test which are to be used to determine if a note bears a family resemblance to one of the judicially crafted non-security instruments. The four factors are: 1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; 2) the plan of distribution of the instrument; 3) the reasonable expectations of the investing public; and 4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary.
13. *Kirschner v. JPMorgan Chase Bank, N.A.*, No. 21-2726 (2d Cir. 2023), Document 207, 07/18/2023, 3543366.
14. "ARRC Closing Report: Final Reflections on the Transition from LIBOR", The Alternative Reference Rates Committee (November 2023), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2023/ARRC-Closing-Report.pdf

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Since 1995, the Loan Syndications and Trading Association has been dedicated to improving liquidity and transparency in the floating rate corporate loan market. As the principal advocate for this asset class, we aim to foster fair and consistent market practices to advance the interest of the marketplace as a whole and promote the highest degree of confidence for investors in floating rate corporate loans. The LSTA undertakes a variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage coordination with firms facilitating transactions in loans and related claims.

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