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CLIENT ALERT

The Resurgence of Loan Total Return Swaps

Apr.29.2020

The recent unprecedented dislocation of the U.S. syndicated loan market has led to a resurgence of interest in loan total return swaps (LTRS). As prices of high-quality secured loans dropped precipitously in March following the outbreak of Covid-19, many market participants sought to take advantage of distressed prices while maximizing liquidity. LTRS provide investors with a flexible derivative product that, among other uses, allows leveraged synthetic exposure to the potentially undervalued loan asset class. During a time of market uncertainty and price volatility, it can be a valuable tool for distressed investors who understand its unique structure and features.

Overview of Loan TRS Structure

An LTRS is a derivative transaction typically between a buy-side investor (the LTRS buyer) and a bank (the LTRS dealer) that references a third-party borrower's syndicated loan (the reference entity and reference obligation, respectively). During the term of an LTRS, the LTRS buyer pays a periodic charge to the LTRS dealer (based on a benchmark interest rate plus a spread), in exchange for the LTRS dealer agreeing to pay to the LTRS buyer all interest and fees that a lender of the underlying reference obligation would receive during the same period. Upon termination of the LTRS, the LTRS buyer must pay any amount of capital depreciation in the value of the reference obligation, and the dealer must pay any appreciation. Therefore, an investor who believes loans are mispriced due to a short-term market dislocation could use LTRS to efficiently take long positions in underpriced loans and unwind those positions after a subsequent market recovery.

The LTRS dealer may endeavor to be market risk-neutral with respect to an LTRS transaction by entering into a back-to-back LTRS with another market participant, by purchasing the underlying reference obligation or by structuring other hedges. To mitigate counterparty default risk, an LTRS dealer also will collect from the LTRS buyer daily variation margin to support any mark-to-market declines in the value of the reference obligation during the term of the LTRS (as is now required by U.S. and EU margin regulations, among others) and initial margin to cover risks relating to unexpected large declines in value and operational delays. Nevertheless, this posted margin is typically a fraction of the amount of cash that would be required to purchase a syndicated loan outright, thus enabling an LTRS buyer to obtain leveraged exposure to a loan's economics.

Key Issues to Consider

LTRS documentation is not standardized and its terms and structures can be heavily negotiated. Both dealers and buyers should consider a number of key issues in the LTRS market, including:

- ISDA Master Agreement: LTRS trades are documented under confirmations incorporating the terms of a negotiated ISDA Master Agreement. This agreement governs payment and collateral mechanics, allocates various risks and is tailored to parties' local insolvency laws and derivatives regulatory regimes. As a practical matter, parties should keep in mind that execution of this document can become surprisingly time-intensive without business focus and counsel sensitive to prevailing market standards and commercial risks.

- Regulatory Compliance: Since the financial crisis of 2008, the United States and the European Union (among others) have implemented extensive regulatory requirements applicable to derivatives products such as LTRS. Regulations promulgated under the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act and European Market Infrastructure Regulation, respectively, govern the conduct of dealers' business, trade reconciliation and reporting, posting and holding of margin, fraud and market manipulation and many other aspects of trading in derivatives. Which rules apply, and when, will depend on a variety of factors – including the parties' respective jurisdictions, the size and type of financial enterprise and the derivative product being traded.
- Counterparty Credit Risk and Margin: Because LTRS provide "synthetic leverage", managing counterparty credit risk is an overarching trade concern. Buy-side participants will want to fully understand how margin call mechanics work under their LTRS trade confirmations (as they are relatively complicated compared to other "vanilla" derivatives), how posted collateral is held and how positions are unwound upon any default. Dealers, meanwhile, may wish to consider whether their forms' existing provisions should be tightened in light of market illiquidity and challenging credit conditions. In all cases, parties must determine which one – *or more* – jurisdictions' rules will govern their trade and understand mandatory variation margin collection requirements (now in effect in all major markets) and applicable minimum initial margin requirements (currently being rolled out in the U.S., EU and elsewhere).
- Termination Rights: An LTRS buyer typically has optional early termination (OET) rights, giving it the ability to close out its synthetic position just as if it sold out of an actual loan position. Dealers generally do not have unfettered OET rights but will attempt to build in rights to unwind the swap in various situations posing increased risk to the dealer, including with respect to the credit quality or liquidity of the underlying reference obligation. These provisions are usually heavily negotiated and require an understanding of market conventions.
- Information Issues: In the United States, a syndicated loan is not a security in the view of federal securities regulators, but an LTRS referencing such a loan is. This means both LTRS dealers and buyers must understand how to comply with anti-fraud securities laws, including section 10(b) of the Securities and Exchange Act. Concerns relating to trading while in possession of material non-public information can be especially acute for credit funds given the close relationships that naturally develop among lenders, agents and borrowers over the course of lending relationships.
- Voting and Control: Although the purpose of the LTRS product is to replicate the economics of loan ownership, an LTRS typically does not extend voting and control rights to the underlying loan to the buyer. There are a variety of practical, contractual and bankruptcy law reasons why a dealer generally will not agree to act as the buyer's proxy for questions put to the lenders. That said, dealers typically try to accommodate their clients' needs, and creative negotiation during a trade can often allay buyer concerns regarding control.

LTRS is not a simple product. But with attention to mechanical details and appreciation for existing regulatory requirements, market participants can put in place trade documentation to reliably gain loan market exposure with minimum outlays of increasingly-precious investment capital.

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