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**The Changing Shape
of Distressed Financing:
*Trends Driving the Evolution
of a Market***

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The Changing Shape of Distressed Financing: *Trends Driving the Evolution of a Market*

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The distressed financing market is in the midst of radical, long-term changes. While there has been considerable change in the financing of distressed firms since the 1980s (a broadening of the DIP market, the institutionalization of distressed investing, loan-to-own strategies, etc.), in the coming years financial sponsors, turnaround professionals, and all others who interact with firms in financial distress will be faced with a vastly different financing landscape. The sources of these changes are apparent to any market observer. However, as the recent increase in corporate distress continues and many in our profession find themselves devoting their limited time to the immediate tactical concerns of today's clients, it is worthwhile to pause in order to consider the financing environment that will exist for distressed firms in the coming decade.

A confluence of trends will drive the evolution of the distressed financing market:

- The continued adoption of the originate-to-distribute (OTD) model among traditional lenders.
- The continued growth and utilization of the secondary loan market to allow traditional lenders to exit troubled credits rather than pursue a workout.

- The continued growth and standardization in the credit default swap (CDS) market to enhance lenders' ability to tailor their credit exposure.

Individually, no one trend would be enough to "shake the market," but it is my view that their combined impact will soon reach a critical mass, after which distressed financing will be considerably altered.

A NEW APPROACH TO LENDING

Banks and other commercial lenders traditionally have played a substantial role in distressed financing, and this will continue. However, the pronounced shift to an OTD business model is a noteworthy development that has intriguing implications. As the role of traditional lenders continues to change, trends already in evidence will continue—structuring of debt facilities in ways that will be attractive to secondary market players, increased use of credit risk transfer techniques, and a weakening of the monitoring role. The transition to a more capital markets-oriented lending universe has been slowed by the current economic environment, but the long-term trend is apparent, and it will persist.

The OTD model challenges the traditional economics of banking. In this model,

profit is no longer generated primarily through the difference between the rate at which a bank is able to borrow and the rate at which it lends. Rather, as a report by the Bank for International Statements puts it:

Banks now profit from leveraged loans not so much by receiving the interest rate spread, but by earning: fees received for arranging the loan; fees and trading profits associated with market-making in the secondary market; fees for arranging amendments to the loan agreement or covenant waivers; and fees and underwriting revenues associated with assisting CLO managers to set up and fund their vehicles.¹

Increasingly it appears that if banks are not able to apply the OTD model to an area of lending, they will gladly pull back from that area, as evidenced by the decline of U.S. banks' share of the primary market for leveraged loans, from approximately 60% in 1999 to 20% in 2007 (see Exhibit 1).²

As the adoption of the OTD model by traditional lenders continues, the structure of debt facilities will be increasingly affected. In an insightful 2006 working paper, the BIS noted:

Covenant packages frequently appear to be designed to ease loan sales, given that over 60%

of loan sales occur within a month of origination. More than half of sold loans are eventually resold, another indication that the intent is to create a loan instrument that will be liquid in the secondary market.³

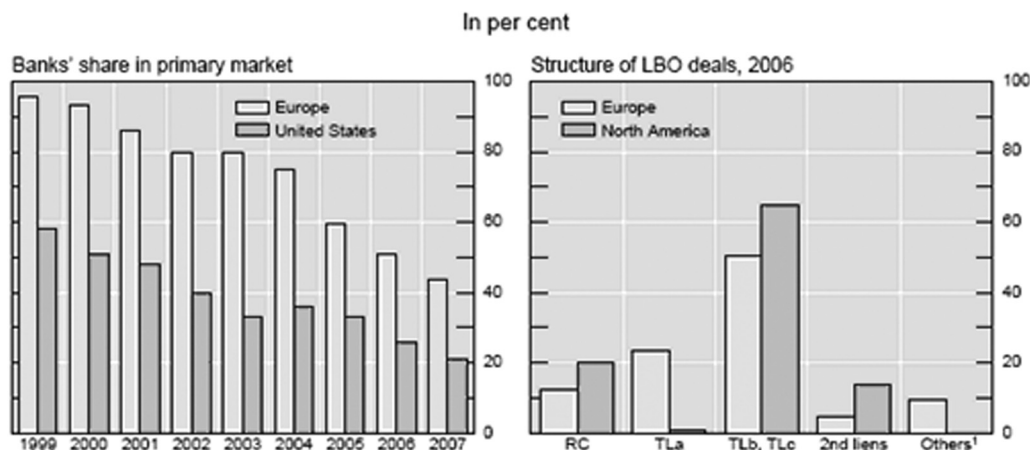
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Banks often sell loans that are designed specifically for an intermediation profit rather than for a long-run investment profit, using more restrictive covenant packages that mitigate selling costs. The riskier the loans, the likelier they are to be sold, controlling for other effects, perhaps because they tie down more bank capital.⁴

This trend must give private equity professionals and turnaround practitioners pause, as it implies an emerging order in which traditional bank workouts will be a thing of the past, and lenders with exposure to distressed credits are those who purposely sought out that exposure with a full appreciation of the risks (and potential rewards) inherent in their position.

The movement to an OTD model among traditional lenders provides strong incentives for them to more aggressively manage their credit risk. As the profit drivers of these firms shift from the interest rate spreads they enjoy to their ability to originate and service loans,

EXHIBIT 1 Changing Landscape of Leveraged Loan Market



Note: ¹Includes letters of credit facilities, bridge loans and capital expenditure facilities.

Source: Standard & Poor's LCD.

appetite for credit risk should logically decline. The two primary means of mitigating risk are selling a loan and buying CDS protection. Assuming loan maturity is equivalent to that of the default swap, the two options are economically equivalent (excluding counterparty risk), though loan sales are more beneficial when taking into account regulatory and disclosure requirements.⁵ The benefits of active credit risk transfer are considerable, and the emerging evidence indicates that those lenders who fail to adopt these techniques will quickly find themselves at a disadvantage.^{6,7}

Traditional lenders have historically played an important role in screening and monitoring their debtors. In the past this role has been in the best interests of lenders, given their exposure. However, with the OTD business model, the incentives to maintain robust screening and monitoring capabilities are likely to decline.^{8,9} Recent academic findings on this topic are not encouraging:

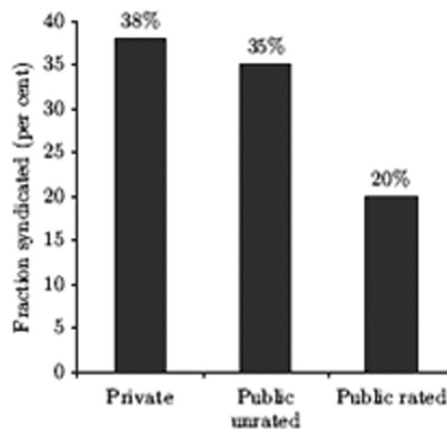
Banks provide unique services in the form of credit evaluation and the monitoring of borrowers. For a bank to have the incentive to provide these services, it seems necessary that it hold a significant fraction of each loan that it originates. Although prior research addresses a bank's motivation to monitor a loan after a portion of the loan has been sold, the efficiency of the post-sale bank monitoring remains an open theoretical and empirical question.¹⁰

The reduced incentives for traditional lenders to monitor their debtors (see Exhibit 2) may lead to an increased need for financial sponsors and other parties to more closely monitor borrowers in order to protect their investments.

The movement toward an OTD business model has significantly altered the economic incentives of banks in a short period of time, and a shift in this direction will continue, especially in areas related to distressed finance. Changes in the structuring of debt facilities are anticipated, as traditional lenders seek to originate loans that can more easily be sold on the secondary market. More aggressive use of credit risk transfer techniques seems inevitable, with not only increased sales on the secondary market but also increased use of credit default swaps to achieve an economically equivalent option. As the profit function of traditional lenders evolves, their rigor in pursuing the monitoring role which they have historically

EXHIBIT 2

Estimates of Syndicated Loan Retention by Lead Arranger



Source: Sufi [2007].

performed will decline. The implication seems to be that financial sponsors and/or other market participants will likely need to bolster their monitoring capabilities.

THE SECONDARY MARKET: PAST AND FUTURE

The secondary loan market has seen considerable change in the past two decades. It has experienced tremendous growth, particularly among leveraged loans. Years of benign credit conditions combined with the rise of the OTD business model have made use of the secondary market preferable to pursuing a workout for many traditional lenders. Finally, the emergence of large alternative investment firms with the capability to reallocate existing capital or raise new capital in pursuit of distressed opportunities has permanently altered the market. The result of these changes is that the secondary loan market is now sufficiently robust for traditional lenders to utilize it in their credit risk transfer strategies, exacerbating the changes that we foresee.

U.S. secondary loan market volume has seen remarkable growth in the past two decades. Volume has increased from \$8 billion in 1991 to more than \$318 billion in 2008. It is especially noteworthy that this growing market seems to focus on credits that are either currently, or have a higher likelihood of at some point becoming, distressed. Data from Reuters Loan Pricing Corporation indicates that from 1991 to 2008 there was

no single year in which less than 9% of secondary loan purchases were distressed, and in the 2001–2003 period distressed loan sales averaged 39% of total secondary loan sales (see Exhibit 3).

It is also noteworthy that leveraged loans account for a majority of the secondary market. As a recent research paper by the FDIC noted:

In contrast with typical loan syndications, the secondary loan sales market is dominated by leveraged, risky loans and the majority of loans are purchased by nonbank, institutional investors. As such, the secondary loan sales market is economically important, allowing banks to diversify their loan portfolios, comply with risk-adequacy regulations, and continue to fund profitable projects even when capital constrained or when facing higher internal lending costs.¹¹

There has been considerable research regarding the effect of the secondary loan market on the customary monitoring role of traditional lenders. Historically these lenders have provided valuable monitoring that has benefited other market players due to their sensitivity to a debtor firm’s downside and relative indifference to its upside. A recent paper that explored the topic concluded the following regarding use of the secondary market by traditional lenders:

It can reduce the incentives of banks to monitor a borrower since a bank can use the secondary

market to reduce its lending exposure to a borrower. If so, such a “loan sale” could significantly reduce or even eliminate a bank’s incentives to monitor the borrower.¹²

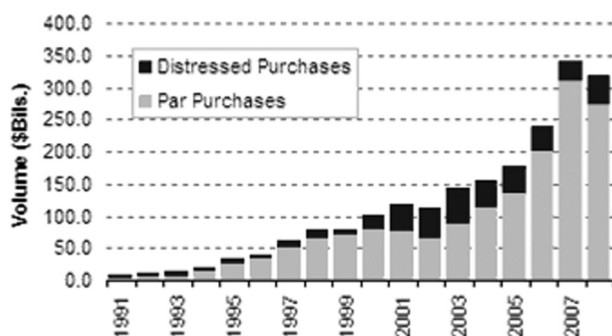
While the matter remains an open question, it is important to recognize the emerging academic view that as traditional lenders utilize the secondary market, their incentives to monitor decrease.

The relatively benign credit market of 2003–2007 led many traditional lenders to make staffing adjustments with considerable long-term implications. With a growing secondary market and a half decade of low default rates, many traditional lenders substantially reduced their workout departments, and now face challenges in hiring and/or training sufficient numbers to address a deluge of troubled credits. Arguably the loss of talent in workout departments, coupled with the increasing liquidity of the secondary markets, will further push traditional lenders toward a preference for loan sales over workouts.

The current decade has seen the evolution of a select number of alternative investment firms into sprawling entities that pursue a wide range of strategies across numerous funds. These firms have a demonstrated ability to shift existing funds to or raise new funds for attractive investment opportunities. The presence of these firms and their ability to rapidly reallocate capital is likely to address, in part, the issue of demand for the abundant supply of distressed loans that seasoned professionals anticipate will be a facet of the market for the next few years.

Numerous factors have combined to make the secondary market an increasingly important aspect of the broader distressed financing market. There is the undeniable reality of the secondary market’s stunning growth, as well as its tendency to focus on distressed and leveraged loans. With workout departments pared down after years of low default rates, we expect to see banks more willing to exit distressed credits as opposed to going through the workout process. As alternative investment firms aggressively seek distressed investing opportunities in the current environment, demand will surge to meet supply and pricing will be less punitive than might have been the case in past cycles. We view the secondary loan market as having reached critical mass in terms of its importance to the broader distressed financing market, and believe that the

EXHIBIT 3 Size and Composition of the U.S. Secondary Loan Market



Source: Reuters Loan Pricing Corporation.

secondary loan market will become a driver of change going forward.

THE CDS MARKET: AN UNDERUTILIZED HEDGING TOOL

The credit default swap (CDS) market has matured to the point that we believe it is now a reliable-enough tool to be utilized in ways likely to have a profound effect on distressed finance. In the space of less than a decade, the CDS market has experienced explosive growth as well as an increasing focus on standardization. Recently, there has been evidence of traditional lenders making use of CDS products in order to tailor their credit exposure, and these kinds of transactions will become increasingly common. What was once a chaotic and unfamiliar market is now a large, reasonably standardized one capable of providing traditional lenders with another means of transferring risk, and hence furthering the evolution of the distressed financing market.

Growth in the CDS market has been breathtaking, but in recent years, steps have been taken to increase the utility of this important market. The rate of growth this market has seen is staggering; the notional value of the CDS market has increased from \$918 billion in 2001 to \$62 trillion in 2007 (see Exhibit 4). Long marked by rampant customization and the lack of a central clearinghouse, the CDS market is beginning to acquire the markings of maturity. Many products, especially index-based CDS

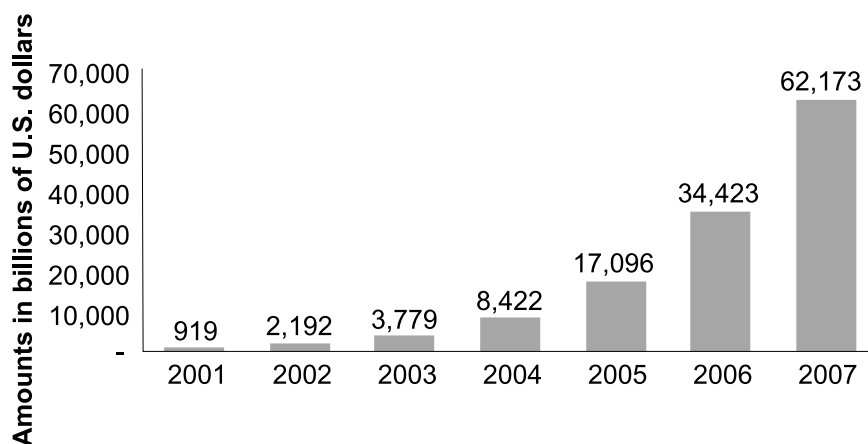
contracts, have become standardized. Electronic trades have risen above 90%, versus 50% in 2005. These trends, combined with the recent pledge by 17 large dealers to create a clearinghouse by year-end, have done much to ease concerns regarding the stability of the CDS market.

As the CDS market matures and risk management officers gain a better understanding of counter-party risk (the risk that the provider of default insurance will itself default), we expect to see banks and commercial lenders make broader use of CDS contracts in order to protect themselves from deterioration in the debtor's business (up to and including a default) (see Exhibits 5 and 6). The Federal Reserve has noted that a number of large European banks have recently executed transactions to hedge exposure to a range of credit risk categories.¹³ This trend will continue, and far from being without precedent, it would be similar in many ways to what we witnessed with the mortgage market earlier in this decade.

The use of CDS products by traditional distressed lenders is an economically logical extension of the OTD model that has become prevalent in the market. As the CDS market has matured, liquidity has increased. Lenders, recognizing the benefits of a market-based model, have displayed a willingness to rely on the liquidity of the credit markets, and despite the current market turmoil, this will continue.¹⁴ A recent study has indicated that the CDS market also serves as a strong predictor of ratings activities, with Fitch Solutions estimating that the CDS market has

EXHIBIT 4

Notional CDS Amounts Outstanding at Year-End



Source: ISDA Market Survey [1987–2007].

EXHIBIT 5 CDS Hedging Transactions

Date	Bank	Credit exposure before hedging (billions)	Amount of hedging reported (billions)	Exposure hedged (percent)
Year end 2006	Bank of America	USD 618	USD 8	1
Year end 2006	Citigroup	USD 633	USD 93	15
Year end 2006	JP Morgan Chase	USD 631	USD 51	8
2006 Q1	Societe Generale	EUR 60	EUR 15	25

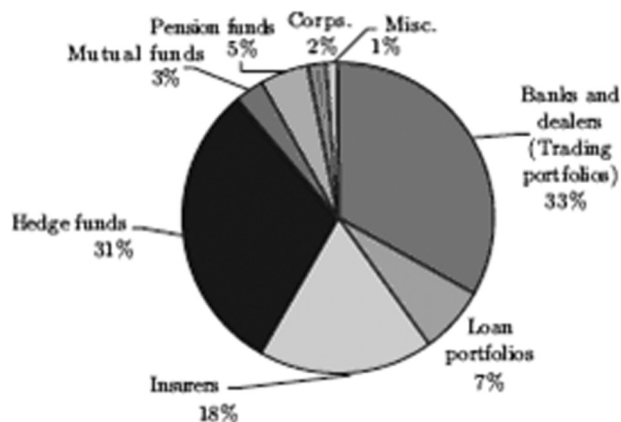
Source: For U.S. banks, 2006 annual reports; for Societe Generale, "Safety first," Risk, August 2006.

EXHIBIT 6 Aggregate Loan and CDS Positions within Large Banks (Banks with at least \$1 Billion in Assets in 2003)

Year	Total loans	CDSs bought	CDSs sold	CDSs gross	CDSs net	CDSs bought % of loans	CDSs sold % of loans	CDSs net % of loans
2001	2,125	217	220	437	-2	10.2%	10.4%	-0.1%
2002	2,238	342	288	630	54	15.3%	12.9%	2.4%
2003	2,379	520	469	988	51	21.9%	19.7%	2.1%
2004	2,671	1,179	1,092	2,270	87	44.1%	40.9%	3.3%
2005	2,891	3,002	2,518	5,520	484	103.8%	87.1%	16.7%
2006	3,298	4,165	4,094	8,259	71	126.3%	124.1%	2.2%

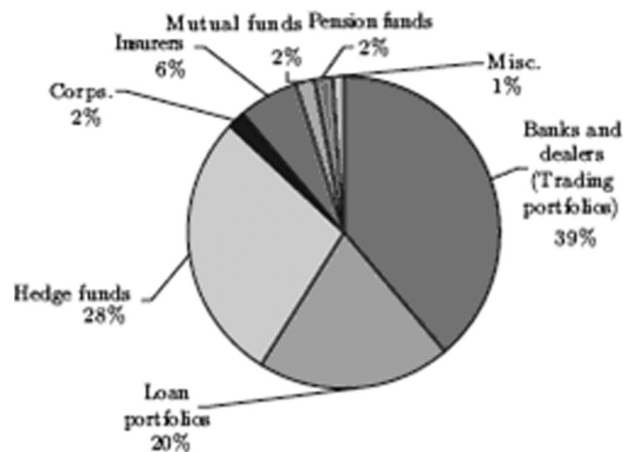
Source: Federal Reserve Bank of Chicago.

EXHIBIT 7 Estimated Breakdown of CDS Buyers of Protection



Source: Bank of America, March 2007.

EXHIBIT 8 Estimated Breakdown of CDS Sellers of Protection



Source: Bank of America, March 2007.

anticipated some ratings activities more than three months in advance. Heightened lender utilization of the CDS market (see Exhibits 7 and 8) is supported by the benefits of increasing liquidity and the observed predictive power of the market. Given this compelling logic, lenders will continue to increase reliance on the CDS market in order to realize these benefits.

CONCLUSION

The distressed financing market is undergoing a period of fundamental change. The level and type of involvement in this sector by traditional lenders is in flux as adoption of the OTD model drives a rethinking of the appropriate level of credit risk to retain. Alternative investment firms lacking the origination capabilities of traditional lenders but eager to participate through the secondary markets are primed to play an increasingly active role in this market. The ability to tailor credit exposure without a loan sale through use of the CDS market offers another avenue for traditional lenders seeking to more actively manage their risk profile. The outline of the emerging order is becoming clear, and it rests with all professionals involved in the distressed financing market to make the necessary adjustments.

Historically, banks and other commercial lenders have played a substantial role in distressed financing, and this will continue. The emergence of the OTD model has altered the profitability equation for traditional lenders, with the result that many are likely to engage in increasingly proactive credit risk transfer activities in order to maximize profitability under the new business model. Despite their historically dominant role in distressed finance, recent market developments have drastically altered the incentives of traditional lenders, providing an opening for capital providers with more aggressive risk tolerances.

Over time, the secondary loan market has achieved critical mass, allowing it to become a driver of further change. The size of the market and its focus on distressed and leveraged credits ensures that it will become an increasingly important aspect of the broader distressed financing market. As traditional lenders seek to originate loans that can be easily sold, the influence of the secondary market will spread throughout the broader distressed financing market.

The maturation of the CDS market offers tantalizing opportunities for traditional providers of capital to tailor their level of exposure to firms of all sizes. With the development of CDS indices it is now possible to construct hedges for exposure to middle-market firms, thereby considerably broadening the usefulness of the market for traditional lenders seeking to mitigate credit risk. In the coming years, traditional lenders will make increasing use of the CDS market in order to tailor their credit risk.

Considering the impact of these trends, we foresee changes great and small for the distressed financing market. Adoption of the OTD model by traditional lenders will drive them to seek to minimize credit risk and will potentially inhibit their customary monitoring role. The secondary market, now large enough to be relied upon as an aspect of a comprehensive credit risk transfer strategy, will exert increasing influence on loan origination as lenders seek to originate loans that can more easily be sold. Through the CDS market, traditional lenders will be able to carefully tailor their credit risk, and these lenders will seize this opportunity. In the near future, we anticipate a distressed financing environment in which workouts are rare; monitoring by traditional lenders is minimal; the secondary market is a component that cannot be ignored; and even current lenders may be indifferent to a default. Truly, it will be a brave new world for which all forward-thinking professionals in this industry should prepare.

ENDNOTES

¹“Private Equity and Leveraged Finance Markets.” Report by The Bank for International Settlements, July 2008.

²Ibid.

³“Innovations in Credit Risk Transfer.” Working Paper by The Bank for International Settlements, July 2006.

⁴Ibid.

⁵Ibid.

⁶Ibid.

⁷Arping, S. “Playing Hardball: Relationship Banking in the Age of Credit Derivatives.” Mimeo, University of Amsterdam, 2003.

⁸Gande, A., and A. Saunders. “Are Banks Still Special When There is a Secondary Market for Loans?” Mimeo, New York University, 2006.

⁹“The Effect of Lenders’ Credit Risk Transfer Activities on Borrowing Firms’ Equity Returns.” Bank of Finland Discussion Paper, July 2006.

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¹²Gande, A., and A. Saunders. “Are Banks Still Special When There is a Secondary Market for Loans?” Mimeo, New York University, 2006.

¹³Gibson, M. “Credit Derivatives and Risk Management.” Report by The Federal Reserve, 2007.

¹⁴Ibid.

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