

## Syndicated Loans--A Rated Market, at Last!

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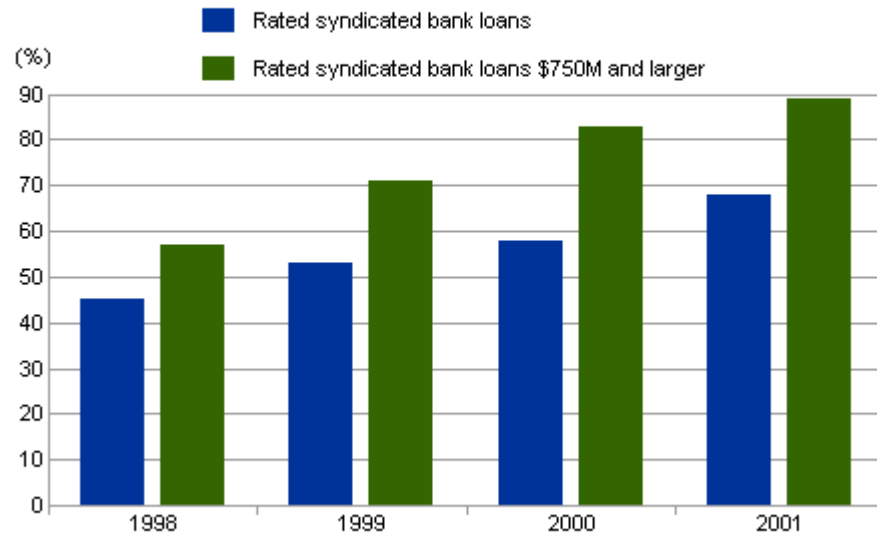
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The tremendous growth in Standard & Poor's loan ratings in the past five years is symptomatic of the accelerating change within the U.S. syndicated loan market from a traditional, relationship-based "bank loan market" to a more efficient, investor-driven "loan market." This article explores the various aspects of this evolution--what differentiates an efficient capital market, like the "new" loan market, from an inefficient, relationship-based market--and who the winners and losers are in the process. (See "Recent Developments in the European Syndicated Loan Market," published on RatingsDirect Feb. 12, 2002, which traces some of these trends in Europe, where a similar evolution, albeit not quite so advanced, is taking place.)

The evolution of the U.S. syndicated loan market from a private, relationship-oriented credit market to a "real" securities market has been proceeding steadily for several years. One noteworthy aspect has been the dramatic increase in the number of credit ratings assigned to syndicated loans. Starting from a base of zero six years ago, Standard & Poor's now rates the loans of about 1,200 companies. Although not as pervasive as in the public bond markets, a Standard & Poor's rating has become increasingly expected on larger syndicated loans. Chart 1 shows the growth in the penetration of ratings in the leveraged loan market, which is the segment of the market of most interest to institutional investors. While rating growth is strong across the board, it is particularly pronounced among the larger loans, with 89% of loan facilities larger than \$750 million having been rated in 2001, up from only 57% just three years earlier.

Chart 1  
**Rated Deals by Volume**



Source: Standard & Poor's PMD.

### **Efficient vs. Inefficient Markets**

The rise in loan ratings reflects the increased efficiency and transparency of the loan market. "Transparency" refers to the widespread availability of data and other market information. Efficient financial markets require it. Without credit ratings, research on both individual issues and the market as a whole, and publicly available pricing data, investors would only feel confident buying securities of issuers they know personally and on terms that are negotiated directly. That, of course, is the situation that prevails in inefficient, relationship-based markets, which is what the U.S. loan market essentially was until about 10 years ago, when its movement toward a more efficient market began to pick up momentum. Outside the U.S. and Europe (where a similar evolution is well under way), loan markets are still largely relationship based and inefficient, by market standards.

Transparency is just one of the features that distinguishes an efficient securities market from an inefficient one. In addition to widely available information about

the issuers and the transactions, to be considered efficient a market must have numerous participants, clear-cut roles for issuers, investors and intermediaries, and an established infrastructure to support primary and secondary distribution of securities. An inefficient market, by contrast, would likely have fewer participants, deals that are individually negotiated between principals that already have a relationship with each other and without reference to the terms of comparable deals (since there is little information available about comparable deals), and the roles of the intermediary (i.e., a banker) and investor generally would be filled by the same institution. The table summarizes many of the structural differences between an inefficient market--i.e., the "old" loan market--and an efficient one--the "new" loan market.

Loan Market Characteristics Then and Now	
"Old" Loan Market	"New" Loan Market
Opaque (information closely held)	Transparent (information widely available)
No credit ratings or third-party research	Credit ratings, independent data and research
Club lending with specialized credit knowledge	Numerous investors
Negotiated or "relationship" pricing	Competitive pricing with comparative pricing information available
Bank plays both intermediary and investor roles	Intermediary and investor roles more distinct
"Buy and hold" lenders	Portfolio theory and secondary trading used to manage portfolios
Documentation and distribution protocols unique to agent bank	Standardized instruments and established trading protocols

The evolution from the "old" to the "new" loan market is not complete, nor is it likely to be in the near future. Smaller loans are often still arranged, distributed and held to maturity in the same way they were 10 or 15 years ago. The largest syndicated loans, meanwhile, are underwritten, distributed, and, later on, traded among investor portfolios in a manner much like public bonds. But in general, there has been an inexorable trend toward an efficient market.

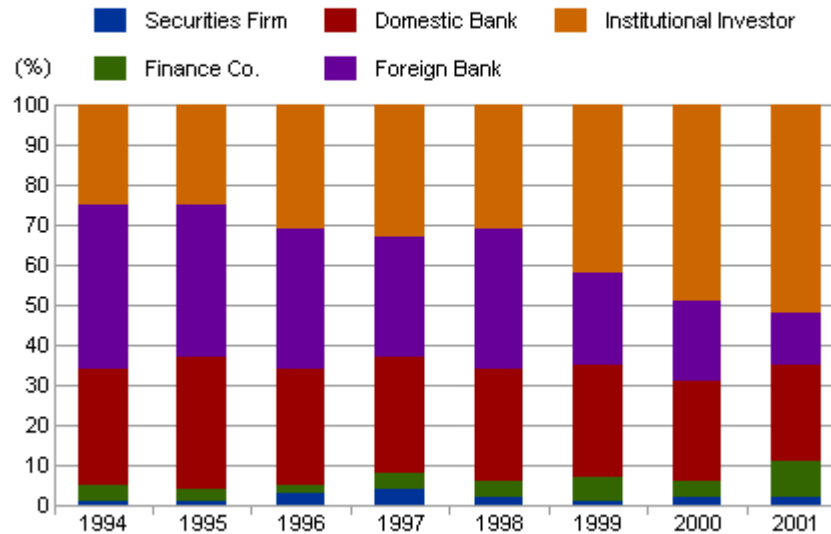
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### **Non-bank Institutional Investors**

One of the primary drivers of this has been the growth in the non-bank institutional loan investor base. These investors, made up of retail mutual funds (primarily so-called "prime rate" funds), specialized loan investment vehicles (CDOs and similar entities), and traditional institutional investors like insurance companies, and other money managers who have discovered the loan asset

class, are accustomed to, and take for granted, the existence of the traditional securities market infrastructure. They must have third-party research, standardized accounting and trading protocols, comparable pricing data, and secondary trading liquidity, or they are unwilling (and sometimes legally unable) to participate. Many such entities fund themselves via debt instruments that Standard & Poor's rates, and their own ratings are therefore dependent on the existence of underlying ratings on the assets they buy into their portfolio. They also are expected to report on the distribution of their assets. This has provided a powerful demand for ratings on syndicated loans that are targeted for distribution to these entities. Chart 2 shows the growth in the percentage of loans destined for distribution to non-bank institutional investors tracked by Standard & Poor's PMD over the past eight years.

Chart 2  
**Primary Market for Highly Leveraged Loans by Broad Investor Type**



Source: Standard & Poor's PMD.

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### **Market-Flex Pricing and the Role of the Syndicator**

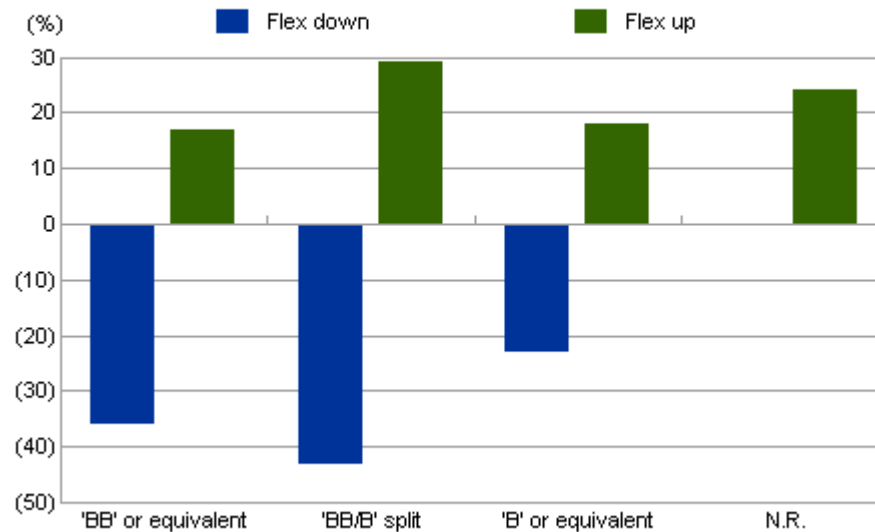
Also driving the use of credit ratings in the loan market has been the adoption of "market-flex pricing" in the past several years by most of the major syndicating banks. Market-flex pricing is a feature of the loan commitment that allows the

syndicator to vary the interest rate margin (i.e., the spread over the base rate, which is generally LIBOR) by a certain amount, often 25 basis points (bps) or 50 bps, as dictated by "market conditions" at the time of closing the loan.

Previously, the syndicating bank committed to a specific margin several weeks before the loan and therefore assumed all the risk of market conditions changing. This was a major difference between the loan market and the bond market, in which bond underwriters commit to bring an issuer to market on a given date and for a specific amount, but with the pricing of the bond established according to the prevailing market rate for credits of that issuer's quality on the specific issue date. A bond issuer would never dream of going to market without a credit rating, since its pricing depends on it. But loan issuers, prior to the arrival of market-flex pricing, sometimes concluded that a rating was unnecessary because the pricing on their deal was already locked in. With the advent of market-flex pricing, loan issuers no longer have that assurance. Most of them are no longer willing to face the uncertainty of a market-determined price on their loan without a rating.

Fortunately, market-flex pricing, while introduced by bankers to protect themselves against under-pricing their loan commitments, can and does work both ways. (Chart 3 shows the recent impact of market-flex pricing in both directions, by rating category.) Banks can actually quote finer spreads to their clients, if they know that by having a market-flex clause in their commitment letter, they do not have to build in an extra margin to cover possible market shocks that may--or may not--even occur. Note that in 2001, rated loans were more likely to have their pricing flexed downward--i.e. in the borrower's favor--than upward; unrated loans, in contrast, invariably had their pricing flexed upward.

Chart 3  
**Institutional Loans Flexed by Rating**

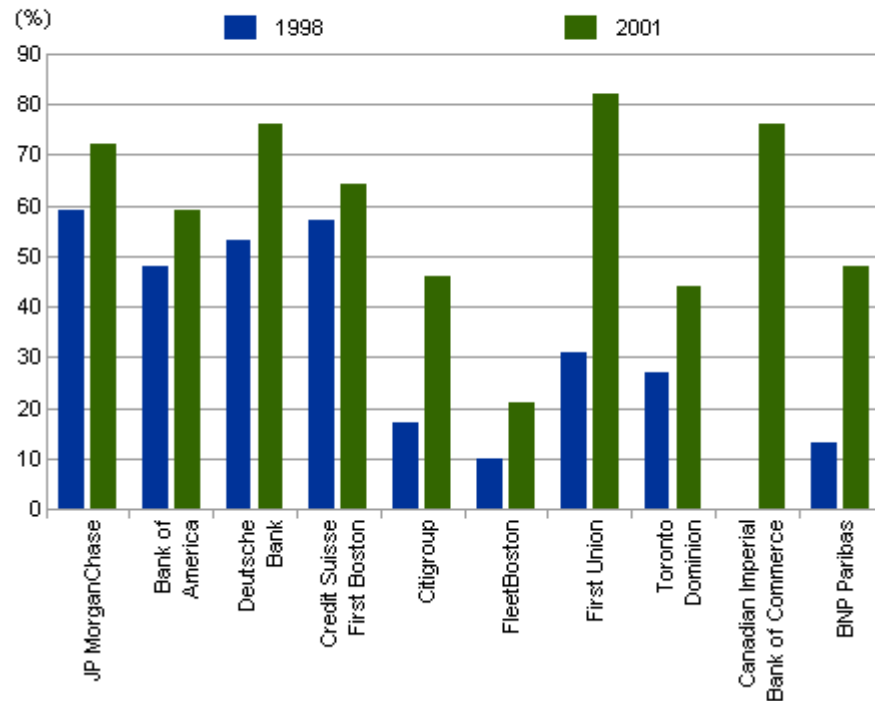


N.R.—Not rated. Source: Standard & Poor's PMD.

The syndicating banks' eagerness to have their clients' loans rated has also been affected by the degree to which the role of "lead bank" has shifted in recent years. Whereas the lead bank's primary motivation some years back was to be the agent for, and therefore obtain an adequate return for, the lending group, its role has now evolved to one quite similar to that of an underwriter in a public bond deal. That means it is motivated more by the fee it receives up front to syndicate the transaction than by the spread income it will receive over time on the relatively small piece of the deal that it holds in portfolio.

Since competition for mandates among syndicators is fierce, syndicating banks have embraced credit ratings as a way to broaden the potential investor base and therefore improve the pricing they can offer to issuers. The improved pricing obviously comes at the expense of investors, including in many instances the portfolio group within the syndicating bank that holds the piece of the loan that it retains. Chart 4 shows the loans rated as a percentage of the total loans syndicated by each of the 10 largest loan arrangers in 2001, compared with three years earlier.

Chart 4  
**Syndicated Bank Loans Rated by  
 Standard & Poor's by Underwriter**



Source: Standard & Poor's PMD.

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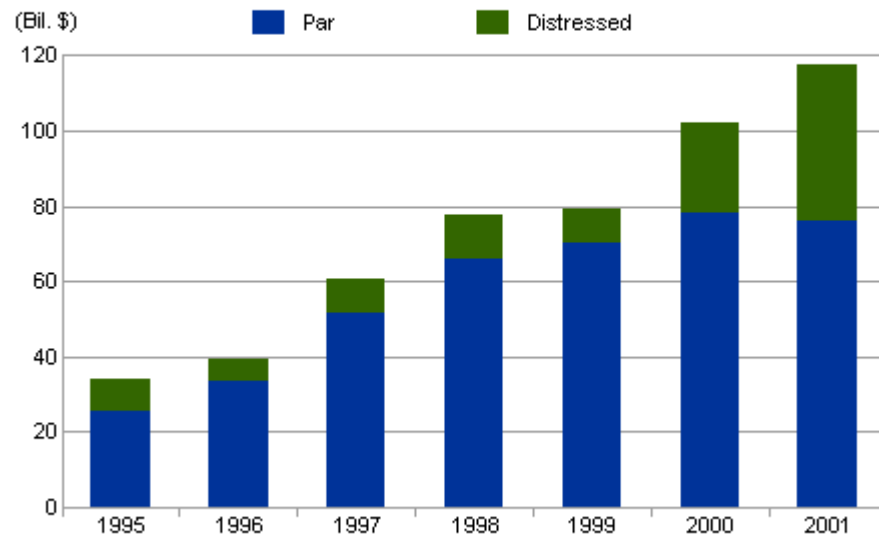
### Other Market Efficiency Drivers

Besides the growth in non-bank loan investors and the rise of more bond-market-like pricing, several other factors have contributed to the growing efficiency of the loan market. One has been the growing use of portfolio theory and sophisticated capital allocation models within the banking and finance industry. The New Basel Capital Accords, once completed and put into effect, are expected to accelerate the banking industry's movement toward risk-based and market-driven methods of bank management and supervision. Virtually all of these various methodologies have one thing in common: a need for consistent, objective and comparable means of measuring credit risk across asset classes, institutions, and geographic and political frontiers. Credit benchmarks, of which ratings are

the most widely known and respected, are an essential component of any such system.

Complementing the "sharper pencils" of all types that banks and other financial institutions use to manage and measure themselves, has been the strong growth of secondary trading in loan assets. Volume in the secondary loan market reached \$117 billion in 2001 (see chart 5). Secondary trading, besides being an attractive business in its own right to the large dealers, has facilitated the growth of the market in many ways. Banks can more confidently adopt sophisticated loan portfolio management techniques if they know there is an actual secondary market they can use to balance and re-balance their portfolios as needed. Many of the non-bank institutional loan buyers, being traditional portfolio managers rather than banks with large credit departments, are comfortable knowing that they can sell out of credits at the hint of trouble or a credit downgrade.

Chart 5  
**Volume in the Secondary Loan Market**



Source: Loan Pricing Corp.

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### **Winners and Losers**

As the loan market becomes increasingly efficient, it is worth reflecting on what

that means, and for whom. Efficiency does not always mean better, at least not for everyone. Nor is inefficiency necessarily a bad thing from everyone's perspective. In the loan market, as in other financial arenas, there were players who benefited from the inefficient markets of the past who have not always applauded the changes that have occurred in the past few years.

But let us start with the winners, who are many. The clearest winner has been the issuer, the corporate borrower who now can tap hundreds of potential investors instead of the handful of banks that previously may have been part of its lending "club." Other things being equal, one can usually negotiate a more attractive deal when there are dozens of potential providers than if there are just a few. But to achieve this advantage, a borrower has had to sacrifice some privacy, and allow itself to be known--via the credit rating process and the research provided to its loan investors--to that wider investor audience. But that is considered by many issuers to be a small price to pay to obtain better pricing, and to maintain access to a broader funding base.

The other big winner has been the large syndicating bank which has made the transition from being a "buy-and-hold" lender, dependent on using its balance sheet to earn spread income, to being a true investment bank that leverages its balance sheet and uses it over and over again to underwrite and distribute loans, and earns the fees for doing so. The league tables tell the story of who these institutions are.

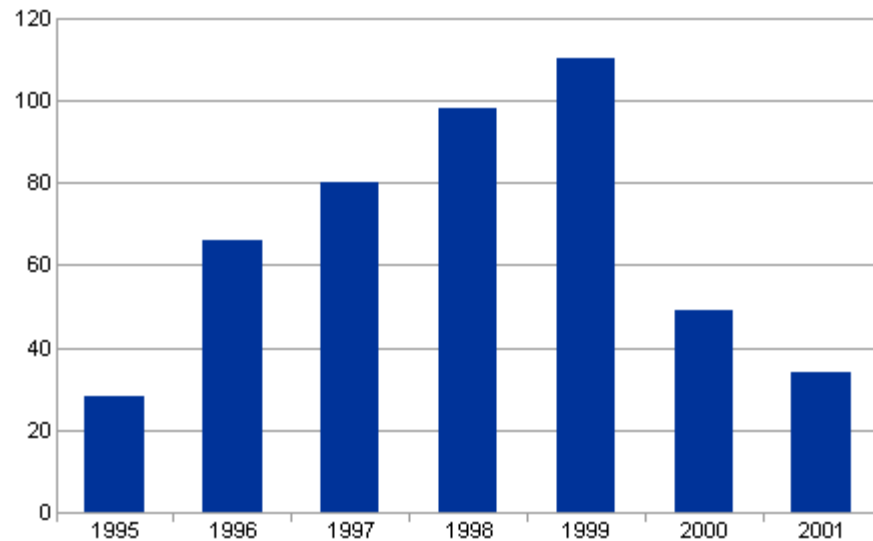
Other winners include the non-bank investors themselves, who previously would not have had access to the sort of loan assets that are now routinely available, and to the banks that have lending appetite on their balance sheets, and can now access loans in geographic areas and industries that they may not have previously been comfortable with.

Finally, the winners also number rating services like Standard & Poor's and the many other providers of transparency, data and research who have become indispensable enablers of the "new" loan market.

You cannot have winners without some losers, and there are entities that were quite successful in the "old" loan market and have been disadvantaged by the changes that have occurred. Foremost among them are the traditional banks that were the typical "buy-and-hold" lenders when loans were done exclusively on a relationship basis, and have not made the transition to the role of underwriter/syndicator. These banks have seen their spread lending revenue shrink, because they are now competing with dozens of new institutional investors for each new loan instead of lending as part of a more exclusive club. But they have not offset that revenue with fee income by becoming one of the

dozen or so banks that originate most of the new loans. As a result, the earnings and profitability of these banks has been under pressure, and, as a group, their ranks have been greatly thinned out via merger and acquisition. (Chart 6 demonstrates the shrinking number of "pro rata" banks, as they are often called, in recent years.)

Chart 6  
**Most Active Pro Rata Investors**  
(Lenders that made 10 or more primary commitments)



Source: Standard & Poor's PMD.

Particularly negatively affected have been those banks that were experts in certain types of lending (e.g., project finance) that required a great deal of specialized knowledge and were therefore the province of only a short list of highly skilled lenders. The introduction of transparency, especially via ratings and the detailed research reports that accompanied them, effectively removes the mystery that may prevent a wider group of investors from participating in these transactions. With dozens or perhaps hundreds of potential investors now able to bid on these loans, rather than just the handful who previously had the requisite knowledge, the supply-demand relationship tilts in the borrowers' favor, and the price of financing tends to come down.

Although most corporate issuers have benefited from the more efficient loan

market, those who value control and want to have close, direct relationships with their lenders may be uncomfortable with the new world of broadly distributed syndicated loans, which are held in portfolio by anonymous institutional investors, and with whom a chief financial officer has little or no contact. While the better terms and cheaper pricing may make up for this in most cases, some companies may prefer the greater control, especially those that anticipate covenant breaches or an ongoing need to renegotiate loan terms. While controls of that sort can still be had, now the company is likely to have to pay extra for them.

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## Looking Ahead

The trends described here are likely to intensify in North America and Europe, where they are well advanced, and to spread throughout the world. Organizations like the Loan Syndications and Trading Association in New York and the Loan Market Association in London are providing leadership and direction in creating consistent legal and operational protocols. National and international bank regulators are promoting more standardized risk-based capital allocation frameworks throughout the world. Bank managements, in their quest for higher returns for their own investors, are unrelenting in their efforts to utilize their balance sheets as efficiently as possible. This will continue to drive them to securitize loan assets and to use credit derivatives and other creative forms of financial engineering to transfer risk to third parties, and to earn a profit doing so. All of this requires a loan market that is highly efficient, with all that implies about the need for credit ratings and other forms of transparency.

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### Sidebar 1

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## How Does a Loan Rating Differ From Traditional Ratings?

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The loan rating is an issue-specific rating that evaluates, along with the company's overall creditworthiness, the specific terms and conditions of the loan, including covenants, collateral, and other structural elements that may affect the lender's ultimate recovery—even if the issuer defaults. It differs from traditional Standard & Poor's ratings, like bond ratings, that focus on the likelihood of timely repayment.

For many years, the first, and often only Standard & Poor's rating that most companies obtained was a bond rating. Over time, a company's bond rating became an unofficial proxy for its overall creditworthiness, so that, for example, a company whose bonds were rated 'A' came to be referred to as a "A' company." Several years ago, Standard & Poor's introduced a stand-alone corporate credit rating (CCR) that is divorced from the rating of a specific debt issue. The CCR reflects an entity's propensity to meet its obligations on time, irrespective of whether they are secured or unsecured, or where they rank within the debt structure.

In the case of secured loans, Standard & Poor's analysts may "notch up" or assign a loan rating that is higher than the company's CCR, if they are confident that the security or other protection afforded to lenders will ensure complete repayment of principal in the event of default. How much an analyst notches up--generally one to four notches, or not at all--depends on the degree of security or other protection that a given deal provides, along with the confidence the analyst has that the protection will be effective in fully covering principal and interest.

Standard & Poor's practice of notching up some--but not all--secured loans to reflect the degree of protection they provide, is supported by empirical loss and recovery data that demonstrate the wide range of post-default experience of secured lenders. Although many secured lenders are, indeed, successful in recovering all or most of their principal and interest in a workout or bankruptcy, many others turn out to be "secured" in name only, and fare no better than typical unsecured creditors. Standard & Poor's loan ratings evaluate the likely default scenario for a given loan issuer, as well as the stressed value of its collateral security (whatever it may be--discrete assets, the enterprise value of the business, etc.) under that default scenario.

Standard & Poor's rated Charter Communications Operating LLC's (CCO) \$5.2 billion loan 'BBB-', two notches above the company's corporate credit rating of 'BB', because it concluded that the value of the underlying cable assets "would reasonably be worth at least double the amount of the fully drawn bank facility, giving secured creditors excellent prospects for full recovery." CCO is a subsidiary of Charter Communications Inc., which has a number of subsidiaries, each with its own bank credit facility. Besides the rating referred to above, Standard & Poor's has assigned ratings to other Charter subsidiaries' loan facilities with varying degrees of notching from the parent's corporate credit rating, reflecting the amount of collateral coverage available to the lenders in each respective facility. (Search in Standard & Poor's RatingsDirect under keyword "Charter Communications" for related articles.)

Another recent example is Saks Inc., whose \$700 million secured credit facility was rated 'BB+' in January. That is one notch higher than the company's 'BB' corporate credit rating, and reflects that Standard & Poor's is "reasonably confident that the lenders will recover 100% of principal," in the event of default. The analyst went on to say that the rating was based on "the facility's good collateral coverage, conservative advance rates, tight structure, and Standard & Poor's belief that Saks' collateral is of high quality."

By contrast, Standard & Poor's recently assigned a 'B+' loan rating to Applica Inc.'s \$205 million secured credit facility, which is the same as the company's corporate credit rating. The loan is secured by a borrowing base of accounts receivable and inventory, and is expected to provide some measure of protection to lenders in the event of default. However, since Standard & Poor's was not confident that it would provide complete recovery of principal, the loan rating was assigned at the same level as the issuer's corporate rating.

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