Syndicated Loans

More insurance companies are taking advantage of current low interest rates by investing in fixed-income security alternatives. For example, six years ago syndicated loans—also known as bank loans or leveraged loans—were not very common investments for insurers. But today, according to the 2014 Insurance Industry Benchmark Survey for Investment Accounting and Treasury Professionals, 13% of insurers are currently investing in syndicated loans, and another 14% have plans to add syndicated loans to their portfolio.

However, syndicated loans do come with challenges. Most investment accountants consider syndicated loans difficult to manage because of issues with data availability, interest payment lags, inaccurate accruals, valuation complications, and investment solution system limitations.

While syndicated loans are complex, understanding the structure, nature, and intricacies of these assets can help reveal how to best manage their potential risks and recognize their potential rewards. A more detailed understanding, combined with Clearwater Analytics’ advanced web-based investment accounting and reporting solution—which greatly simplifies the processing and accounting of complex assets—helps make syndicated loans a manageable choice for many investors.
Why Invest in Syndicated Loans?

Syndicated loans are private placement securities that are generally senior debt secured by borrower assets. They are attractive to many investors because the U.S. Securities and Exchange Commission (SEC) does not require that they be registered. This allows investors to borrow outside the traditional parameters of fixed-income securities. The lack of SEC registration also means less cost for the borrowing corporation at issuance.

Investors pursue syndicated loans for one primary reason: Yield. The non-traditional nature of these loans allows investors to command a higher rate of return. Furthermore, because they commonly sit atop the corporate capital structure, holders of syndicated loans are usually among the first creditors repaid in the event of a bankruptcy. Although syndicated loans are considered very complex, their high rate of return is attractive to many investors. In addition, the availability of advanced investment solutions that can overcome complex instruments’ reporting and data integration challenges has helped make syndicated loans less intimidating to insurance investors.

Syndicated Loan Issue Process

The nature and structure of syndicated loans often allows the loan to receive a better rating from credit agencies than it would otherwise be afforded. Borrowers that utilize syndicated loans for funding include those that are less credit-worthy, require a large loan, or require funding for a non-traditional project.

The process of syndicating these loans begins with an interested borrower, who approaches an arranging bank with its funding needs. The arranging bank is then responsible for shopping out the loan to interested lenders. One member of this loan syndicate is ultimately appointed as the agency bank and is the lender-side representative.

The agency bank serves as both the clearinghouse and underwriter of the syndicated loan and is responsible for administering the loan on a daily basis. This includes monitoring the borrower’s compliance with the loan terms, performing postmaster and record-keeping activities, and acting as the general point of contact for all communication between borrower and lenders.

Syndicated Loan Covenants

After the syndicated loan lenders have been identified, the participating entities establish covenants that the borrower must adhere to. Covenants are essentially the prospectus of a syndicated loan, and contain language that mandates certain conditions, including the financial ratios the borrower must consider, repayment of the loan ticking fees (opportunity-cost fees paid by borrower while funds remain undrawn), and any other applicable standards and specifics. Syndicated loan covenants generally fall into one of two covenant categories: Maintenance Covenant Loans and Covenant-lite Loans.

Maintenance Covenant Loans provide a greater degree of protection for the investor, but are much more restrictive, and therefore less desirable, for the borrower. Maintenance Covenant Loans might require the borrower to meet certain financial metrics throughout the life of the loan, such as keeping the debt-to-cash flow under a certain ratio. Maintenance Covenants might also include language providing for maintenance tests, which allow lenders to catch problems early, or in some cases negotiate better concessions from the borrower (rates, spreads, etc.).

Covenant-lite Loans (often referred to as Cov-lite Loans), are much less restrictive than traditional Maintenance Covenant Loans, and are more often associated with better-rated issuers. Whereas Maintenance Covenant Loans allow lenders to take action against a borrower that is passively in violation of the covenant—that is, the borrower has not intentionally violated the terms of the covenant—Cov-lite Loans generally require that the borrower actively take action outside the parameters of the covenant before it is considered in violation of the covenant.

For example, if a borrower’s operations deteriorate to the point that they are out of compliance with their covenant, under a Cov-lite Loan a lender might not be able to force the borrower to make payments under the loan (depending on the terms of the covenant). In the same circumstances under a Maintenance Covenant Loan, a lender could force the borrower to make payments on the loan. Under both a Maintenance Covenant Loan and a Cov-lite Loan, if the borrower wants to take on more debt and the addition of that debt would put them in violation of their covenant, the lender might have the right to forbid the borrower from taking on additional debt (depending on the terms of the covenant).

1 While syndicated loans are often secured by borrower assets, this is not always the case (see description of Security Trustee in LMA Guide to Syndicated Loans, pp.3; http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf)
Syndicated Loan Structure

Syndicated loans have traditionally been set up in a tiered structure: Borrower, Deal (Lien), Facility, and Contract level. The information detail and complexity increases with each level down the structure.

Deal (Lien) Level

The total amount borrowed under the loan, the transfer location for funds, the borrower, the agent, the guarantor of the loan, the underwriter, and any limitations on use of funding are established at the deal level. Facilities are delineated at this level, and some covenant language not previously specified might be included as well.

Some loans have standard CUSIPs at the deal level; some do not.

Facility Level

Details such as maturity date and facility type are specified at the facility level and can be set by either the agency bank or the borrower. As with deals, some facilities have a standard CUSIP. Facility type is specified at this level, as well as additional covenant language.

Facility type is indicated at this level as follows:

- **Term Loans**: The provider has a predetermined period of time to draw the loan (availability/commitment period). Repayment may be either amortized (installment payments, usually associated with Term A and Term D loans) or bullet (one repayment at the end of the loan, usually seen with Term B and Term C loans). Term loans cannot be redrawn once repaid.

- **Revolver**: Borrowers are allowed to draw and redraw up to the maximum loan amount any time during the term of the loan facility. Revolver loans drawn to repay another loan payable on the same repayment date in the same currency are known as rollover loans.

- **Term-out Revolver**: Borrowers must adhere to the same specifics as for a revolver loan, but with added language allowing a conversion to a term loan on a predetermined conversion date. Spreads often increase if the term-out conversion is exercised.

- **Delayed Draw**: Borrowers can draw the loan down to purchase specific assets for a predetermined period of time. Ticking fees are paid to the lender during the commitment period, as well as on unfunded portions of the loan. Delayed draw facilities cannot be redrawn.

- **Paid-in-Kind (PIK)**: Borrowers that wish to roll interest into the loan rather than make payments to lenders may elect to issue PIK facilities. Interest that is recognized as PIK becomes additional debt and typically accrues at a higher interest rate than the original facility.

- **Letters of Credit**: In the event of borrower default, letters of credit are issued by independent creditors stating funds will be repaid to lenders. Commitment fees are earned on letter of credit commitment amounts.

Contract Level

The most detailed level of a syndicated loan is the contract level, where lenders can specify nuanced items such as reference rate, coupon frequency, coupon rate, float spread, accrual start date, and prepayments.

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3 Ibid.
4 “Handbook of Finance, Financial Markets and Instruments” (Fabozzi)
Accounting Treatment

While syndicated loans are treated much like traditional corporate debt instruments for accounting purposes, they do have a few distinct characteristics that set them apart.

Unlike corporate bonds, syndicated loan contracts are re-signed on a fairly regular basis (typically quarterly), and updates to contracts might include information about rate changes, amount outstanding, tenor, etc. When details of a re-signed loan are deemed materially different, old facilities are exchanged for new ones.

Syndicated loans trade flat with long settle dates and do not accrue until the trade settles. Best practices allows for private placements to be recorded as of the date the security is recognized as legally changing hands.\(^5\)

Due to the tiered structure of syndicated loans, data provided at the most granular level will most accurately reflect security information. Contract level information is preferable, but facility level is sufficient for accounting needs if contract level information is unavailable.

Third-party data tends to be limited for syndicated loans. Wall Street Office (WSO) is currently seen as the premier data source and trading platform for syndicated loans, though some other data providers offer third-party data as well. Available third-party data (including that from WSO) is typically facility-level data rather than contract-level data.

There is not a mandatory, standardized security identifier for syndicated loans because these instruments are not registered with the SEC. However, many issuers do take advantage of traditional CUSIP assignments by the CUSIP Bureau.

Trade-Related Cash Flows

Syndicated loan holders need to consider trade-related cash flows. Assignment fees, which are charged by agency banks to cover the costs associated with executing the deal, should be included with the book value of the security, along with any commission paid.\(^6\) The economic benefit (security-related cash flows received by or paid to the seller between trade date and actual settle date) should be treated the same as post-trade pay downs.

5 ASC 946-320-25-2
6 ASC 946-320-40-1

“As our portfolio continues to grow, leveraging the yield available in alternative assets, including bank loans, is critical for our organization. Clearwater’s bank loan functionality allows us to focus on our investing needs and goals, without worrying about any of the associated financial reporting challenges in this asset class.”

Jim Krygier, Chief Investment Officer
The Warranty Group

Delayed Compensation and Cost of Carry

Both delayed compensation and cost of carry come into effect when delivery of the security is delayed.

Delayed Compensation is the interest income accrued from the contractual settle date to the actual settle date, based on the loan interest spread. This is a seller-paid cash flow consisting of interest and fees associated with the loan that the buyer would have earned during the delay period.\(^7\) If the security is distressed (trading at less than 90% of par), delayed compensation is paid for days exceeding T+20. If the security is not distressed (that is, it is trading in excess of 90% of par), delayed compensation is paid for days exceeding T+7.

Cost of Carry is a buyer-paid cash flow that is only relevant when a security is distressed. In such an event, the buyer pays the seller the current LIBOR rate for the delay period in excess of T+20.

Syndicated loans traditionally float at a rate over LIBOR, although there are examples of loans that float over different types of LIBOR and PRIME. Syndicated loans also have multiple accrual rates, such as one rate applied to a funded portion of a revolver, and a separate rate applied to the unfunded portion.
Regulatory Reporting Implications

For regulatory reporting, syndicated loans are treated like corporate bonds with D, part 1 treatment. Additionally, the treatment with respect to designations, Risk-Based Capital, and AVR/IMR follows logic similar to the logic currently established for long-term corporate debt instruments.

Key Considerations

Syndicated loans’ relatively simple reporting requirements, combined with their high yields, make them attractive investments. But as with any other high-yield investment, syndicated loans are not suitable for all investors.

Investors wishing to capitalize on syndicated loans first need to consider their risk tolerance. Investors with a higher risk tolerance could dedicate an entire mandate to syndicated loan investments, while investors with a lower risk tolerance could choose to invest ad-hoc in their primary institutional accounts.

Additionally, those with a lower risk tolerance or a smaller overall portfolio could invest in syndicated loan funds instead of in a single syndicated loan asset. Similar to a money funds strategy, this approach diversifies investments while still pursuing higher yield.

How Clearwater Streamlines the Syndicated Loan Process

- Accounts for unique transactions and accrual schedules
- Reconciles disparate sources of data
- Provides expertise on syndicated loan complexities
- Aggregates data from leading data providers specializing in syndicated loans
- Produces detailed accounting, performance, and risk reports using a robust and flexible accounting engine

For more information on how Clearwater can help you integrate and simplify your investment analytics, contact a Clearwater professional at sales@clearwateranalytics.com.

About Clearwater Analytics

Clearwater Analytics® is the leading provider of web-based investment accounting, reporting, and reconciliation services for corporate treasuries, insurance companies, investment managers, and financial institutions. Clearwater aggregates, reconciles, and reports on over $1.2 trillion in assets across 25,000+ accounts daily. For over a decade, Clearwater has helped insurance clients such as CopperPoint Mutual Insurance Company, C.V. Starr, Group Health Companies, The Main Street America Group, Savings Bank Life Insurance Company of Massachusetts, The Warranty Group, and Wilton Re streamline their investment and accounting operations. Clearwater remains committed to continuous improvement of the solutions we are providing to current clients, while encouraging prospective firms to rethink how they approach their investment accounting and reporting challenges.