Guide to Secondary Loan Market Transactions

A Loan Market Association Guide
A LOAN MARKET ASSOCIATION GUIDE

A GUIDE TO SECONDARY LOAN MARKET TRANSACTIONS

Loan Market Association

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This "Guide to Secondary Loan Market Transactions" is not intended to be completely comprehensive. Rather, it seeks to provide an overview of the role of the secondary market in the syndicated loan market. Most importantly, this publication is not designed to provide legal or other advice on any matter whatsoever.

The Loan Market Association

The Loan Market Association (LMA) is the trade body for the Europe, Middle East and Africa (EMEA) syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 650, covering 60+ nationalities, and consists of banks, non-bank lenders, borrowers, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the EMEA loan market vis-à-vis lenders, borrowers, regulators and other interested parties.
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INTRODUCTION

Syndicated loans started as a way of allowing lenders to lend large sums of money to a single borrower, where the sums involved went far beyond the credit appetite of a single lender. Origination and syndication of the transaction take place in the primary market; it is where lenders lend directly to borrowers, with loans syndicated before the loan is made, or shortly thereafter.

Following completion of the transaction, the loan becomes "free to trade", subject to the terms and conditions contained in the primary documentation. The secondary loan market refers to the sale and distribution of syndicated loans by lenders in the original syndicate or by subsequent purchasers of the loan.

The secondary loan market has aided the growth of the syndicated loan market by opening the market to a wide variety of types of institution, including, amongst others, insurance companies, pension funds and hedge funds, fuelling an increase of liquidity within the primary and secondary markets. The secondary loan market is also an essential tool that lenders use to manage their loan portfolios.

The purpose of this guide is to provide an introductory overview of the secondary loan market. Amongst other things, this guide shall provide a (1) target timeline for a typical secondary loan market transaction, including a brief explanation of the documentation which may be entered into by the parties; (2) description of the parties active in the secondary loan market; and (3) description of the common methods used by lenders to transfer syndicated loan participations.
Section 1

DEVELOPMENT OF THE SECONDARY LOAN MARKET

The secondary loan market refers to the sale of loans that occurs after syndication of the original loan has been closed and allocated. It includes sales or trades of syndicated loans made by lenders in the original syndicate and those made by subsequent purchasers.

A lender under a syndicated loan may decide to sell all or part of its commitment in a facility for a number of reasons, including:

1. **Realising Capital**: if the loan is a long-term facility, a lender may need to sell its share of the commitment to realise capital and improve its liquidity to be able to take advantage of new lending opportunities;

2. **Risk Management**: a lender may consider that its loan portfolio is weighted with too much emphasis on a particular type of borrower, geography, industry or maturity. By selling its commitment in this loan, it may lend elsewhere, thereby taking advantage of new lending opportunities and diversifying its portfolio;

3. **Regulatory Capital Requirements**: a bank’s ability to lend is subject to both internal and external requirements to retain a certain percentage of its capital as cover for its existing loan obligations. The secondary loan market is becoming an increasingly important tool for lenders to actively manage their loan portfolios to comply with regulatory capital requirements; and

4. **Crystallise a loss**: the lender may decide to sell its commitment if the borrower runs into difficulties, thereby realising an immediate value for its commitment, rather than holding on to a commitment where there is no guarantee that the borrower will be able to repay its debt. In addition, a lender can incur substantial costs when monitoring a borrower in financial difficulty, for example, regularly reviewing the borrower’s overall financial position, reviewing its options should a borrower breach a term of the facility agreement, and analysing its rights vis-à-vis other creditors. Specialists dealing in distressed debt provide a market for such loans.

That said, there are a number of reasons that a buyer will want to acquire a commitment in a facility, including:

1. **Develop and expand relationships**: a primary lender may wish to increase its exposure to a specific borrower, thereby increasing its profile and developing its relationship with the borrower, so that it may take on the role of agent or arranger in future syndications and/or cross-sell products to the borrower. Additionally, lenders may use the secondary loan market to acquire a commitment in a facility that they were not a primary party to, to build a relationship with the borrower or other financial institutions;

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1 The application of capital ratios imposed by national regulators and EC directives, specifically by way of implementation of Basel II and Basel III, requires banks to maintain capital equivalent to a certain percentage of their risk-weighted assets, so that sufficient capital is available to support the bank against losses. For further information, see the LMA Guide "Regulation and the Loan Market".
2. **To make a profit**: traders seek to use the secondary loan market to make a profit, by selling on an acquired debt at a level higher than its purchase price, usually within a short space of time; and

3. **To own part of the debtor company**: specialist investors may buy a large portion of a borrower's debt, potentially with a view to acquiring control of the company. Alternatively, the investor may look to influence the borrower's insolvency or restructuring process. The investor may be making an investment on its assessment of the probability that the company will be successfully rescued, the ultimate aim being to profit from any subsequent upside in the value of the business. The investor may also be taking a view that the breakup value or recovery via insolvency will be sufficient to make a profit on its original investment.
Section 2

HISTORICAL DATA

The secondary loan market is a private market and data with regard to depth and liquidity is limited. There is no single data source to determine the actual volume of loans traded. Data which is available is collated on a contributor basis, via third party service providers, and reflects in the main only those transactions concluded on an intermediated basis, i.e. those trades which have passed through trading desks, rather than those traded directly between seller and buyer without the involvement of one of the banks contributing to the data collation exercise. A 12-year overview of reported volumes, for the years 2004 to 2017, is given below. Given the limitations as described, the expectation would be that actual traded volumes are somewhat higher.

Over the last 12 years traded volumes as reported have been dominated by leveraged finance. A breakdown of reported EMEA volumes in 2016 and 2017 are given below.
Section 3

MARKET PARTICIPANTS

Up to the mid-1990s, participation in the secondary loan market in Europe was dominated by a small number of US houses, predominantly investment banks, specialist debt traders and vulture funds, with activity focused on the distressed market. However, from the mid-1990s onwards, institutional investors and other non-bank financial institutions increasingly looked to the secondary loan market to invest their money. Today's secondary loan market is utilised by a diverse and vast number of participants, including investment banks, commercial banks, hedge funds, pension funds, private equity funds and specialist loan brokers, each looking to transact in par, near par and/or distressed debt.

In the distressed market, the diversification and growth in the number of participants follows from the diversification and growth in the number of participants in the leveraged finance market generally. In addition, government agencies, such as the Irish National Asset Management Agency (NAMA), were set up to buy non-performing debt as a result of the 2007-2009 financial crisis.

Although there are no statutory or conceptual barriers to a borrower, or its associated companies, buying back its own debt, there may be practical or commercial difficulties in its doing so. We will not explore the possibility of borrower-buy backs in this guide.
Section 4

TYPES OF DEBT

A. PAR AND NEAR PAR DEBT

Par value or near par value loans are traded at or very near to (and in some cases above) their face value. These are loans that the market considers to be extremely likely to be repaid on time and in full. The secondary loan market in par debt is particularly useful for lenders that wish to change the focus of their lending portfolio by concentrating on, or diversifying away from, particular borrowers, countries or types of business. The purchase of debt may also be used to build a relationship with specific borrowers or particular lenders in a syndicate, especially if the buyer was unable to participate in the original syndication.

B. DISTRESSED DEBT

Distressed debt (also known as "impaired debt" or "sub-performing debt") refers to loans that are unlikely to be repaid in full because the borrower is either in a form of insolvency process or in severe financial distress. Distressed debt typically trades at a significant discount to face value. A buyer will take a view on the likelihood that either a portion of the debt will be repaid as part of the insolvency settlement or that the borrower will recover and the loan will eventually be repaid in full.

In some cases, the buyer will buy enough debt to secure influence in the borrower's insolvency or restructuring process, perhaps ultimately assuming control of the borrower. In the latter case, the buyer will make its investment decision based also on its ability to rescue an insolvent or distressed company.
Section 5

ANATOMY OF AN LMA TRADE

A. STAGES OF AN LMA TRADE

Assuming that a trade commences when either a prospective Seller decides to sell an asset or a potential Buyer decides that it wishes to acquire a particular loan asset, a trade breaks down into a number of relatively well-defined stages.

I. Identify the counterparty

Parties must be aware of any restrictions contained in the underlying credit documentation regarding the type of entity to whom loans can be transferred (by novation) or assigned. There is generally less of an issue where the 'sale' is to be by way of participation, although occasionally credit documentation does impose restrictions on participations as well as transfers and assignments. In addition, parties should be aware that there may be restrictions regarding the minimum amount a lender can transfer and the minimum amount a lender must hold.

II. Confidentiality

Once potential counterparties have been indentified the question of confidentiality arises, as the prospective buyer will wish to undertake due diligence on the loan asset it is acquiring. In most instances, the underlying credit documentation will impose a duty on all parties to maintain the confidentiality of the terms of the transactions and the credit documentation, explicitly setting out the instances in which confidential information may be disclosed. However, where English law applies and credit documentation is silent on the subject of disclosure, borrower consent must be obtained before any disclosure of information relating to the borrower, the group or the financing received, including copies of the credit documentation, can take place. Note that this need to obtain consent where the credit documentation is silent on the subject of disclosure applies irrespective of whether a confidentiality agreement is entered into between the prospective seller and buyer.

III. Due diligence

A prospective buyer is expected to have carried out all necessary due diligence prior to the trade date and any relevant "know your customer" checks. Due diligence by a prospective buyer cannot, of course, start until the required confidentiality agreement has been entered into. Once entered into, the seller can provide the buyer with the necessary information, including copies of the credit documentation and financial information.

Having acquired the relevant information, the buyer will then seek credit approval to purchase the asset.

IV. The Trade

Once credit approval is obtained, the seller and the buyer should be in a position to carry out a trade. This will normally be done over the phone. Unless the parties explicitly stated that the trade is

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2 See the "LMA Transparency Guidelines" for further information on confidentiality issues market participants should consider when looking to trade in the secondary loan market.
subject to contract, there should be a binding contract at the time of the oral trade (the Trade Date).

The key terms usually agreed orally at the time of the trade include:

- the price paid – is it at par, a premium (i.e. above face value) or a discount;
- the facility and specific tranche – a borrower could have a number of multi-tranche facilities in the market at any one time. Parties will therefore want to ensure that they are both looking to trade the same tranche of the same facility;
- amount – whether the buyer is purchasing the whole of the seller’s commitment, or just a portion of it. This could impact how any voting rights are apportioned;
- the form of purchase – whether the trade is to settle via legal transfer only, via legal transfer with a fall-back option to funded participation or directly via funded participation;
- the target settlement date - being the date on which the trade is physically settled, the default target date being as soon as reasonably practicable;
- the treatment of interest payments and fees – the treatment of any unusual fees, such as repayment premiums, should be expressly agreed as a trade specific term; and
- trade specific representations and warranties.

V. The Confirmation

The trade confirmation (the Confirmation) is designed to record the terms of the trade as agreed orally. It is envisaged that at the time of the oral trade, the seller and buyer will agree all those matters which are required to be decided in order to complete the Confirmation, including which of the parties is to prepare it. The party charged with that responsibility is referred to as the Responsible Party. The Confirmation is to be completed by the Responsible Party and sent to the other party, usually within two business days of the Trade Date. The other party is required either to sign and return the Confirmation to the Responsible Party or to raise any disagreement with any of the terms of such Confirmation, usually by no later than the end of the second business day after delivery of the Confirmation. It should be noted that the Confirmation is intended solely to evidence the terms that were agreed at the time of the trade; it is not intended to be subject to negotiation in its own right.

VI. Third party consents

Consents of third parties, most commonly the borrower, may be required. However, since restrictions on the ability to transfer debt affect the marketability of the debt, facility agreements

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3 In *Bear Stearns Bank plc v Forum Global Equity Ltd* [2007] EWHC 1577 (Comms), the High Court held that parties to a distressed debt trade concluded a contract during a telephone conversation, when the price for the trade was agreed but the settlement date was not; transactional documentation was to be prepared by the parties’ respective lawyers following the call. The case is significant because it endorses distressed debt market practice and gives certainty to oral trades.
will often include a requirement that the borrower does not unreasonably withhold consent. In some cases, facility agreements provide for "deemed consent" to operate in specified instances, for example, a transfer of debt to an institution within a designated class could be effected without borrower consent.

Where consent is required, the seller should apply (via the Facility Agent) for any such consent on, or as soon as practicable after, the Trade Date. The refusal of any necessary consent will not lead to the transaction being terminated without any liability of either party. Instead the seller and buyer will be required to settle the proposed transaction by a funded participation or by some mutually acceptable alternative means which provides the seller and buyer with the economic equivalent of the agreed-upon trade; this is founded on the principle that a "trade is a trade".

VII. Transaction documentation

The parties choose who is to prepare the documentation required to complete the transaction, with parties looking to execute the transaction documentation as soon as reasonably practicable after the Trade Date. Documentation will include transfer certificates, usually in the form scheduled to the underlying facility agreement, and pricing letters, which detail the various fund transfers required, including payments to the agent and between the buyer and seller.

VIII. Settlement date

If the facility is documented using an LMA facility agreement and the transfer is by way of novation, the trade is legally completed on the later of the date specified in the transfer certificate and the date the transfer certificate is signed by the Agent (the Settlement Date). In all other cases, the trade is legally completed on the settlement date agreed by the parties. The asset is transferred to the buyer and, unless the trade is to be completed by way of risk participation, the settlement amount is required to be paid. Depending on the circumstances and the nature of the asset, the settlement amount may be required to be paid by the buyer to the seller or by the seller to the buyer or, in some cases, two way payments may be required. The settlement amount is adjusted to take account of any delayed settlement compensation, being a mechanism used to put the parties in the economic position they would have been in had the trade settled within the timetable recommended by the LMA (10 Business Days after the Trade Date for par and 20 Business Days after the Trade Date for distressed). The settlement amount will also be adjusted for any principal repayments received from the borrower by the seller between Trade Date and Settlement Date.

IX. Post-settlement date

Any notices which need to be given, or other matters which need to be carried out, should be done as soon as possible after the Settlement Date. This may, for example, include giving notice to the borrower that the assignment is complete and/or registration of the buyer as a secured party in overseas jurisdictions.

X. Secured Debt

Most secured loans traded in the secondary loan market will be syndicated loans that are part of
multilateral financing structures, which will often include a security trust arrangement. In a syndicated loan, which is documented under English law, a security trustee is typically appointed to hold security on trust for all the lenders from time to time. The incoming lenders take the benefit of the security on completion of the trade without any need for any amendments to the security documents or additional registration, as the security itself remains untouched.

The use of a security trust arrangement avoids the need for the security to be assigned or for new security to be taken when a loan is transferred. New security would trigger a new registration requirement and, in the event of insolvency, this fresh security would be particularly susceptible to challenge during any hardening periods.

In most cases, once a transfer occurs in accordance with the provisions of the facility agreement, the incoming lender becomes a Finance Party and as such, a beneficiary of the security. However, in some cases, the incoming lender may also be required to accede to a security trust deed and/or intercreditor agreement to ensure that they also agree to be bound by the terms of those documents. The form of the accession is usually contained in a schedule to the security trust deed and/or intercreditor agreement.

Note that where there are non-English Obligors and/or there is security which is not governed by English law, the security trust arrangement may not be recognised in the relevant jurisdictions. This can be problematic for transfers of the loan and related security.

B. TIME-LINE

Set out below is a target time-line for a straightforward secondary loan market trade, showing the points at or by which the parties should aim to enter into the various documents to a trade.

<table>
<thead>
<tr>
<th>T – x</th>
<th>KYC requirements satisfied</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Buyer and Seller exchange Confidentiality Letters (if necessary)</td>
</tr>
<tr>
<td></td>
<td>Buyer commences due diligence on Credit Documentation (if required)</td>
</tr>
<tr>
<td>T</td>
<td>Trade Date – oral agreement of the trade (or, as the case may be, written agreement of the trade (e.g. by email))</td>
</tr>
<tr>
<td>T + 1</td>
<td>Seller sends:</td>
</tr>
<tr>
<td></td>
<td>• Request to Agent for Borrower consent</td>
</tr>
<tr>
<td></td>
<td>• Credit Documentation to Buyer (unless sent before Trade Date)</td>
</tr>
</tbody>
</table>

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4 A security trust is a trust that is used to hold security over an obligor’s assets that are secured in favour of a trustee (the security trustee) for the benefit of the obligor’s lenders as beneficiaries. Note that in some jurisdictions a trust structure is not appropriate or legally possible, it is therefore important to take local legal advice before implementing such a structure.
<table>
<thead>
<tr>
<th>Time</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>T + 2</td>
<td>Responsible Party sends Confirmation to Other Party</td>
</tr>
<tr>
<td></td>
<td>Agent sends consent request to Borrower</td>
</tr>
<tr>
<td>T + 4</td>
<td>Other Party returns Confirmation to Responsible Party</td>
</tr>
<tr>
<td>T + 5</td>
<td>Responsible Party sends Transaction Documentation to Other Party</td>
</tr>
<tr>
<td>T + 7</td>
<td>Borrower’s approval of trade</td>
</tr>
<tr>
<td>T + 7 (Par Trade)</td>
<td>Both parties sign Transaction Documentation – deliver to the Agent</td>
</tr>
<tr>
<td>T + 15 (Distressed Trade)</td>
<td></td>
</tr>
<tr>
<td>T + as soon as reasonably practicable</td>
<td>Settlement Date</td>
</tr>
<tr>
<td>T + 10 (Par Trade)</td>
<td>If applicable, delayed settlement compensation starts to accrue</td>
</tr>
<tr>
<td>T + 20 (Distressed Trade)</td>
<td></td>
</tr>
<tr>
<td>T + 60 (Par Trade only)</td>
<td>Buy-in/Sell-out applies if one party fails to perform its Settlement Delivery Obligations</td>
</tr>
</tbody>
</table>
Section 6

TRANSFER MECHANISMS

English law provides several legal techniques to transfer a loan to a third party. The most common forms of transfer to enable a lender to sell its loan commitment are:

I. novation (the most common legal mechanic using transfer certificates scheduled to facility agreements);

II. legal assignment;

III. equitable assignment; and

IV. sub-participation.

Methods (I) and (II) result in the lender disposing of its loan commitment, with the new lender assuming a direct contractual relationship with the borrower, whilst methods (III) and (IV) result in the lender retaining a contractual relationship with the borrower. Each of these methods is examined in more detail below.

A. Novation

Novation is the only way in which a lender can effectively 'transfer' all its rights and obligations under the facility agreement. The process of transfer by novation effectively cancels the existing lender's obligations and rights under the loan, while the new lender assumes identical new rights and obligations in its place.

The contractual relationship between the transferring lender and the parties to the facility agreement ceases and the new lender enters into a direct relationship with the borrower, the agent and the other lenders. At the time the new lender becomes a party to the facility agreement the loan could be fully drawn, particularly if it is a term loan facility. However, particularly in the case of a revolving credit facility, the new lender could be assuming obligations to advance monies to the borrower.

All of the parties to the original syndicated facility agreement, including the borrower, need to consent to the novation. The documentation required to effect a novation of a participation in a syndicated loan depends on the provisions in the facility agreement. However most facility agreements (including the LMA recommended form) contain comprehensive novation provisions in which all parties (including the borrower) agree that, provided the other conditions to any transfer by novation set out in the facility agreement are complied with, they consent to the novation. Most transfers by novation are effected by the execution of a transfer certificate.⁵ The form of Transfer Certificate is usually attached as a schedule to the facility agreement. The agent, the new lender and

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⁵ In Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd [2010] EWCA Civ 1335, the Court of Appeal confirmed that parties may give their consent to novation in advance, provided that the scope and the terms of the new contract are sufficiently clear and specific. The decision is not binding (it was an interlocutory appeal) but it provides comfort that the standard practice of obtaining consent in advance in many lending transactions is effective.
the existing lender are the only parties usually required to execute the transfer certificate.

B.   Legal Assignment

An assignment involves the transfer of rights, but not obligations, under a contract. In the context of the syndicated loan, a legal assignment will transfer all of the existing lender's rights under the facility agreement (including the right to sue the borrower and the right to discharge the assigned debt) to the new lender. The obligation of the existing lender to provide funds to the borrower cannot be transferred by legal assignment and thus remains with the existing lender. Similarly, the obligations of the existing lender to the other finance parties cannot be assigned. The new lender therefore usually provides an indemnity to the assignor and the other finance parties that it will assume those obligations as if named as a lender under the facility agreement.

In order to be a legal assignment, s.136 of the Law of Property Act 1925 provides that the assignment must be:

- absolute (i.e. an unconditional transfer);
- a transfer of the whole of the debt outstanding to the existing lender, and not just part of the debt;
- in writing and signed by the existing lender; and
- notified in writing to the borrower and any other obligor under the facility agreement.

If any element of this requirement is missing, the assignment is likely to be equitable rather than legal (see Section 5.C below).

C.   Equitable Assignment

As mentioned above, an equitable assignment is created when one or more of the provisions of section 136 of the Law of Property Act 1925 is not met, provided the intention to assign is present between the parties. This means that the new lender will obtain a beneficial interest in the debt.

In contrast to a legal assignment, the new lender, as the equitable assignee, must join the existing lender, as assignor, in any action on the debt. The most significant difference between a legal and equitable assignment arises if the borrower is not notified of the assignment. In this instance, the new lender will be subject to all equities (for example, mutual rights of set-off) which arise between the existing lender and the borrower, even after the loan has been assigned.

D.   Sub-participation

A sub-participation is essentially a contractual agreement between the lender and the participant to make funding arrangements. It is an entirely separate contract from the underlying facility agreement and does not involve the transfer to the buyer of a legal or beneficial interest in the debt. The participant will, therefore, not have any directly enforceable rights against the borrower. Borrower consent is not usually required and so this method can be confidential.

A sub-participation may take one of two forms:-
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I. Funded participation

Under a funded participation the existing lender (the grantor) and the participant enter into a contract providing that, in return for the participant paying the grantor an amount equal to all or part of the principal amount loaned by the grantor to the borrower, the grantor will pay the participant an amount equal to all or the relevant share of principal and interest received by the grantor from the borrower in respect of that amount.

In a funded participation, the participant agrees that its deposit will be serviced (in terms of payment of interest) and repaid only when the borrower services and repays the loan from the grantor. The funded participation agreement must ensure that the grantor is put in funds in time to meet the borrower’s demands for drawdown. Therefore, the participant takes a double credit risk, that of the borrower failing to pay and of the grantor failing to pay.

II. Risk participation

Under a risk participation, the risk participant will not immediately place any money with the grantor, but will agree, for a fee, to put the grantor in funds in certain circumstances (typically on any payment default by the borrower). The grantor therefore exchanges the credit risk of the borrower for that of the participant. Risk participation is therefore akin to a guarantee for the loan, and may be provided by a new lender as an interim measure before it takes full transfer of a loan.

There is no direct contract between the participant and the borrower, but the participant usually obtains rights of subrogation. Therefore if the participant has to pay the grantor as a result of the borrower’s default, the participant gains the right to step into the grantor’s shoes and pursue all remedies of the grantor against the borrower.
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The secondary loan market has aided the growth of the syndicated loan market by opening the market to a wide variety of types of institution, fuelling an increase of liquidity within the primary and secondary markets. The secondary loan market is also an essential tool that lenders use to manage their loan portfolios.

The aim of this paper is to provide an overview of the role of the secondary market in the syndicated loan market, identifying, amongst other things, participants active in the secondary loan market, the types of debt available, a typical anatomy of a trade and the different transfer mechanisms.