The U.S. Leveraged Loan Market
Today's drivers, tomorrow's challenges

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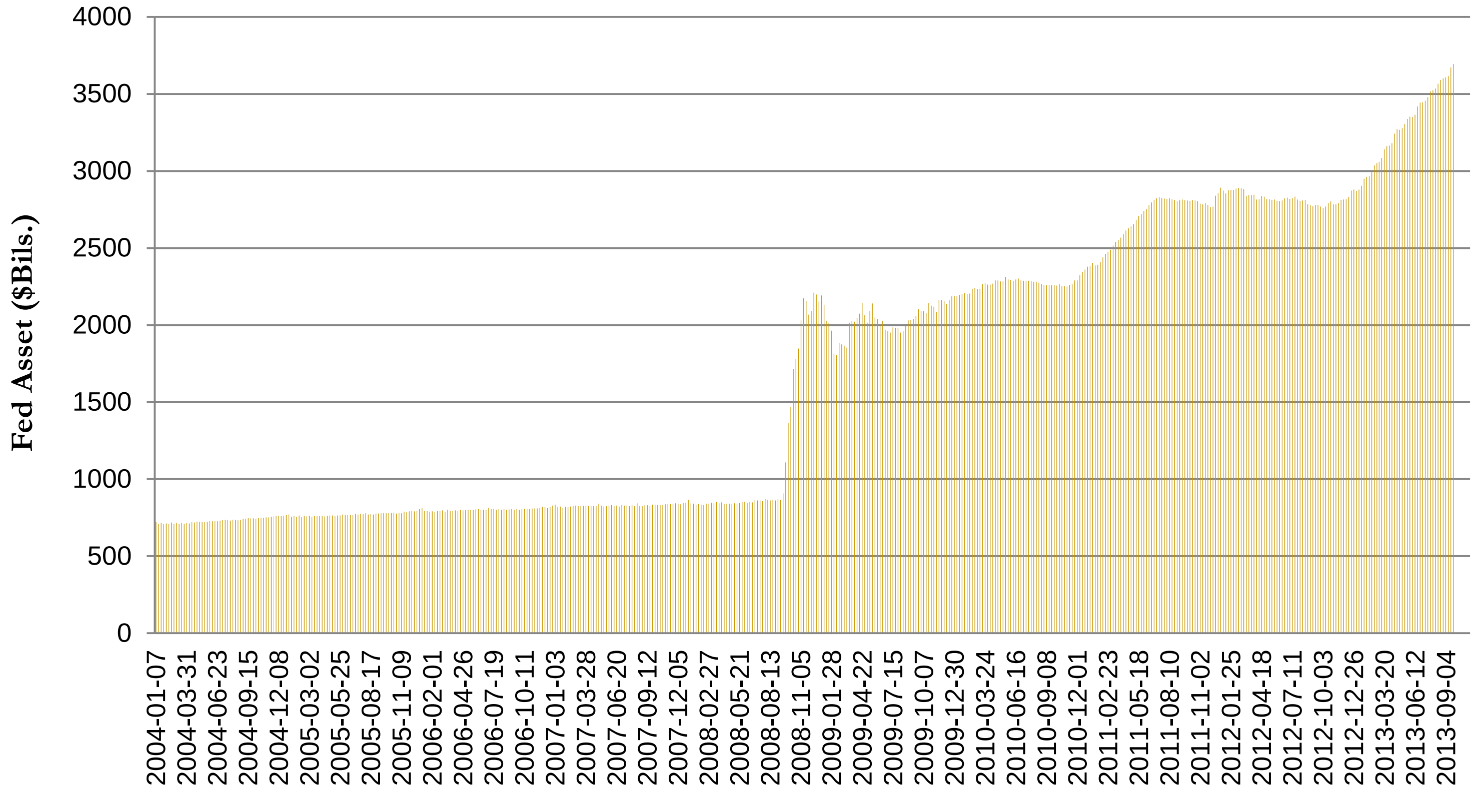
Presentation Overview

- Today's Leveraged Loan Market
- Tomorrow's Regulatory Environment
- What Might Happen When They Meet

Today's Market

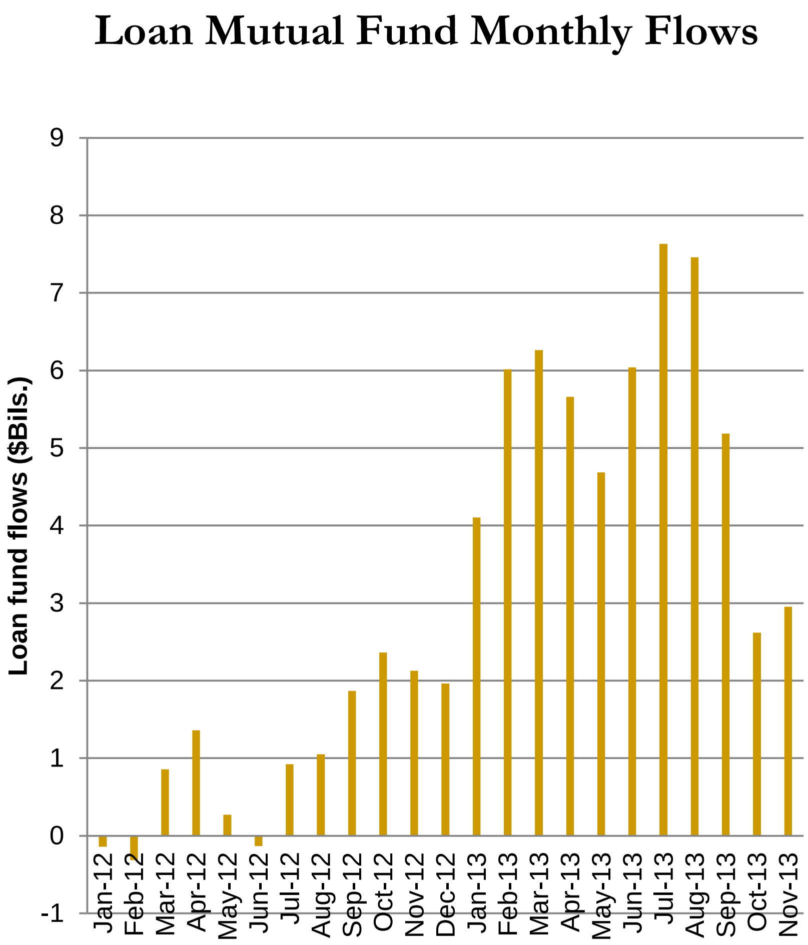
Setting the Stage: Federal Reserve buys assets…
And investors seek yield (and assets) elsewhere

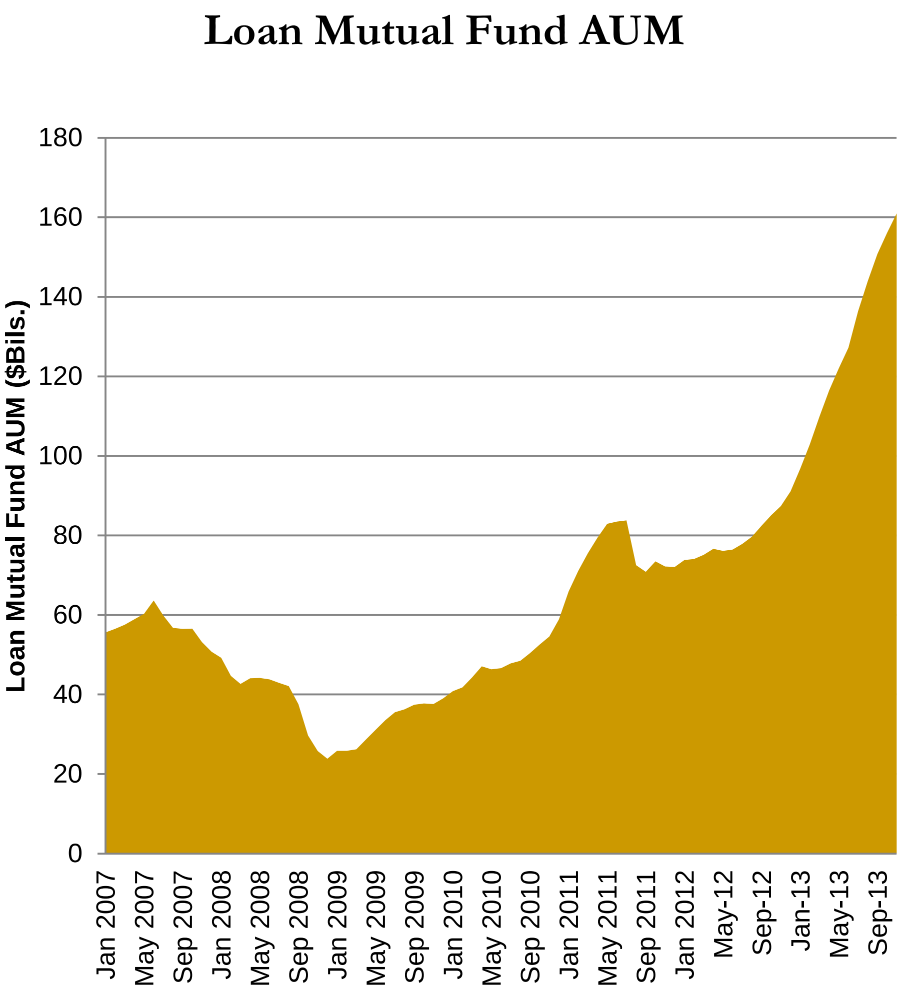
Federal Reserve Balance Sheet



Source: Federal Reserve

Money flows into loan mutual funds…and AUM Climbs





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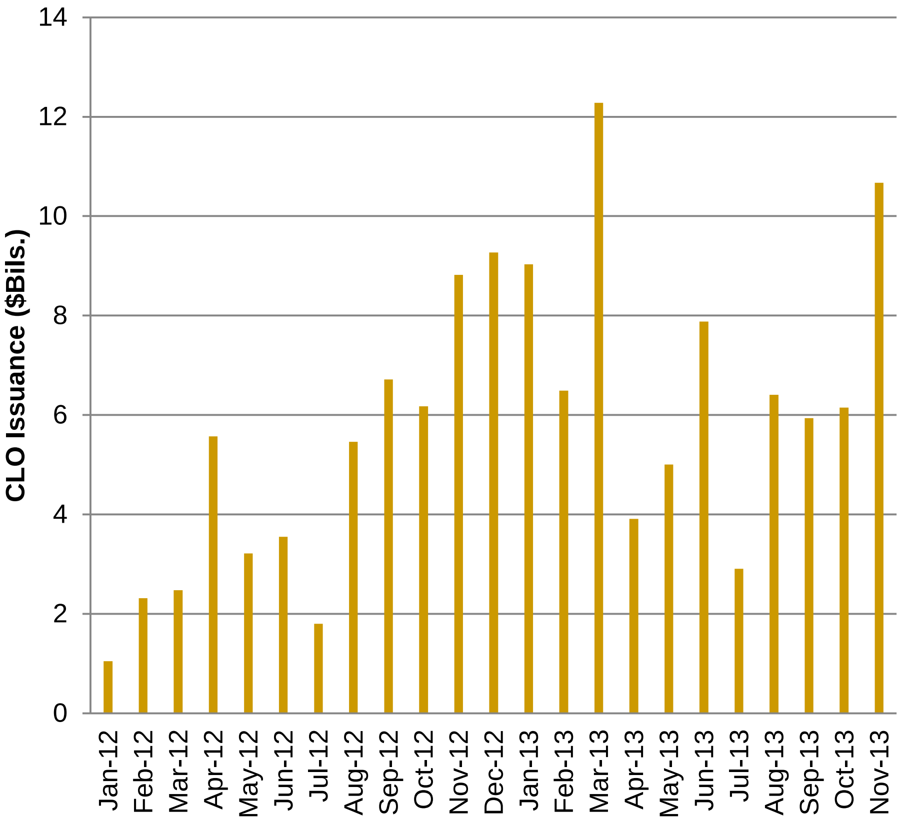
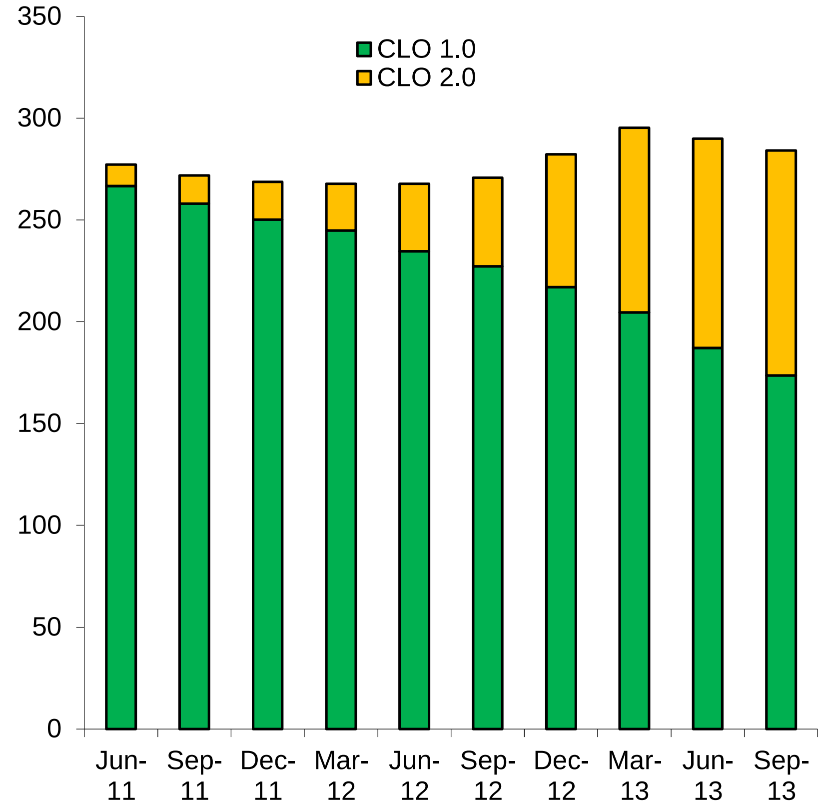
Source: Thomson Reuters LPC

CLO issuance climbs
(but CLO AUM not moving as much)

Monthly CLO issuance



CLO AUM



Source: Thomson Reuters LPC, Citi

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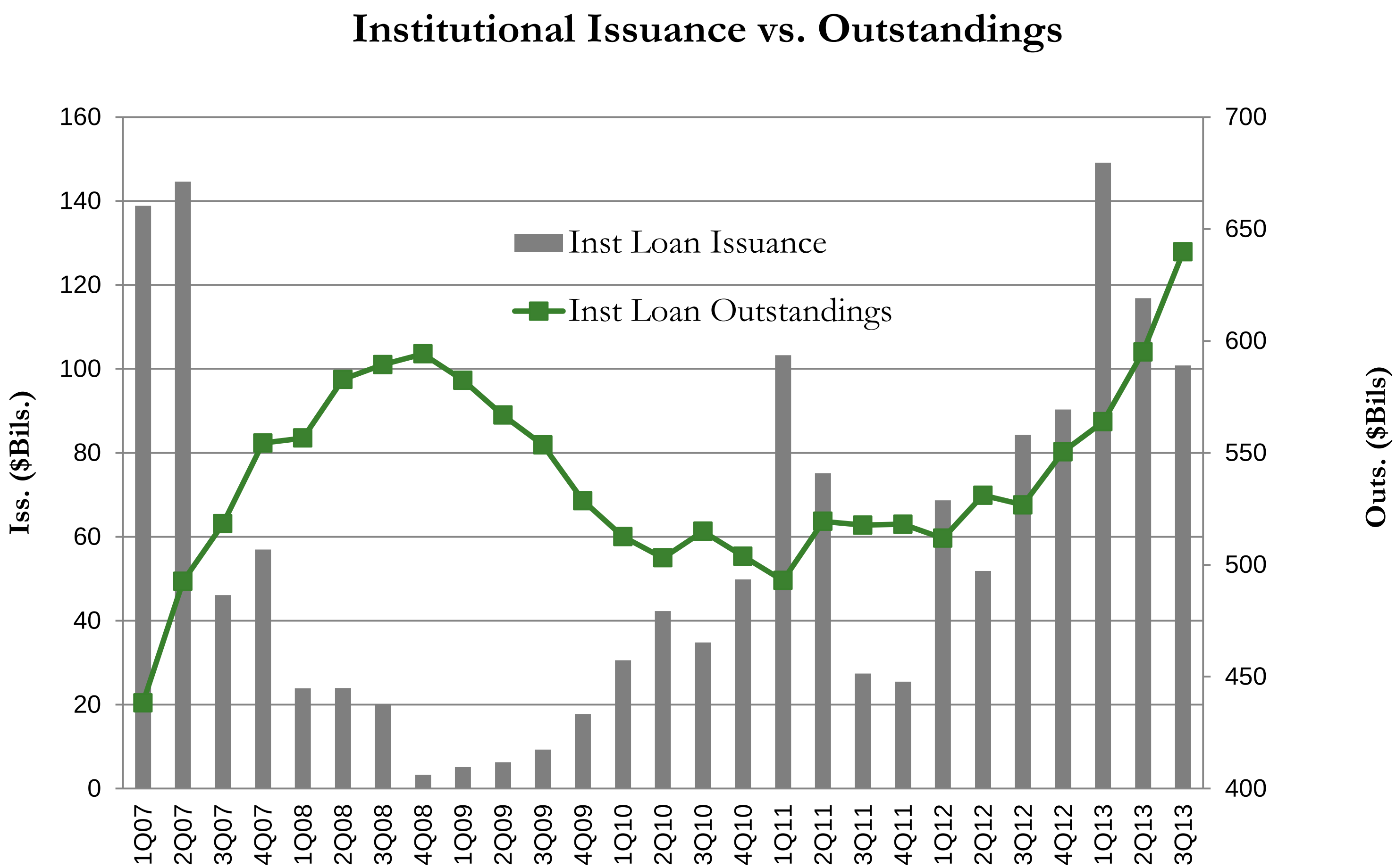
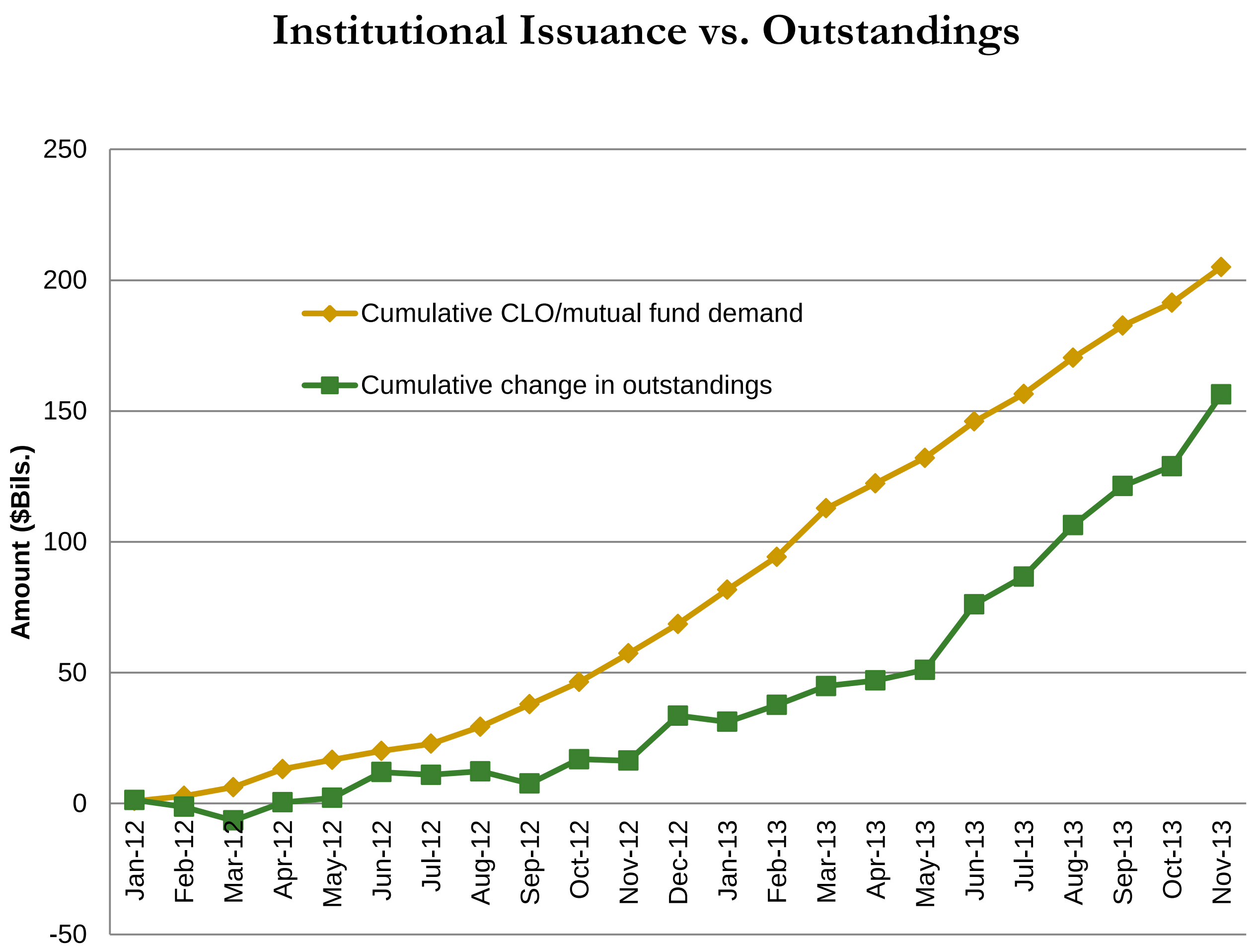
Institutional outstandings climb past Pre-Crisis levels



Source: S&P/LCD, S&P/LSTA Leveraged Loan Index

"Visible" demand outstrips supply by nearly $50 billion

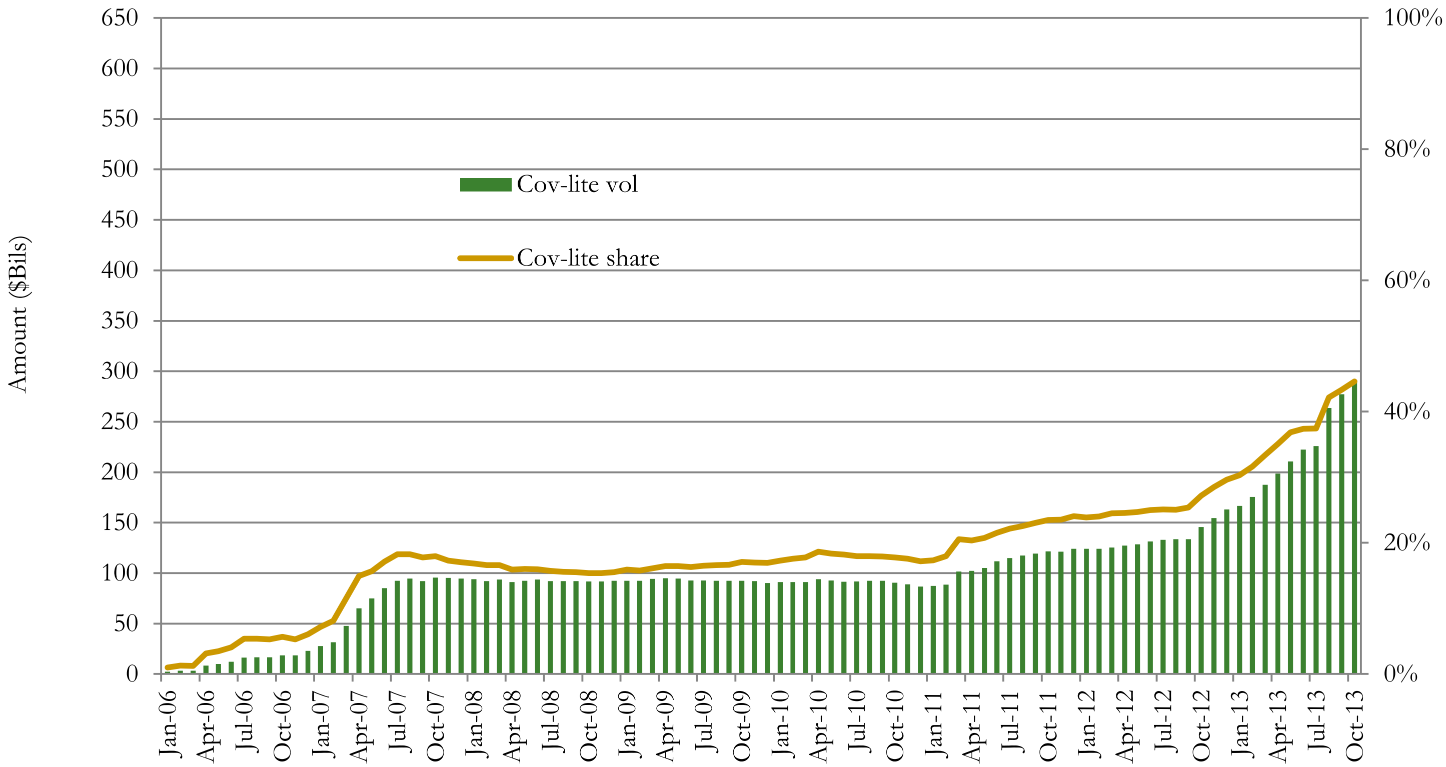


Source: S&P/LCD, S&P/LSTA Leveraged Loan Index

Impact on terms & conditions

There *are* more covenant lite institutional term loans

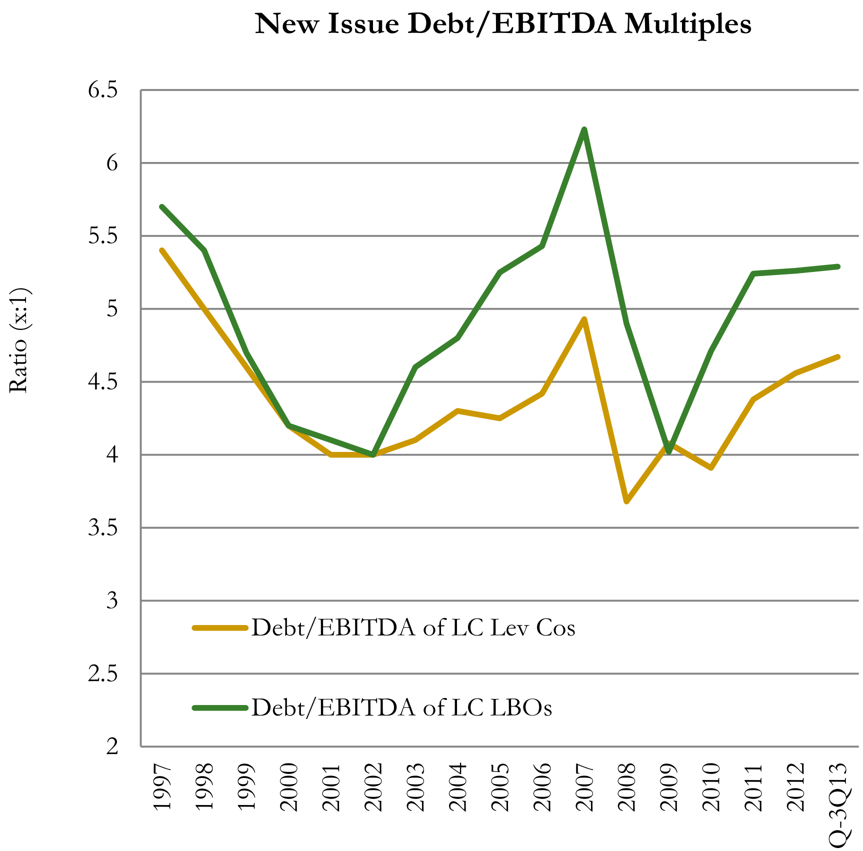
Covenant lite loan volume/share in the S&P/LSTA Leveraged Loan Index

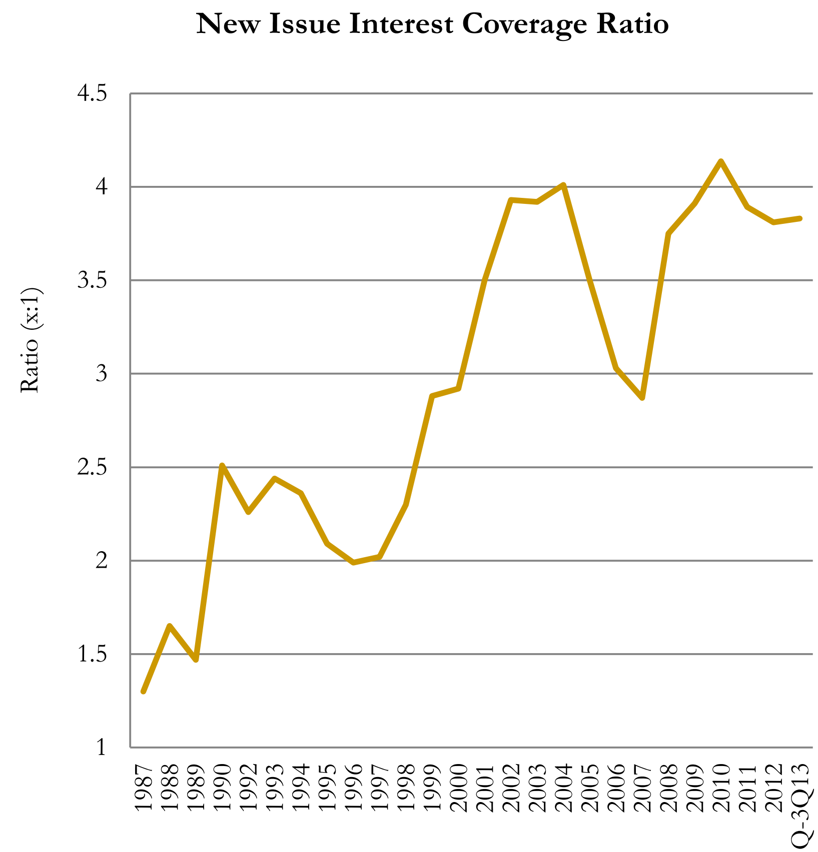


- Covenant lite loan issuance now comprises half of new issue institutional loans – and 40% of outstanding loans
- These loans do not have maintenance covenants, but ***do*** have incurrence covenants
- Covenant lite loans returned because they performed well: Lower default incidence and higher recovery given default in the crisis

Source: S&P/LSTA Leveraged Loan Index

New issue loans: Metrics are more bullish… But not at 2007 levels

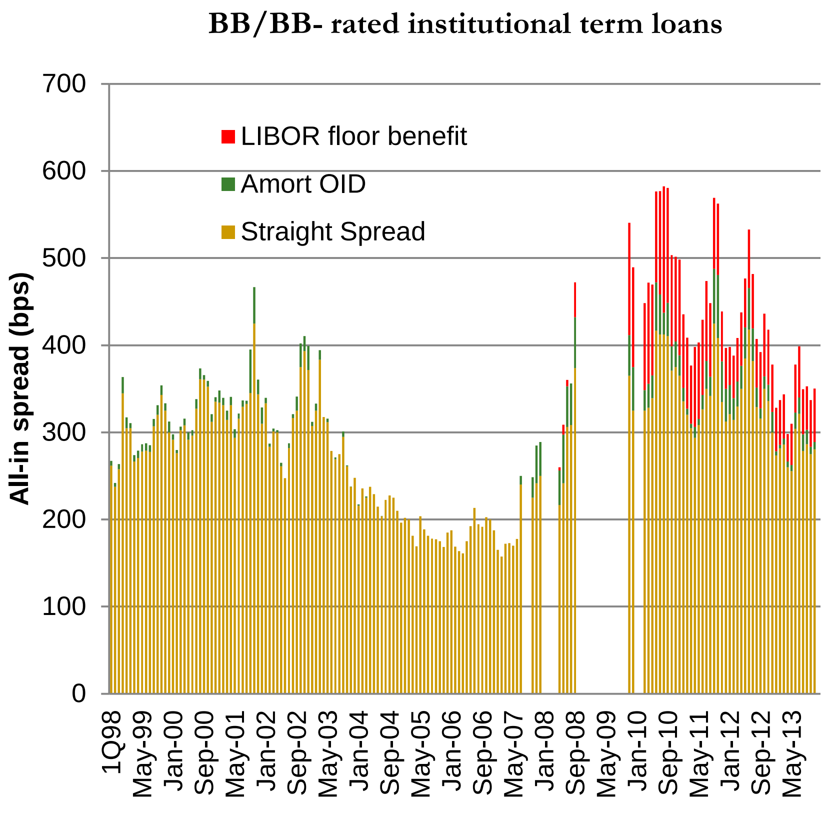


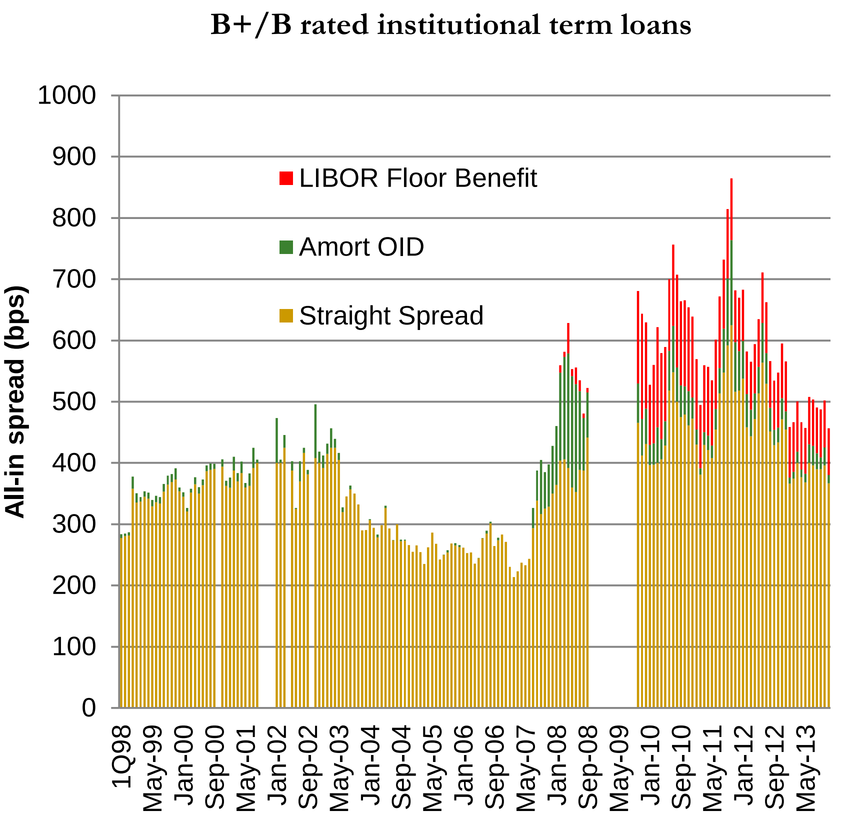


- While debt/EBITDA multiples are climbing, coverage ratios are very strong

Source: S&P/LCD/Capital IQ

New issue loans: Institutional term loan spreads Contracting, but well above pre-Crisis lows





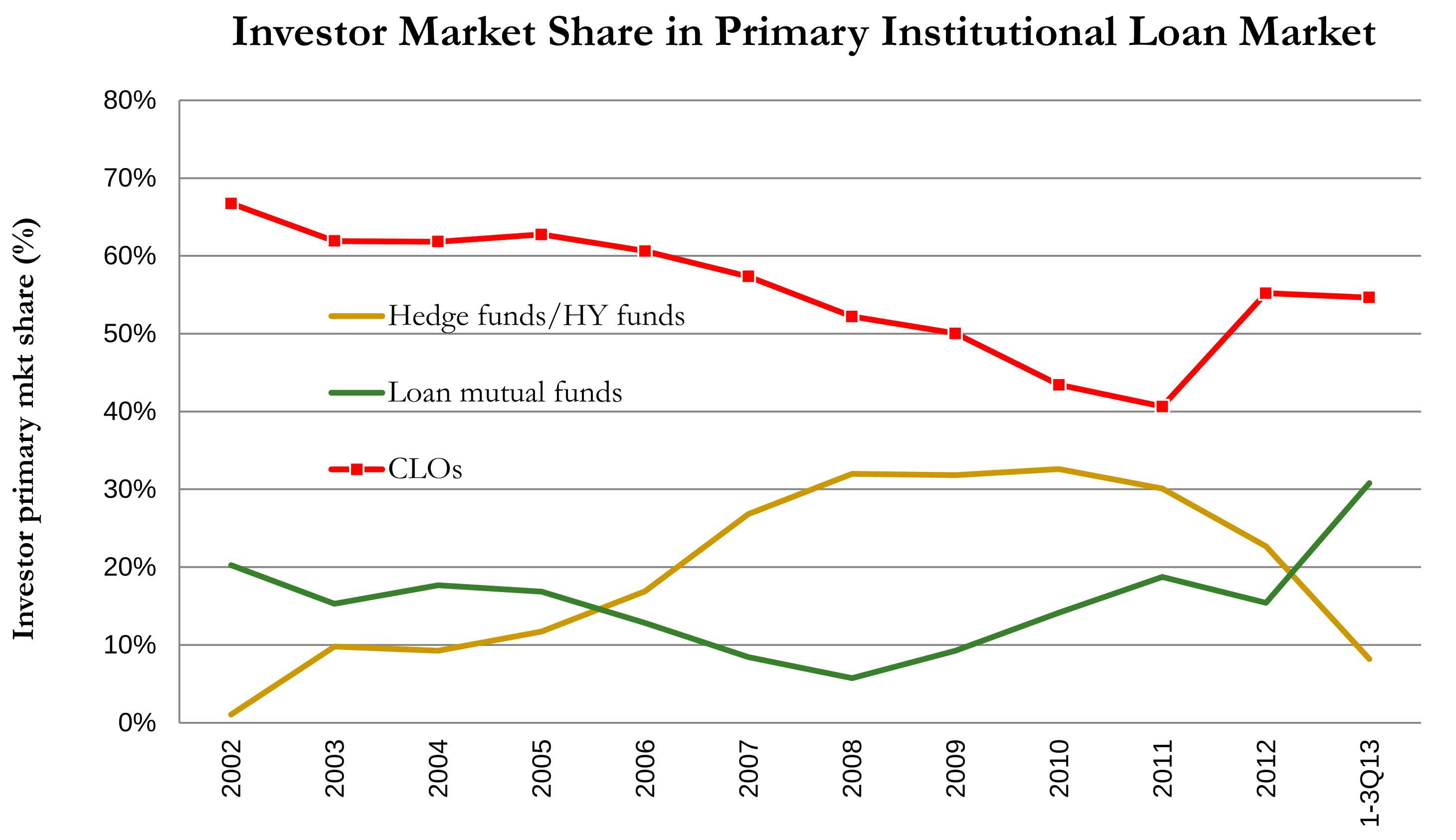
Source: S&P/LCD/Capital IQ

The Regulatory Environment:

Risk retention & Leveraged Lending Guidance & Volcker, Oh My!

Risk Retention

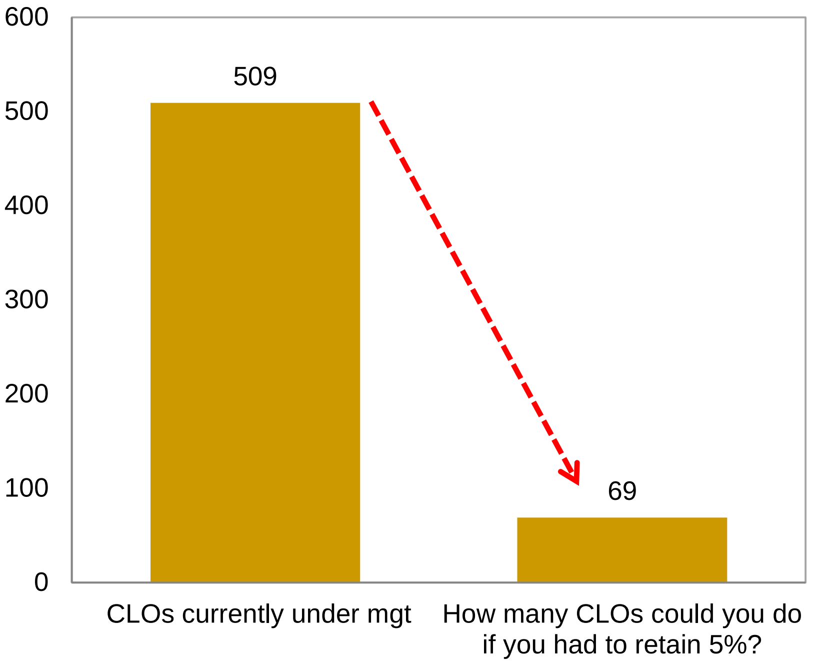
CLOs are the biggest non-bank lender…
If they are no longer viable, what happens?...



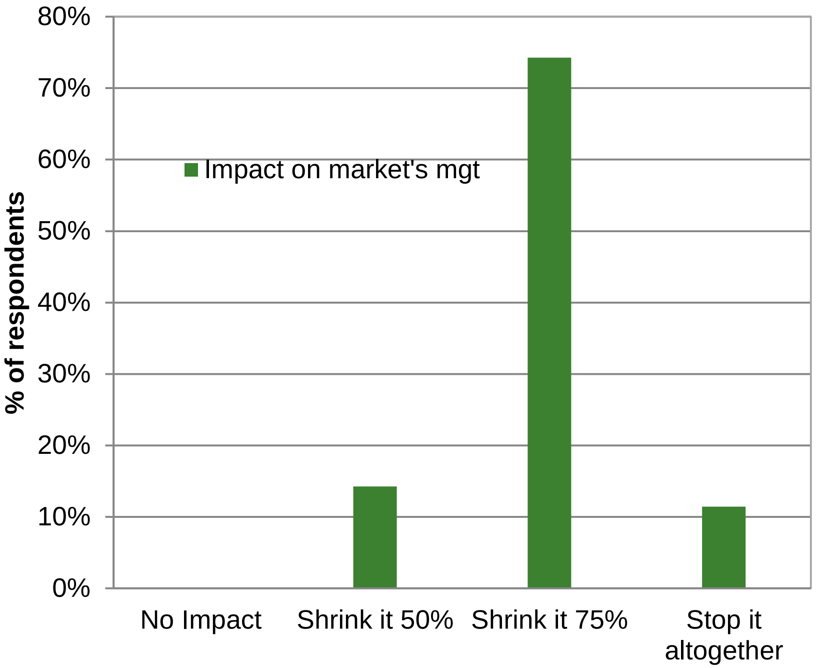
Source: S&P/Capital IQ/LCD

Risk Retention Shutters CLOs: According to an LSTA survey, market shrinks by more than 75%

CLO managers say their CLOs under mgt would drop 88%...



Managers estimate the overall CLO market would shrink by 75%



- The LSTA asked managers running 70% of U.S. CLOs whether they could manage CLOs if they were required to retain 5% of the fair value of any new CLOs
- According to the LSTA Survey, managers, who currently manage more than 500 CLOs, said they would only run approximately 70 CLOs – in total – if the risk retention rules went into effect as originally written (*left*)
- They estimated it would reduce the CLO market by 75% (*right*) …and this is before the disruptive horizontal retention cash flow diversion language

Source: LSTA Manager Survey, July 2013

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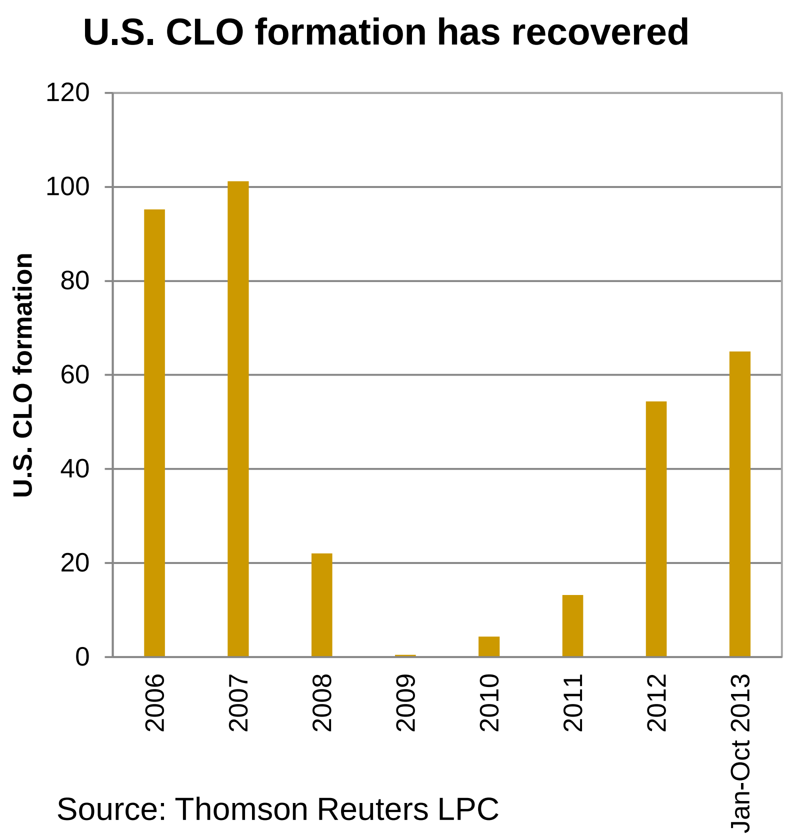
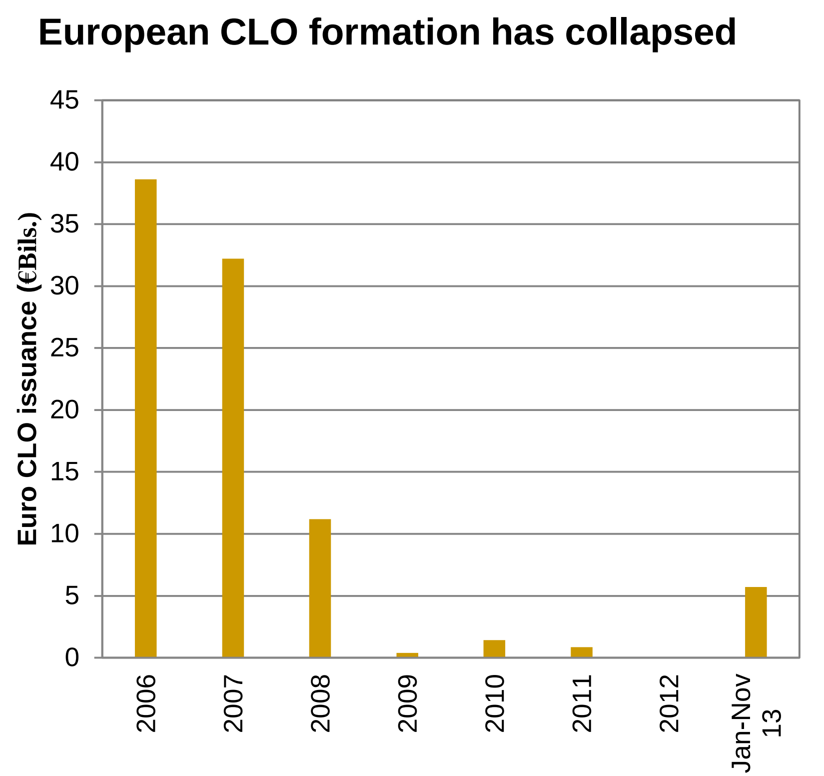
Without risk retention (yet), U.S. CLO formation has recovered; European CLO formation has collapsed



Source: Thomson Reuters LPC

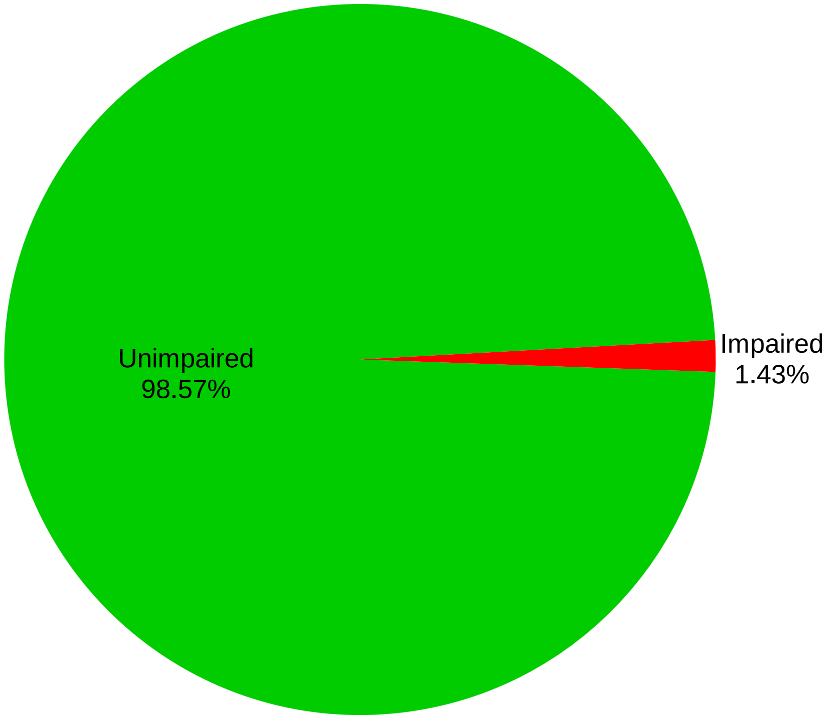


Source: S&P/Capital IQ/LCD

- U.S. CLO formation has recovered, bringing capital to U.S. companies
- European CLO formation collapsed, due in part to risk retention rules

Performance: CLO note impairments have been all but non-existent

Cumulative **impairment rate from Jan 1996 to May 2012**



- Over the course of 17 years, the cumulative impairment rate of CLOs has been de minimus – less than 1.5% in that entire time span
- Losses will be lower than impairments, because impairments can include market value EOD, distressed exchanges, etc., in addition to realized losses

Source: Moody's Investors Service

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Why should I care if the CLO market shrinks?

- **Scenario 1: Other credit providers do not step in… leveraged loan market contracts…reducing availability of credit to non-IG borrowers (particularly in the middle market)**
- **Scenario 2: Other credit providers (such as HY bonds) do step in…but magnitude of replacement depends on elasticity of demand… margins increase…increasing the cost of credit to non-IG borrowers**
- **Scenario 3: Other credit providers (such as loan mutual funds) do step in…but this replaces match-funded investors with maturity transforming investors…possibly increasing the volatility of the loan asset class**

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Leveraged Lending Guidance

Leveraged Lending Guidance

- **Areas of explicit focus include (but are not limited to…)**
  - Defining leveraged loans – leverage, purpose, HLT definition, RE secured loans, etc
  - Underwriting standards – delevering ability, covenants
  - Pipeline management
  - Enterprise valuation
  - Reporting and analytics
  - Risk rating loans
  - Deal sponsors
  - Stress testing
- **Particular areas of focus (or so we hear…)**
  - Ability to amortize senior secured debt or 50% of all debt in 5-7 years
  - Covenant lite loans
- **Applies not just to loans held by banks, but also loans arranged (but not held) by banks**
  - Defining Concept (?): Banks should not underwrite loans they are not willing to hold

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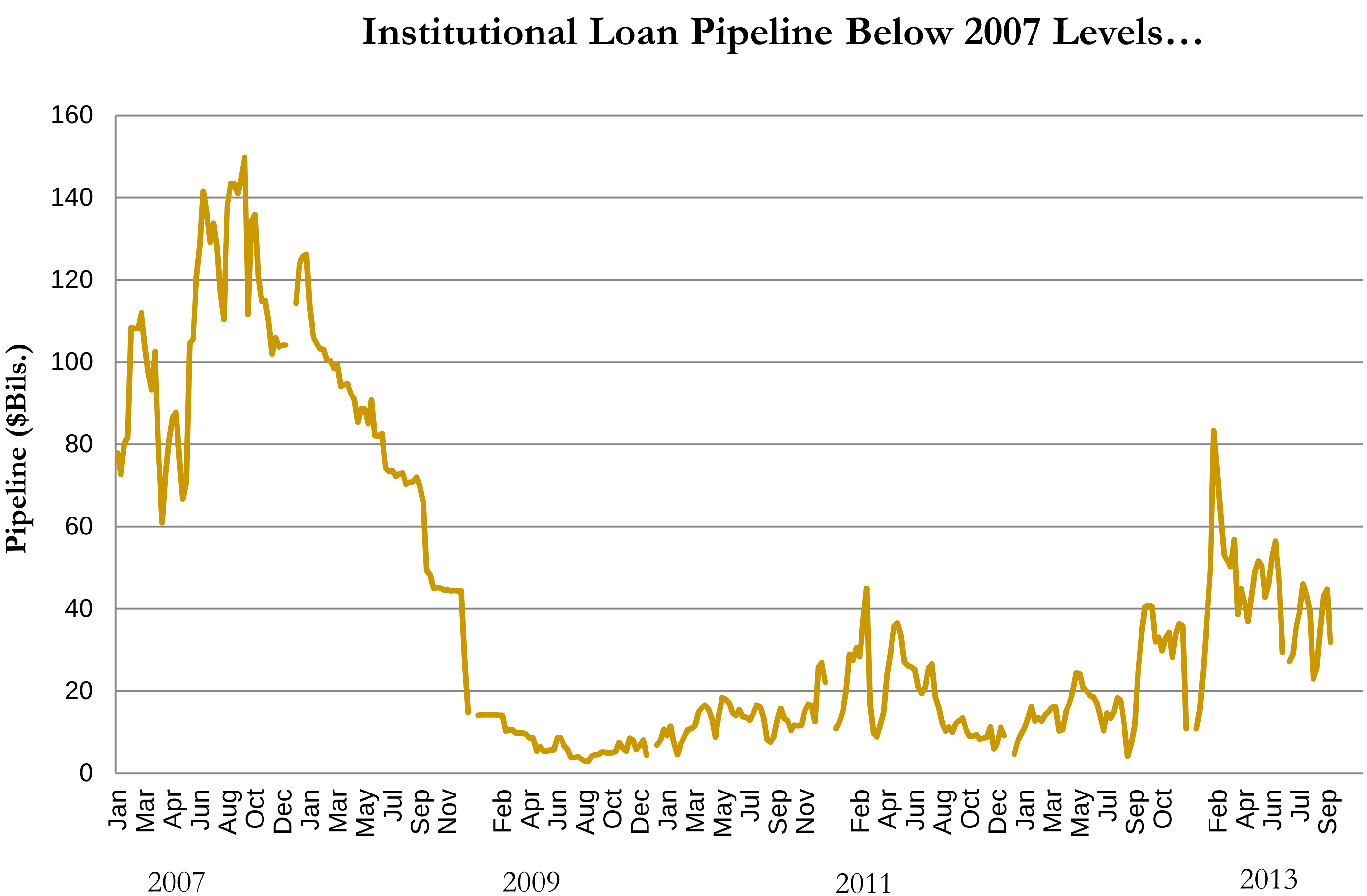
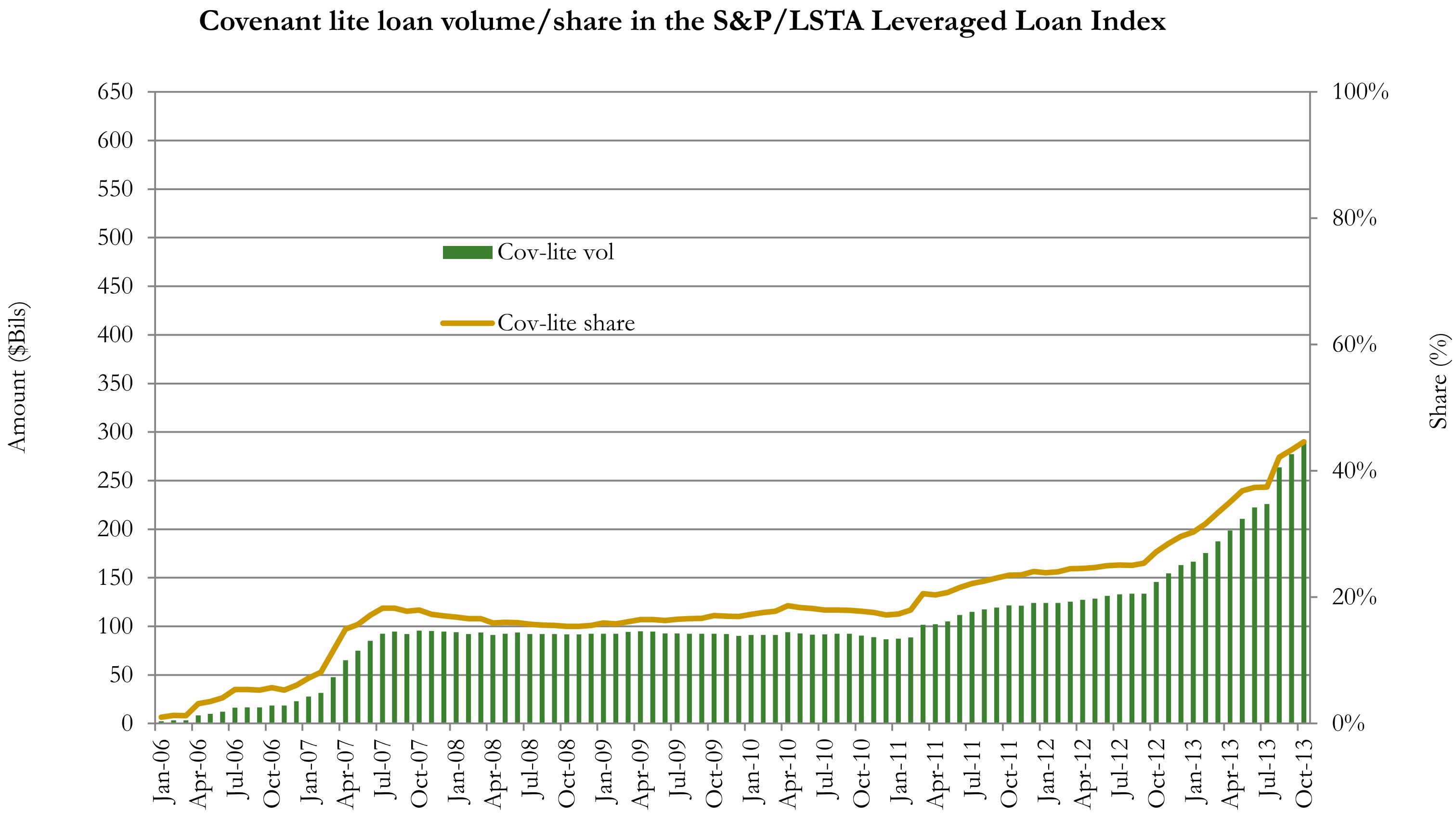
Institutional term loan pipeline being managed tightly



Source: Thomson Reuters LPC

There definitely *are* more covenant lite institutional term loans



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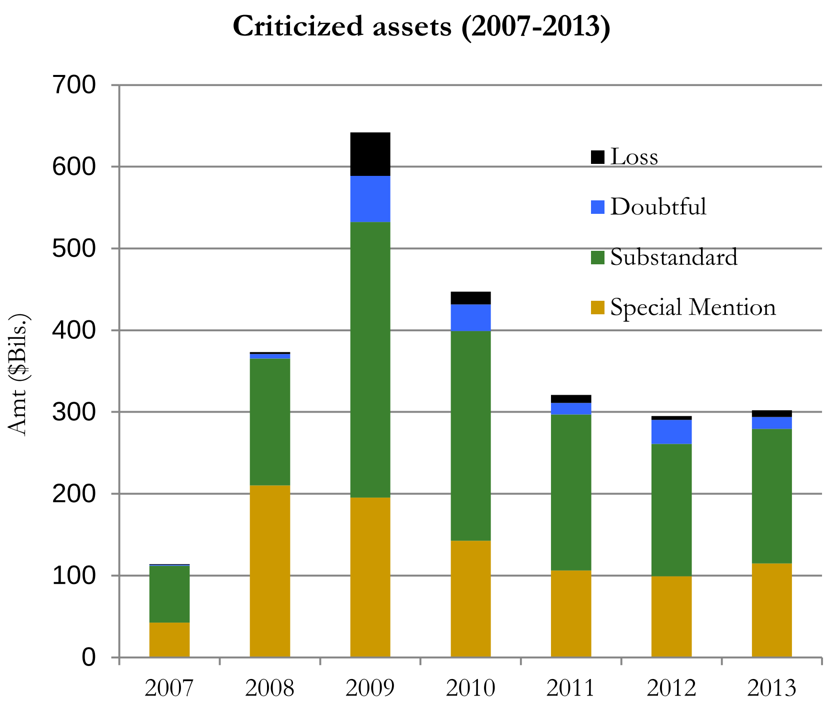
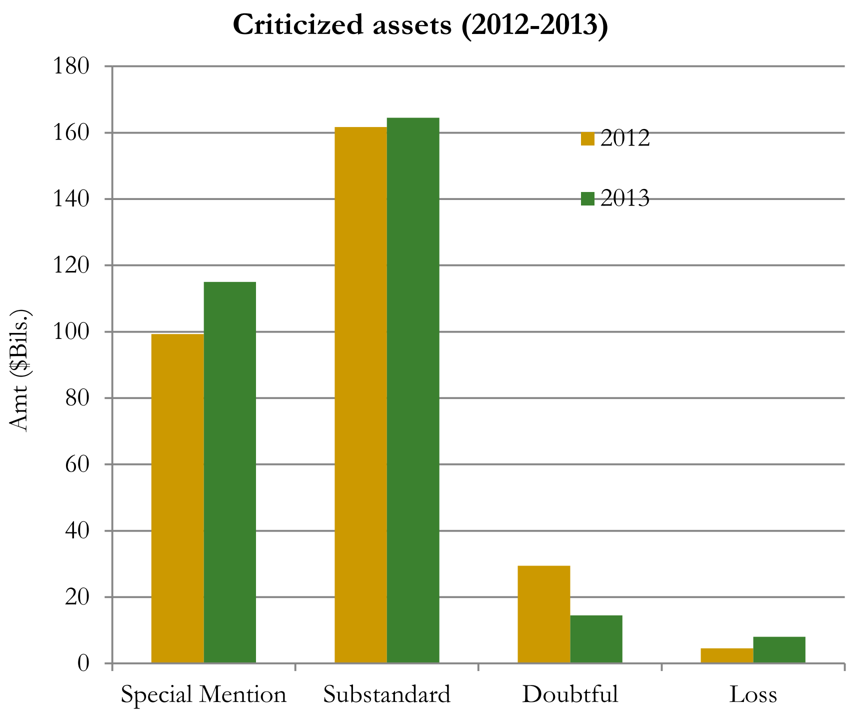
Leveraged Lending Guidance and the SNC Review





- In the 2013 SNC Review, Classified Assets decreased, but Criticized Assets increased
- This was primarily driven by an increase in Special Mention loans
- SNC Review referenced the Leveraged Lending Guidance…and observed that a "focused review of leveraged loans found material widespread weaknesses in underwriting practices, including excessive leverage, inability to amortize debt over a reasonable period, and a lack of meaningful financial covenants."
- 42% of leveraged loans were criticized

Source: 2013 SNC Review

How might Leveraged Lending Guidance impact the leveraged market?

- **Background: The HLT designation from the early 1990s helped launch the institutional term loan market**

- **What is happening with the market today?**
  - Generally…mass confusion
- **What might ultimately happen?...**
  - Banks figure out how to comply; the market continues?
  - Banks back away from leveraged lending; the leveraged finance market shrinks?
  - Banks back away from leveraged lending; senior secured floating rate market develops?
  - Banks back away from leveraged lending; non-bank originators step in?

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Ultimately, today's leveraged loan market is simply responding to supply and demand cues…

…But longer term, regulation may drive the evolution (or devolution) of the leveraged loan market