10-13-2010

Loan Syndication Trading Association Presenation on Financial Reform and the Leveraged Loan Market

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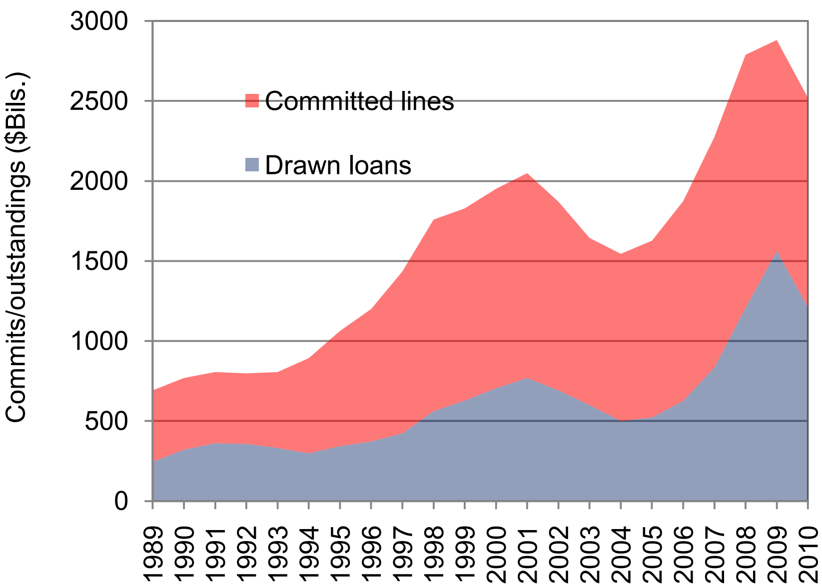
Financial Reform and the Leveraged Loan Market

Bram Smith, LSTA – Moderator

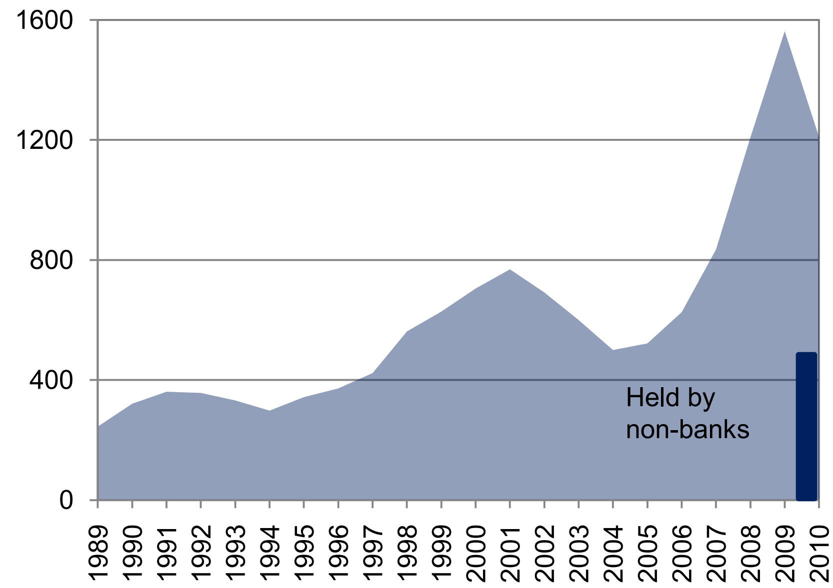
Andy O'Brien, JPMorgan Chase
Scott Page, Eaton Vance
BJ Sanford, Promontory Financial Group

U.S. Corporate Loan Market is a Vital Source of Capital for American Business

U.S. Corporate loan and loan commitments outstanding



U.S. Corporate loans outstanding



- According to government data, the U.S. syndicated loan market totals roughly $2.5 trillion of committed lines and outstanding loans
- It is a key source of financing for many large and middle market companies in the U.S.
- Over one-third of outstanding loans are held by non-banks; half of those are held by CLOs

Source: Shared National Credit Review

Promontory Financial Group

Washington Atlanta New York London Tokyo Singapore Sydney Milan Toronto Paris San Francisco

Dodd-Frank Act and the Bank Loan Market

Loan Syndications & Trading Association Annual Conference

October 13, 2010

Uncertainty Still Prevails

Uncertainty Still Prevails

- Regulators beginning a long and complex implementation process
- Dodd-Frank provisions affecting the bank loan market:
  - Suffer from greater than average vagueness and uncertainty
  - Are generally in the “first tranche” of the implementation effort (but it’s a very deep tranche)
- There are no answers to most of your questions
- Important things to know about the rule writers:
  - They are serious about thinking through the issues and creating rules that work for the market, although not necessarily for every player in the market or for the status quo ante
  - Mixed views of leveraged loans as a product

Institutional Regulation

Institutional Regulation

Institution	Old Regime	New Regime
Systemically important non-banks	Varies. Usually no consolidated supervision	Fed supervision, heightened prudential requirements
"Large, interconnected" depository institution holding companies	Fed or OTS supervision	Fed supervision, heightened prudential requirements
Non-bank affiliates of banks engaged in bank-permissible activities	Varies.	Bank-like supervision of bank permissible activities
Functionally regulated non-bank subs of FHCs	Fed restricted from supervising	Fed freer to supervise
Hedge funds and private equity funds	With some exceptions, no significant regulation	Generally required to register under Advisers Act
Swap dealers and major swap participants	Varies. Participants often not regulated	SEC/CFTC registration; conduct, capital, margin standards

Product and Activity Regulation

Product Regulation

Provision	Major Requirements	Sleeper Issue
Securitization risk retention	"Securitizer" and/or "originator" must retain 5% of the risk. Except when they don't.	Underwriting standards for exempt products – a new common reference point?
Credit ratings reform	Changes to NRSRO regulation; review of references to credit ratings in regulations; potential automatic assignment of agencies to ABS deals	Quest for rating agency alternatives – fruitless quest or rhetorical question?
Volcker Rule	Restricts proprietary trading and investment in "private equity and hedge funds" by banks and their "subsidiaries and affiliates"	Less important to most players than commonly thought. But will the need to correct a technical error create an open season for Dodd-Frank amendments?

Underrated Dodd-Frank Impacts

Underrated Dodd-Frank Impacts

- Office of Financial Research
- Mandatory stress tests
- Regulation of systemically important non-bank firms
- Broader reach for already strengthened prudential standards on capital, liquidity, risk management, and incentive compensation

Mark-To-Market

FASB Proposal: Accounting for Financial Instruments

Summary of Proposal

- Exposure Draft issued by FASB in May 2010
  - Comments were due on September 30, 2010
  - Currently over 1700 comment letters received by FASB
  - Public roundtables to occur in October 2010
- Impacts classification and measurement, impairment and hedge accounting
  - Applies to all reporting entities and most financial instruments
  - Significantly expands the use of fair value accounting
  - Eliminates the HFS and HFI classifications currently applicable to loans
  - Differs significantly from IFRS 9 and IASB's proposed impairment model

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FASB Proposal: Accounting for Financial Instruments

Classification and Measurement

- Proposed classification/measurement categories:
  - Fair value through net income or Other Comprehensive Income
  - Amortized cost – limited to short term receivables/payables

Note: Classification must be designated at the date of purchase/origination of the loan and **cannot** be reassessed (even if business strategy changes).

FASB Proposal: Accounting for Financial Instruments

Classification and Measurement

- Potential F/S impacts of the Proposal:
  - All purchased/originated loans will be fair valued on the balance sheet
  - There will likely be an increase in level 3 fair value measurements
  - All loan commitments will be recognized and fair valued at the commitment date (regardless if not considered derivatives)
- Potential implementation issues:
  - Financial reporting systems will need to be modified
  - Systems will need to track both amortized cost and fair value amounts
  - There will likely be an increased reliance on valuation models
  - Fair value information will need to be produced on an accelerated timeline

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FASB Proposal: Accounting for Financial Instruments

Credit Impairment

- Proposed impairment model:
  - Single impairment model applicable to all financial assets
  - Impairment continues to be based on an incurred loss model
  - Required to consider past events and existing conditions but cannot consider future events
  - Permitted to assess impairment on a pool basis or an asset by asset basis

Scott Page

Director of Bank Loans
Eaton Vance

October 13, 2010

SFAS 167: A Primer

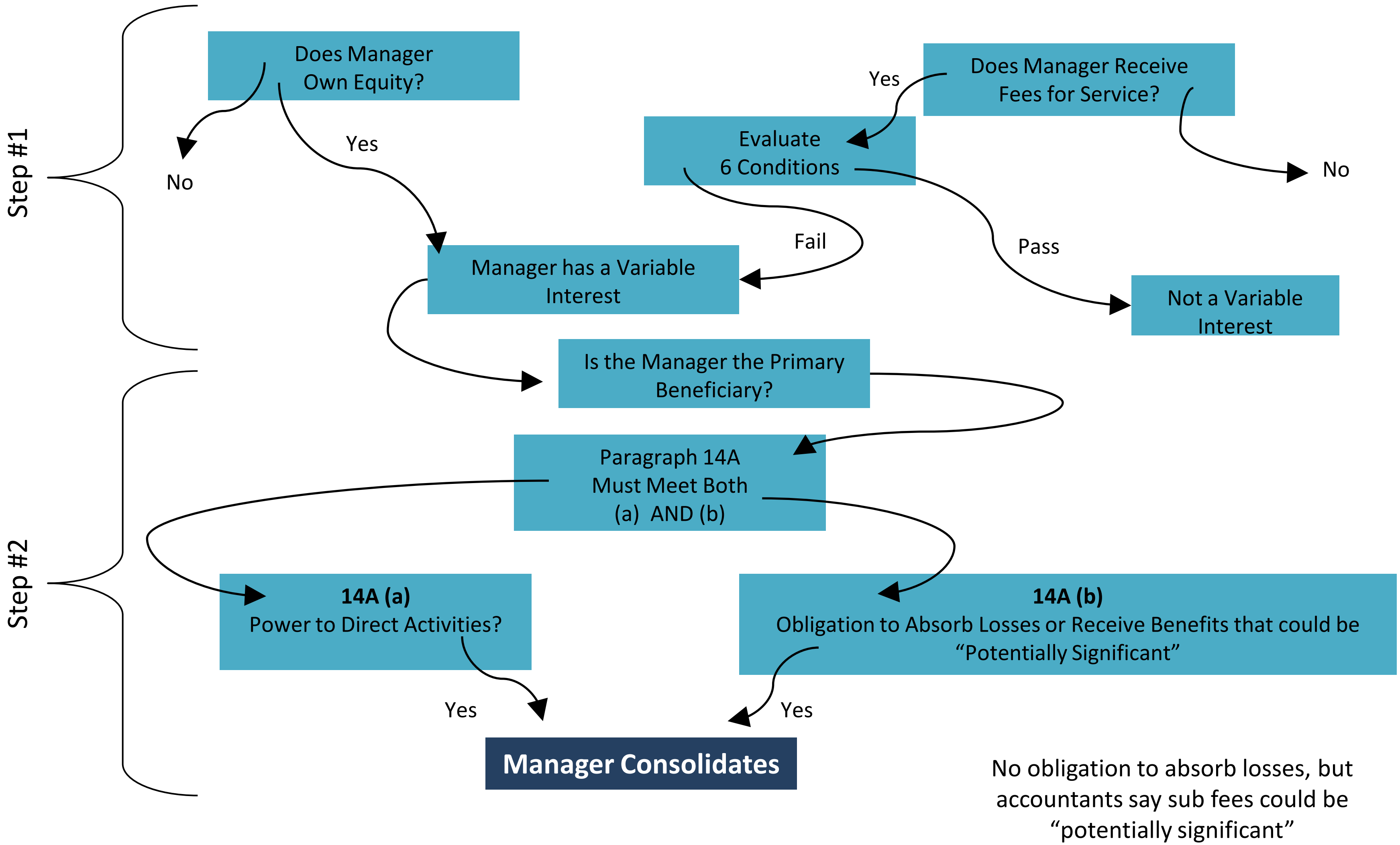
Stated Objective of the FASB:

- "The objective of this statement is to amend certain requirements of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements".

Approach:

- SFAS 167 determines whether an entity has variable interests through analysis of the entity's assets, liabilities, equity and other contracts.
- Next, the statement attempts to identify the Primary Beneficiary (i.e. the party to consolidate).
- The FASB states that it attempts to replace the quantitative approach of FIN 46(R) with an approach that is expected to be "primarily qualitative".
- Actual interpretation by accountants appears more focused on quantitative measurements.

FASB 167


Step #1
Does Manager Own Equity?
No
Yes
Does Manager Receive Fees for Service?
Yes
No
Evaluate 6 Conditions
Fail
Pass
Manager has a Variable Interest
Not a Variable Interest
Step #2
Is the Manager the Primary Beneficiary?
Paragraph 14A Must Meet Both (a) AND (b)
14A (a) Power to Direct Activities?
14A (b) Obligation to Absorb Losses or Receive Benefits that could be "Potentially Significant"
Yes
Yes
Manager Consolidates
No obligation to absorb losses, but accountants say sub fees could be "potentially significant"

Mutual Fund Company X
Balance Sheet Without VIEs

Assets

Cash	$235
Restricted cash for debt retirement	125
Management and distribution fees receivable	106
Other receivables	18
Net PP&E	53
Investments	168
Goodwill	2242
Intangible Assets	3089
Miscellaneous assets	27
Total Assets	**$6062***

Liabilities

Liabilities Current Portion of Debt	$117
Accounts Payable	16
Accrued Liabilities	112
Other Short Term Liabilities	15
Long Term Debt	3796
Deferred Income Tax Liability	994
Miscellaneous liabilities	80
Total Liabilities	**$5130***

Equity

Total Equity	**$932***

Long Term Debt/Equity: 4.1x
Debt/EBITDA: 9.4 x

Source: www.sec.gov, at June 30, 2010
*In millions

Mutual Fund Company X
Balance Sheet With VIEs

Assets

Cash	$663
Restricted cash for debt retirement	125
Management and distribution fees receivable	106
Other receivables	94
Net PP&E	53
Investments	3489
Goodwill	2242
Intangible Assets	3089
Miscellaneous assets	31
Total Assets	**$9892***

Liabilities

Liabilities Current Portion of Debt	$117
Accounts Payable	16
Accrued Liabilities	112
Other Short Term Liabilities	139
Long Term Debt	7459
Deferred Income Tax Liability	994
Miscellaneous liabilities	80
Total Liabilities	**$8916***

Equity

Total Equity	**$976***

Long Term Debt/Equity: 7.7x
Debt/EBITDA: 18.2 x

Source: www.sec.gov, at June 30, 2010
*In millions

BASEL III

Basel Committee on Banking Supervision

Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leveraged Ratio	Supervisory monitoring		Parallel run 1 January 2013 – 1 January 2017 Disclosure starts 1 January 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

Basel Committee on Banking Supervision

Phase-in arrangements (shading indicates transition periods)
(all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

NEW ISSUE LOAN VOLUME AND STRUCTURE

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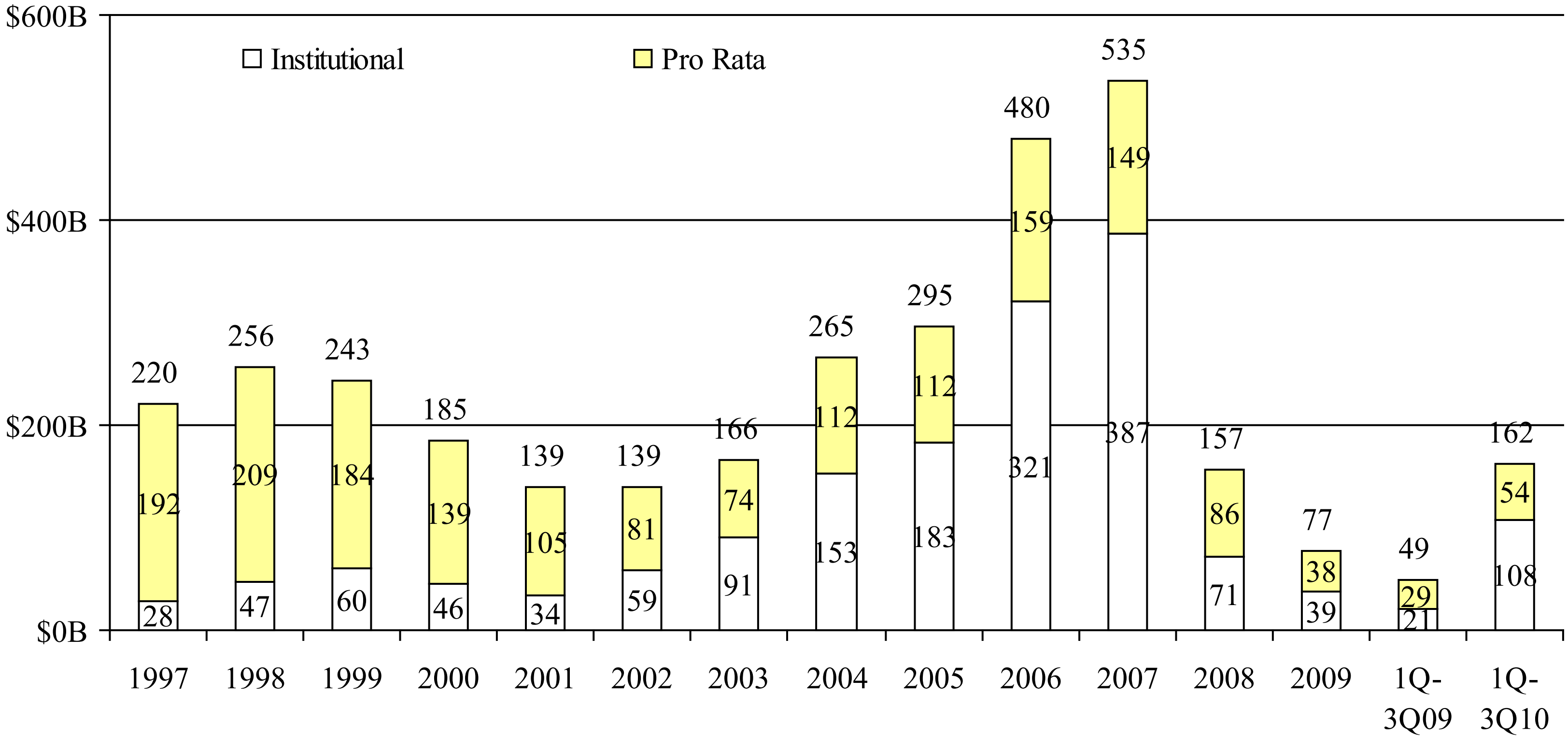
US Dollar Denominated Annual New-Issue Leveraged Loan Volume Excludes Existing Tranches of Add-ons and Amendments & Restatements with No New Money



Note: These numbers comprise U.S. dollar denominated loans and are subject to revision as LCD collects additional data.

www.lcdcomps.com

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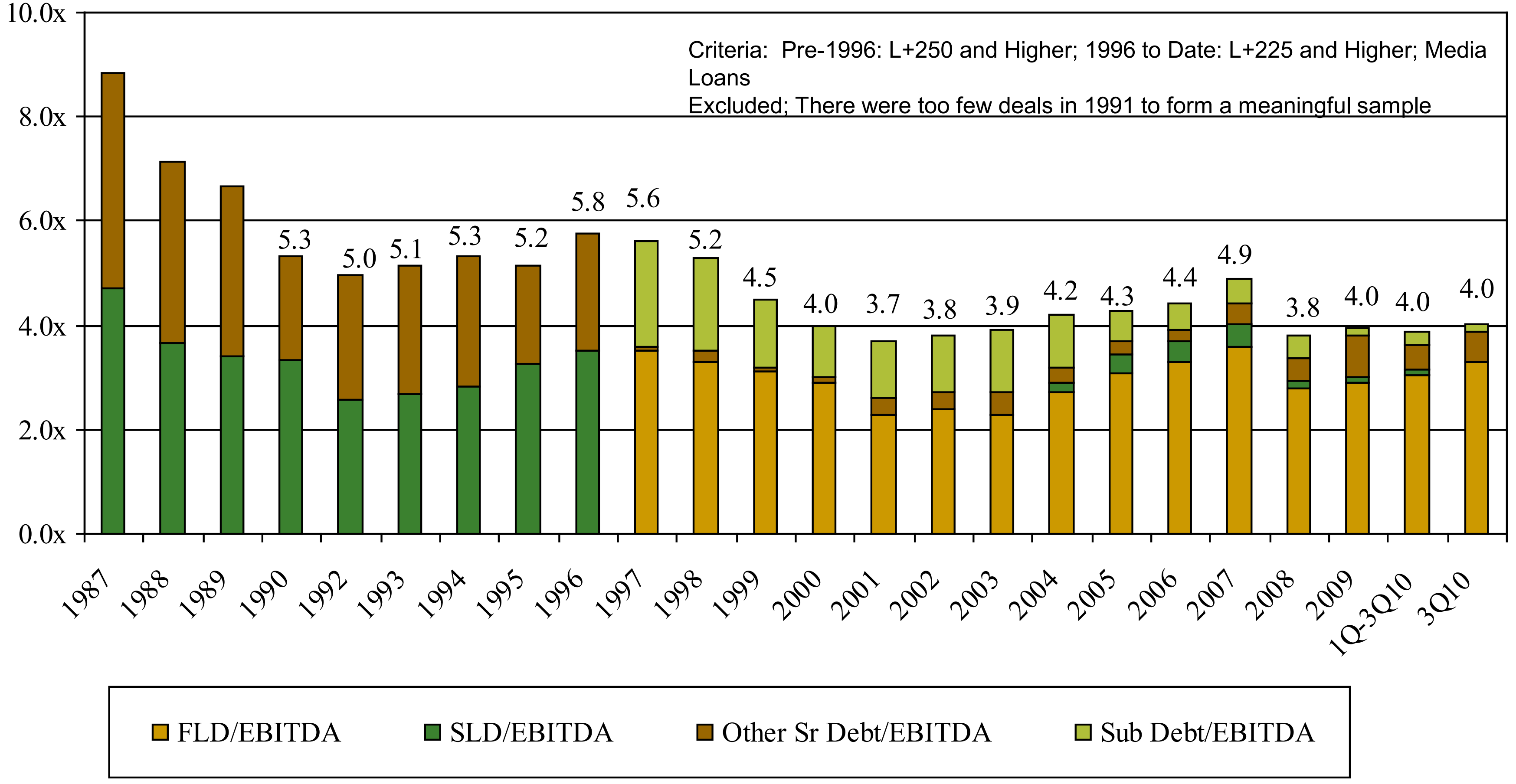
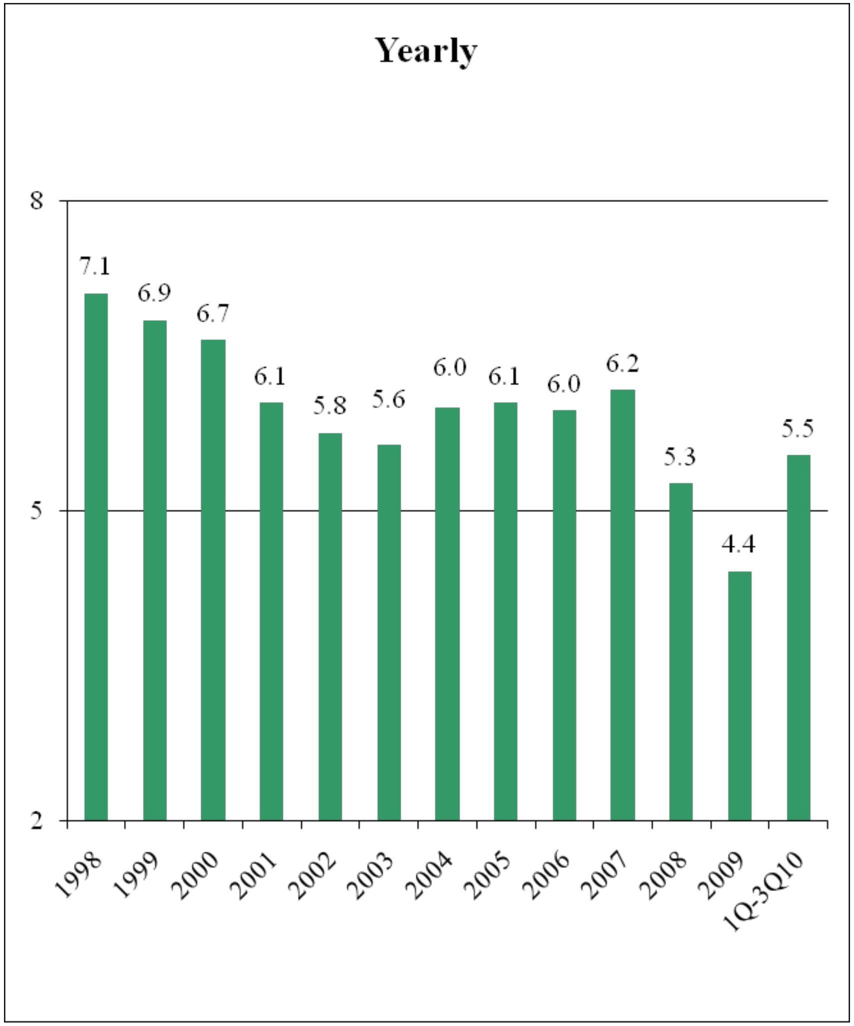
Average Debt Multiples of Highly Leveraged Loans

Note: For years 1987-1996, breakouts of first-lien debt & second-lien debt were not available, therefore the lower portion of the column reflects Bank Debt/EBITDA and top reflects all Non Bank Debt/EBITDA



Average Weighted Term of Institutional Loans



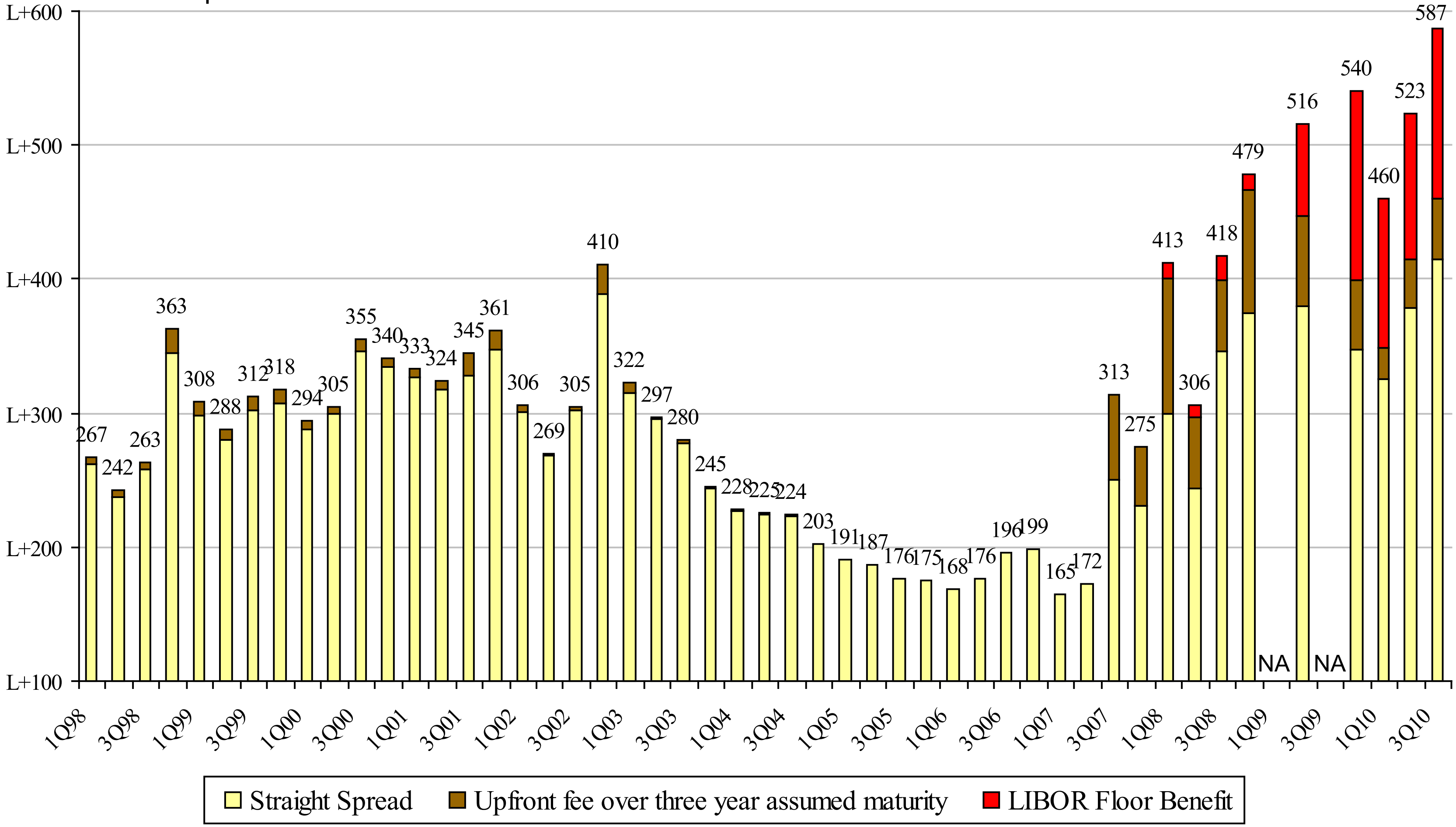
LOAN PRICING

Average All-in Spread of BB/BB- Institutional Loans

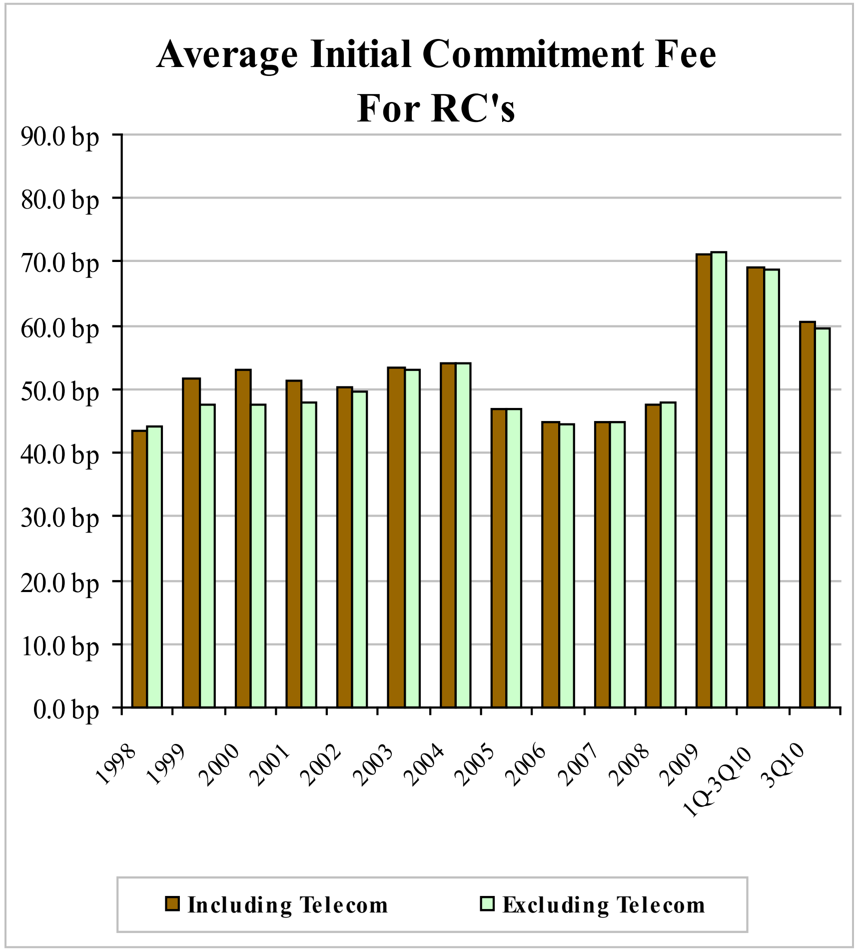
Quarterly

Assumes upfront fees is amortized evenly over an assumed three-year life; Upfront fee includes original issue discount

As of 10/5/06 LCD began using Corporate Credit Rating by S&P and Corporate Family Ratings by Moody's for rated spread and rated upfront fee calculations

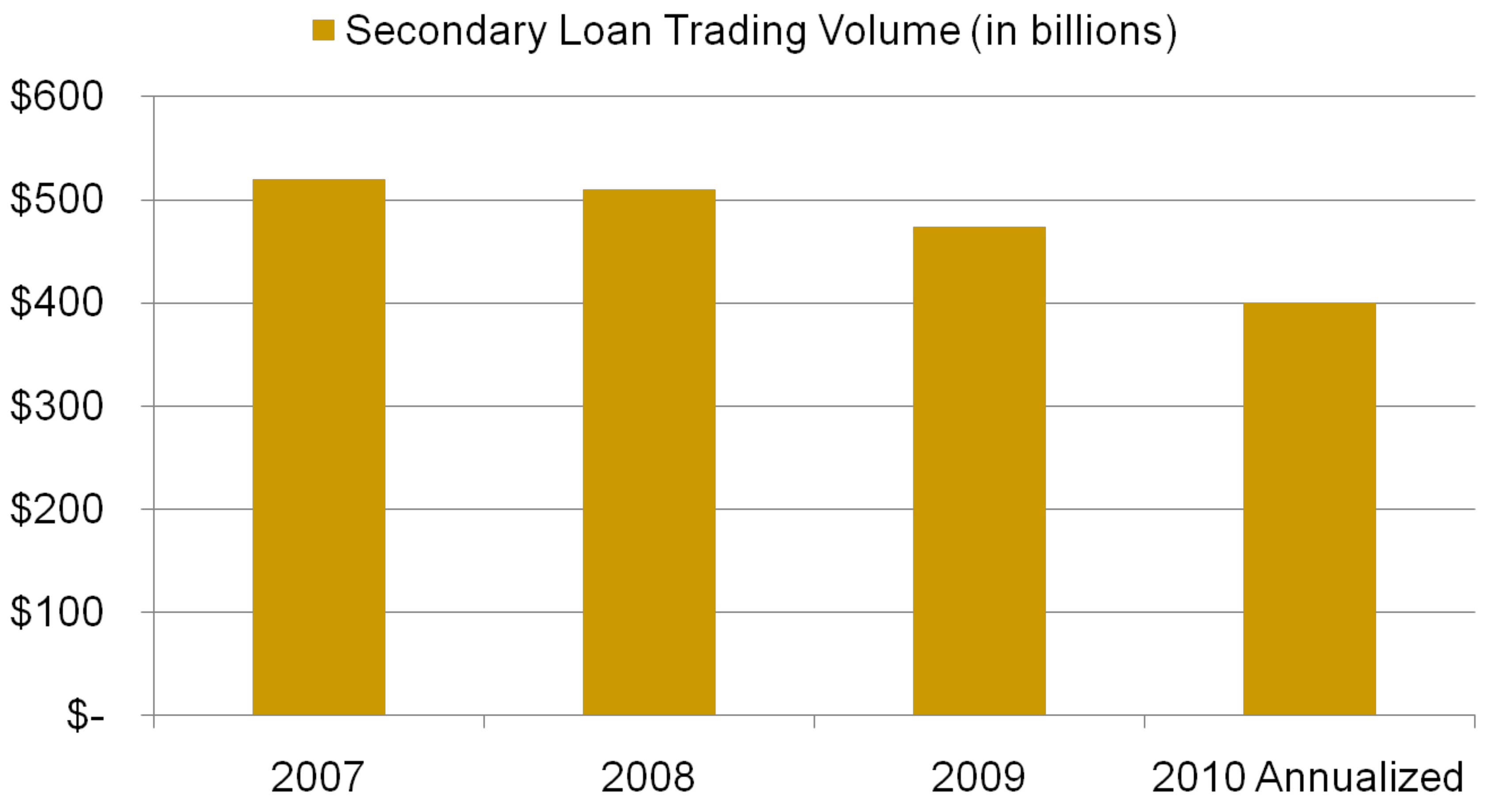


Commitment Fees of Revolving Credits 1998 – 3Q10



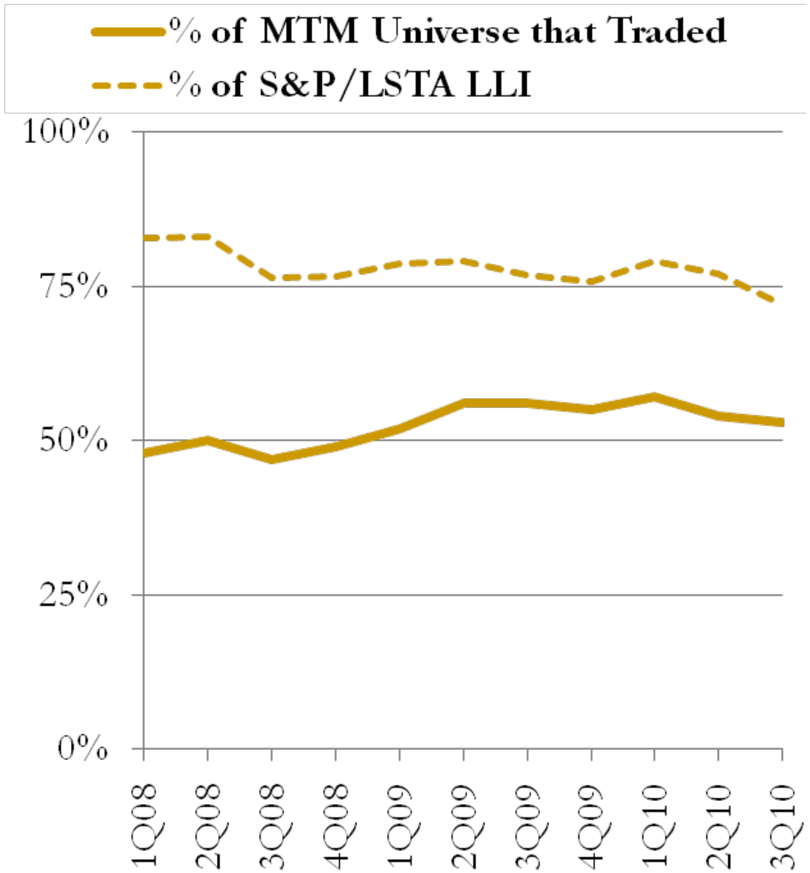
TRADING, LIQUIDITY AND SETTLEMENT

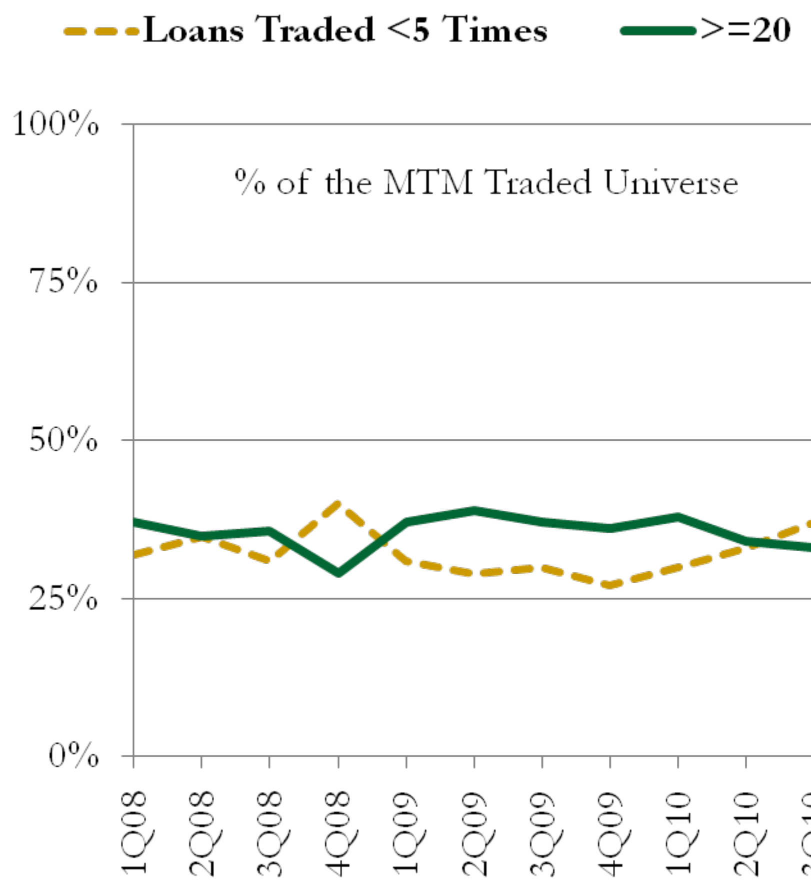
2010 Annual Secondary Loan Trading Volume is Estimated at $400 Billion



3Q10 Loan Market Breadth and Depth Reported Slight Declines

A Smaller % of the Loan Universe Traded and those Loans that Traded Did so Less Frequently





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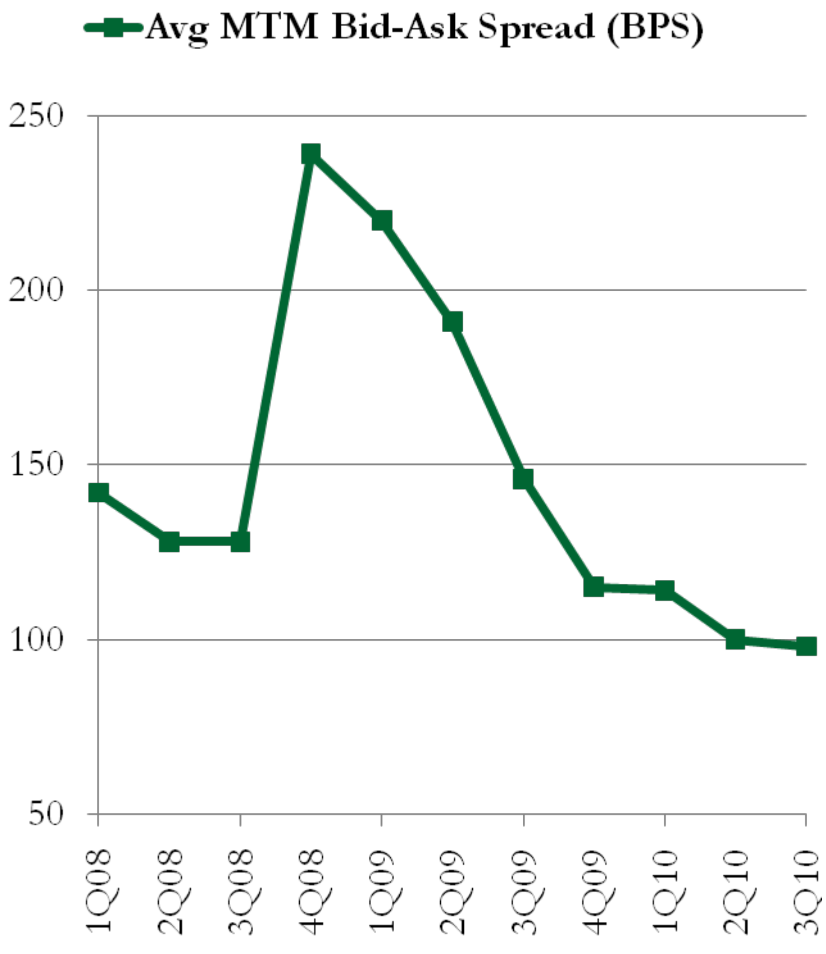
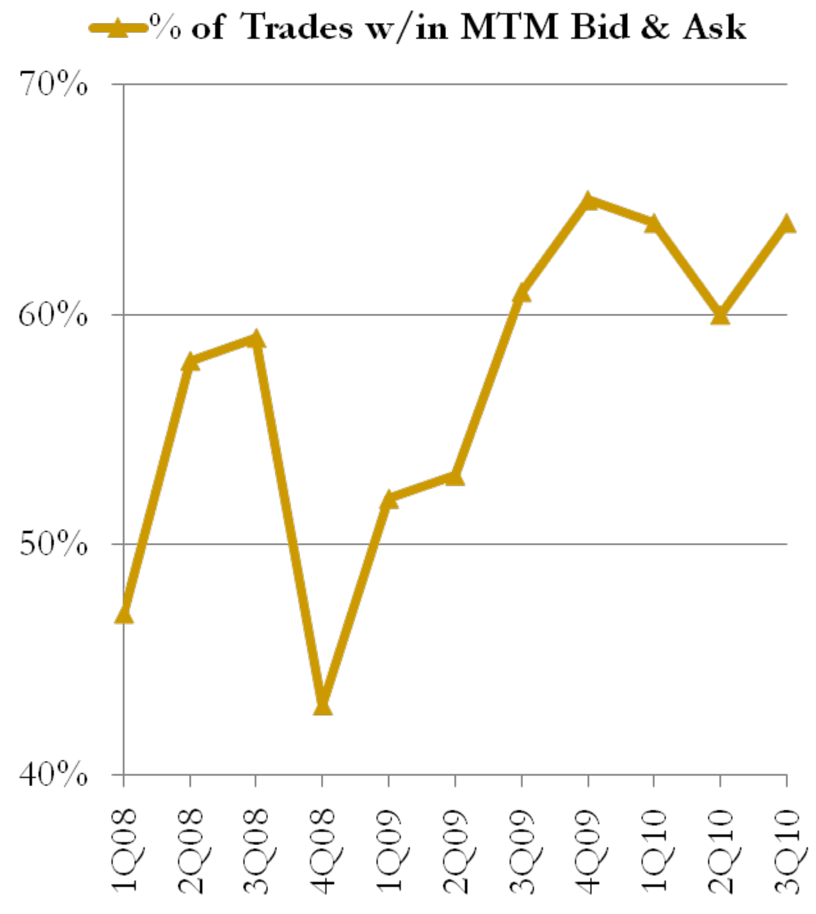
64% of 3Q10 Trades Took Place at a Price Within Their MTM Bid and Ask on Trade Date





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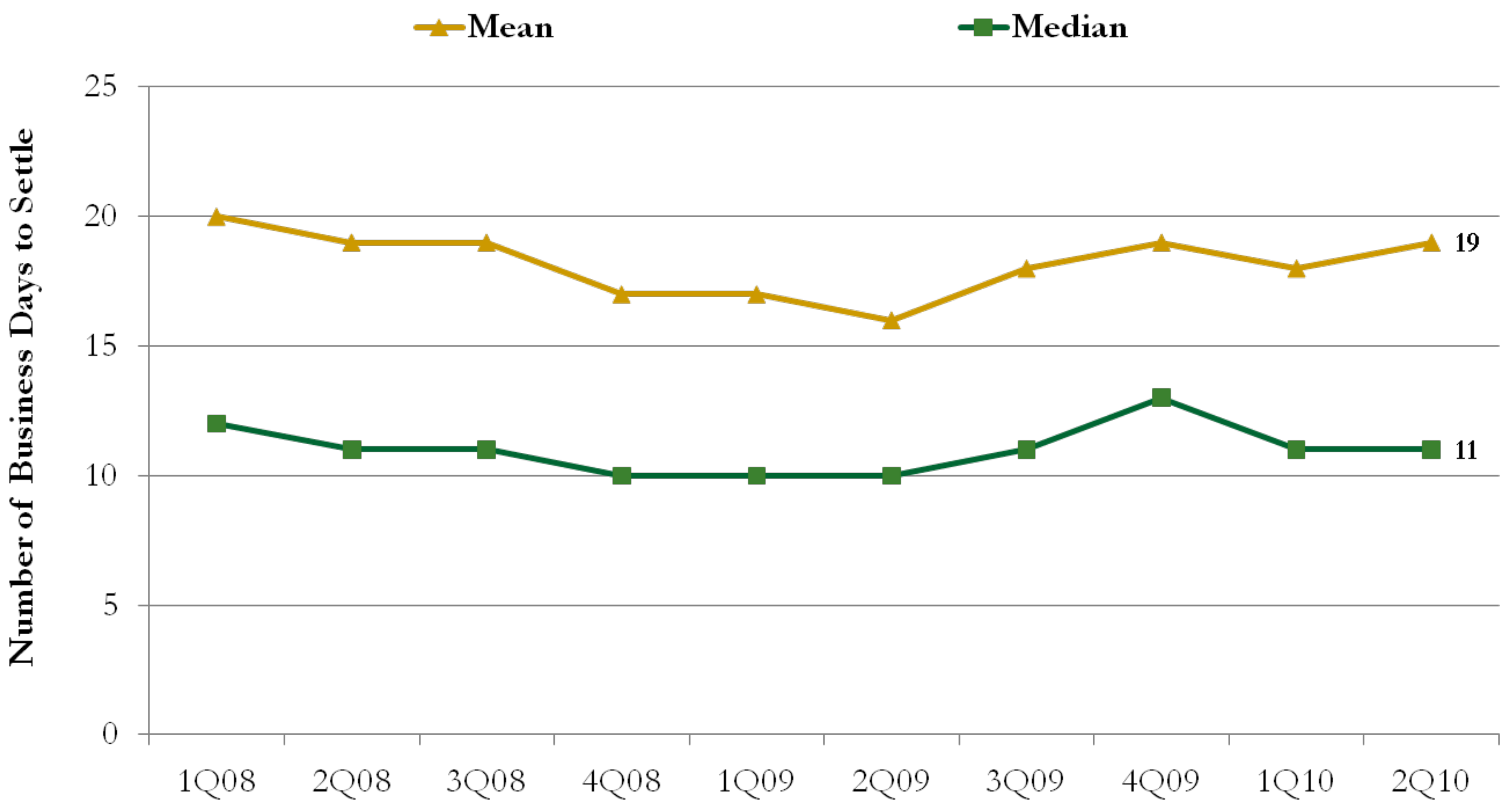
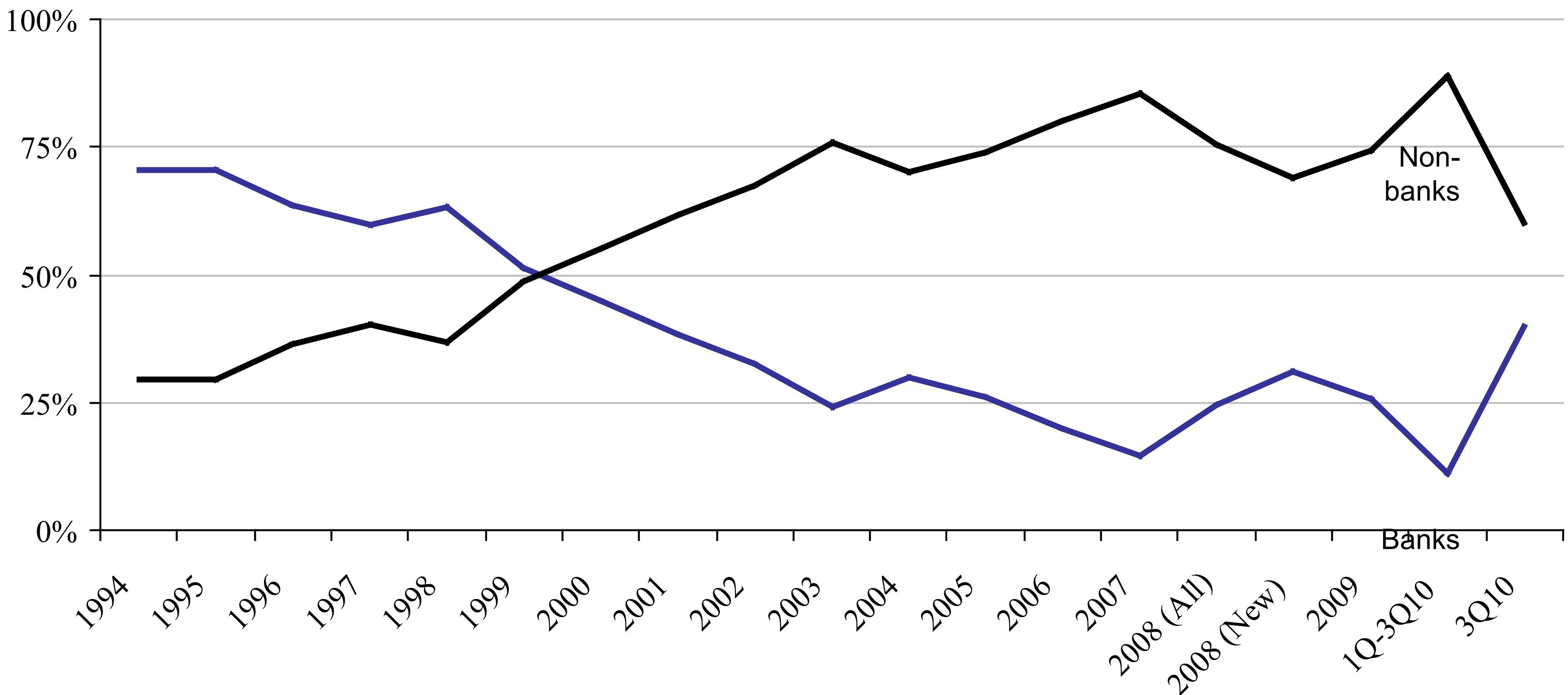
Par Settlement Times Increased to T+19 During 2Q10



BUYER COMPOSITION

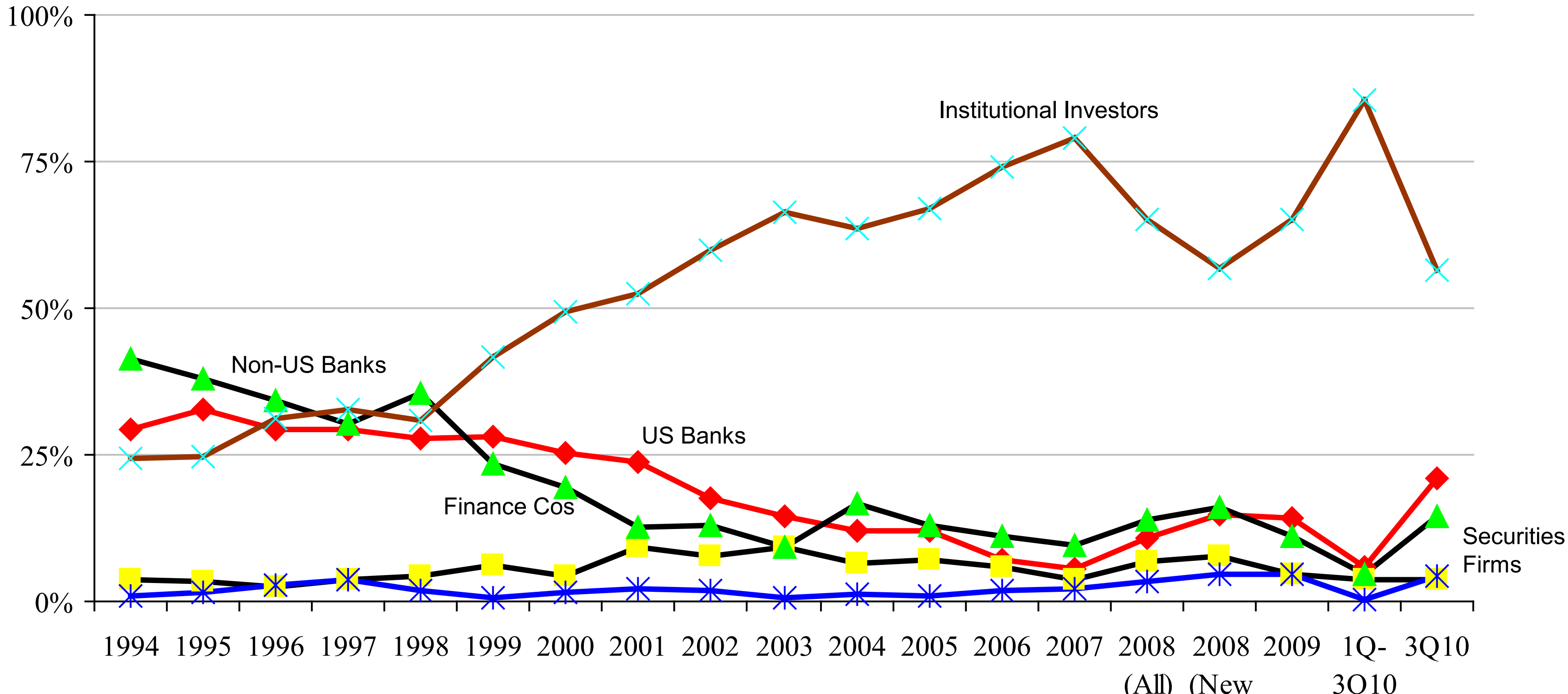
Primary Market for Highly Leveraged Loans: Banks vs Non-Banks

Non-banks include: institutional investors, insurance companies, finance companies and securities firms



Excludes all left and right agent commitments (including administrative, syndication and documentation agent as well as arranger)
For 2Q08, All Deals includes block sales like TXU while New Deals include only deals launched and structured this year

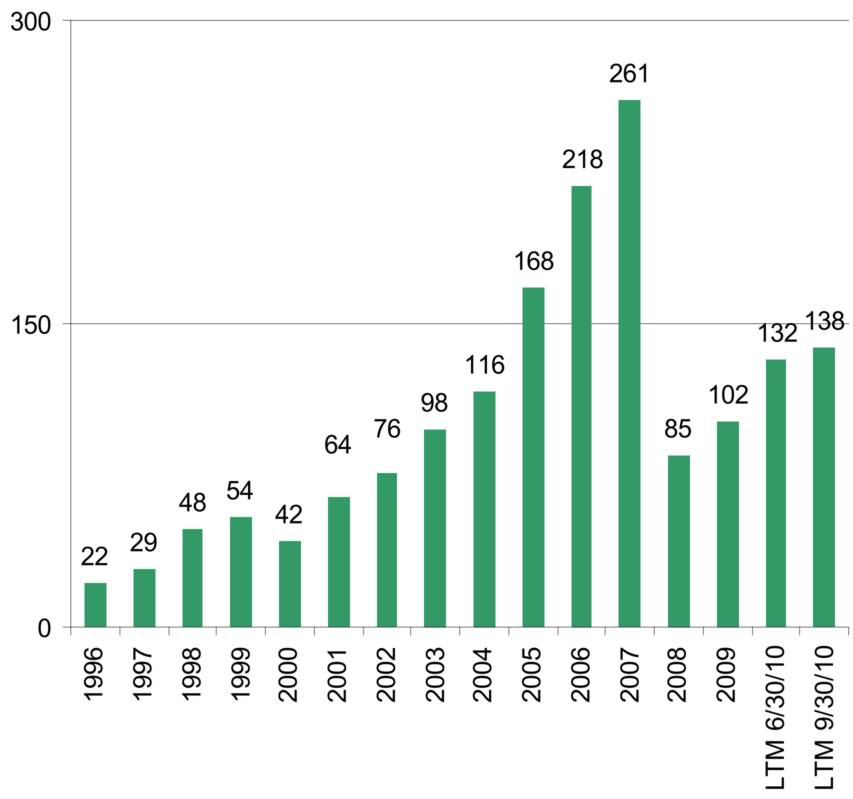
Primary Market for Highly Leveraged Loans by Broad Investor Type 1994 – 3Q10



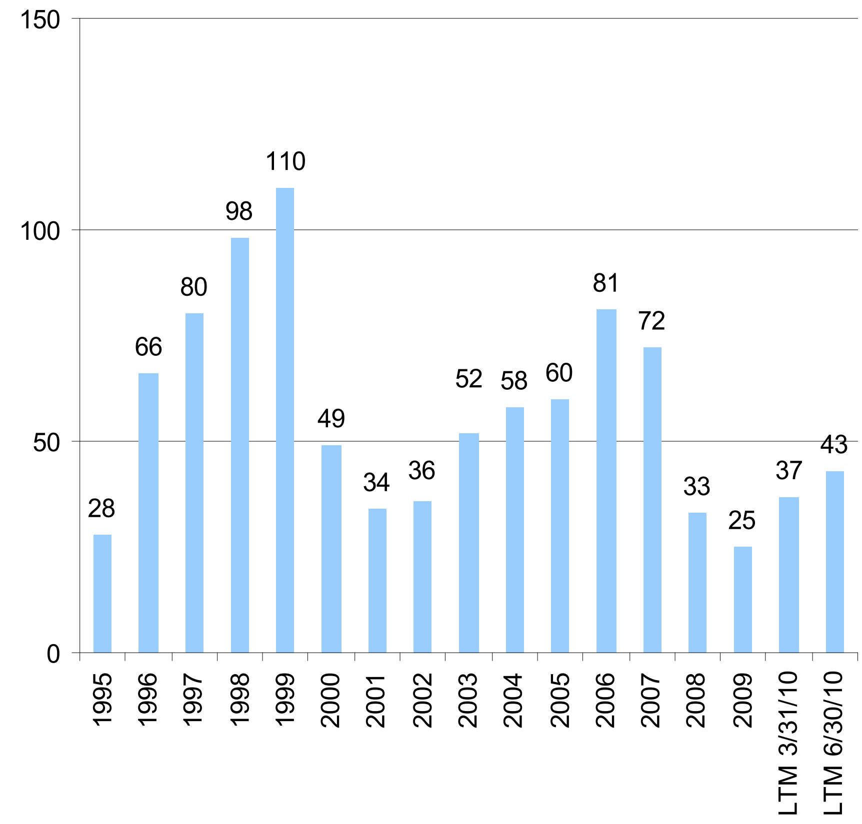
Excludes left and right agent commitments (including administrative, syndication and documentation agent as well as arranger)
For 1H08, All Deals includes block sales like TXU while New Deals include only deals launched and structured this year
* Excludes RC-only ABL's

Active Lenders in the Non-Investment Grade Loan Market

Investor Groups with >=10 Primary Commitments
(5 for 2009 and LTM 3/31/10 given the lack of volume)

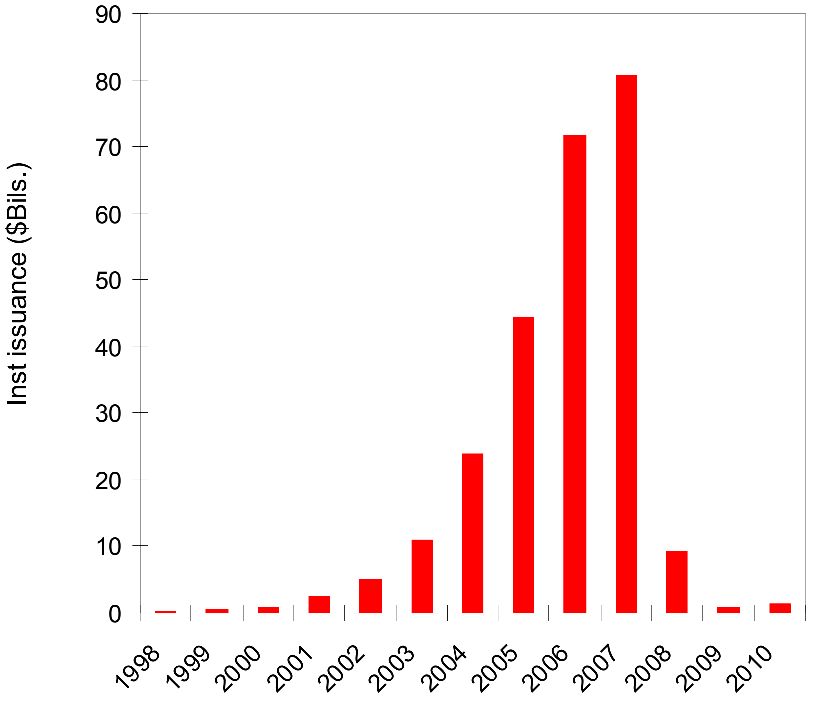


Bank lenders with >=10 Primary Commitments



Source: S&P/LCD

CLO Issuance



Source: Thomson Reuters LPC, S&P/LCD

QUESTIONS?