SENIOR BANK LOANS

Access to secured debt at floating interest rates

A low volatility profile combined with positive returns during turbulent stockmarket periods have led to senior bank loans being given allocations ahead of high-yield securities in investors' portfolios. But what are the characteristics of this asset class, and what are the available investment opportunities?

Senior bank loans[1] are loans made to non-investment grade companies primarily to finance acquisitions, refinance existing debt, support organic growth, or pay out dividends. Senior bank loans are originated by large, money centre banks and are then syndicated out to institutional investors (CLOs, mutual funds, hedge funds, insurance companies, pension funds, etc.) as well as to other banks. The size of these loans can vary from €50m to well over €3bn.

The senior bank loan market historically had been dominated by commercial banks. However, as bank regulatory capital requirements for loans increased, and commitment and underwriting fees were pushed down by increased competition, institutional investors have entered the market on a large scale. In the US, this development started in the early 1990s, while in Europe it has begun much more recently. Today, commercial banks are using their loan operations to earn fees and to bring in additional sources of revenue (cash management services, M&A advisory work, etc.).

Figure One: The Senior Bank Loan Market

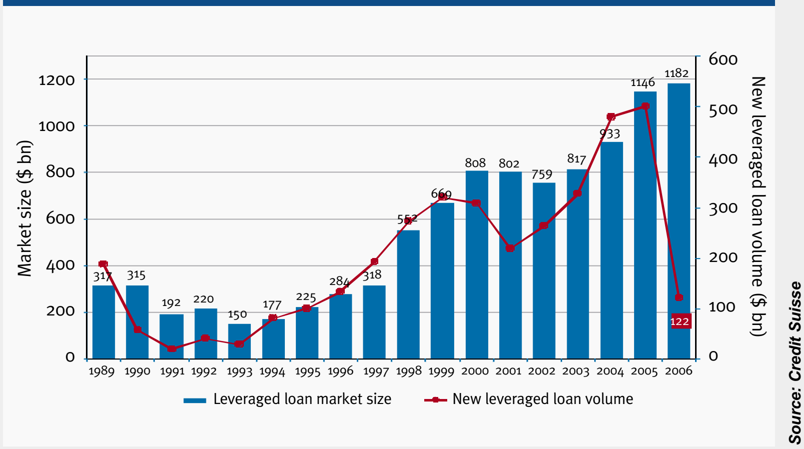


Figure Two: Capital structure of non-investment grade company

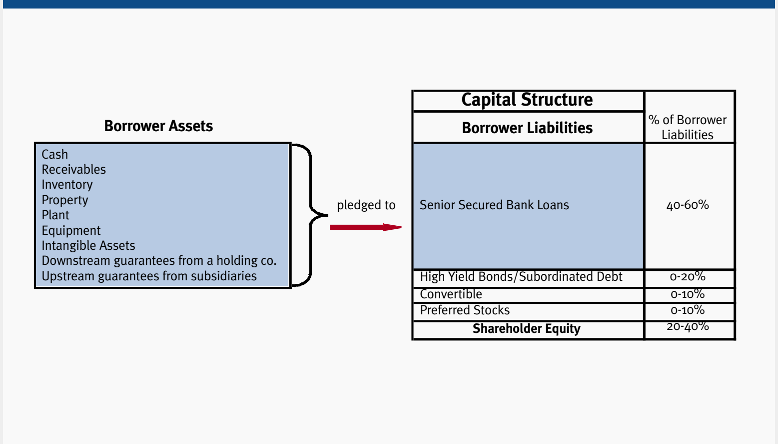


Figure One shows the primary issuance volumes and size of the asset class in the past 17 years for the US. As the chart shows, the senior bank loan market has grown significantly since 1989, and it continues to grow both in the US and Europe. Currently, the total size of the US senior bank loan market is roughly $1.2trn, while the European market is roughly €280bn. In the US, institutional investors comprise almost 75 per cent of the investors in this asset class, while traditional banks make up only 25 per cent. In Europe, institutional investors comprise 40 per cent of the investors in this asset class, vs 60 per cent for banks, although this is changing in favour of the institutional investors in Europe.

CHARACTERISTICS

Senior bank loans are senior secured floating rate debt instruments. In a borrower's capital structure, they are typically senior to all other debt and they are secured by the assets of the company. Figure Two shows the simplified capital structure of a non-investment grade company.

An important aspect of senior

bank loans is that they are floating rate, not fixed rate. Senior bank loans pay interest at rates that represent a fixed spread (typically 150 basis points or more, depending upon the credit quality of the loan) over the London Inter-Bank Offered Rate (Libor), and these rates reset periodically, usually monthly or quarterly.

As a result, senior bank loans have an ultra-short interest rate duration, making them a natural hedge against fluctuations in short-term interest rates. Because their interest rates float, senior bank loans always pay at market rates, so the underlying principal value of a senior bank loan is relatively insensitive to changes in short-term rates.

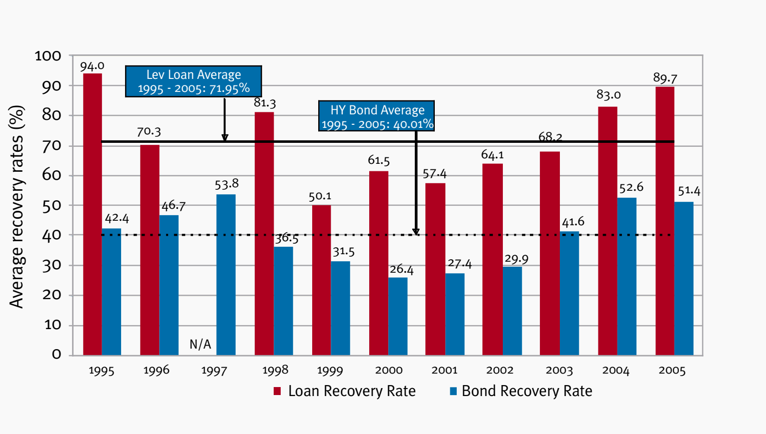
Another important aspect of senior bank loans is that they are secured by the assets of the borrower. In default situations, senior bank loans historically recover significantly more than unsecured high yield bonds (see figure three).

The floating rate nature of senior bank loans, combined with their senior secured position in a borrower's capital structure, produce a very low volatility profile. Figure Four shows the volatility of several asset classes. Senior bank loans are represented in the chart by the S&P/LSTA Index.

In addition, senior bank loans historically have produced positive returns, even in the turbulent years of 1998 and 2001/2002. Figure Five shows how senior bank loans, unlike high yield bonds, have never experienced a negative return year.

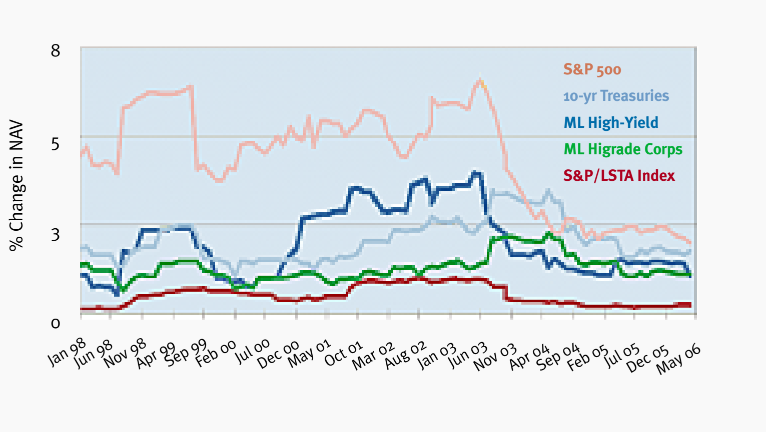
Lastly, senior bank loans exhibit very low correlation to other asset classes. Figure Six shows the correlation to several common investment categories.

Figure Three: Recovery Rates



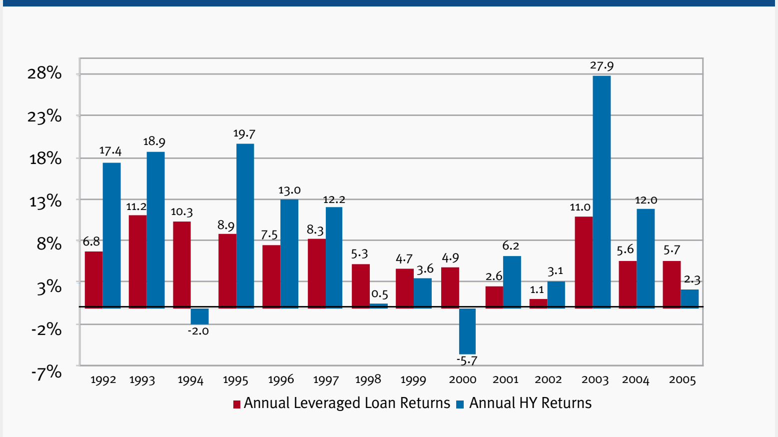
Source: Credit Suisse

Figure Four: Asset Class Volatility



Source: Credit Suisse

Figure Five: Ann. Leveraged Loan Returns vs Ann. High Yld Returns



Source: Credit Suisse

INSTITUTIONAL INVESTORS

For institutional investors, diversification is an important method to enhance performance relative to risk. Institutional investors are investing in senior bank loans because of their unique risk/return characteristics (low volatility vs relative high returns amongst others) and diversification (low correlation vs other asset classes). This distinctive pattern of returns produces low correlation benefits with respect to most other asset classes, making a position in senior bank loans particularly valuable in terms of its potential contribution to the diversification of institutional portfolios.

OPPORTUNITIES

Senior bank loans provide high

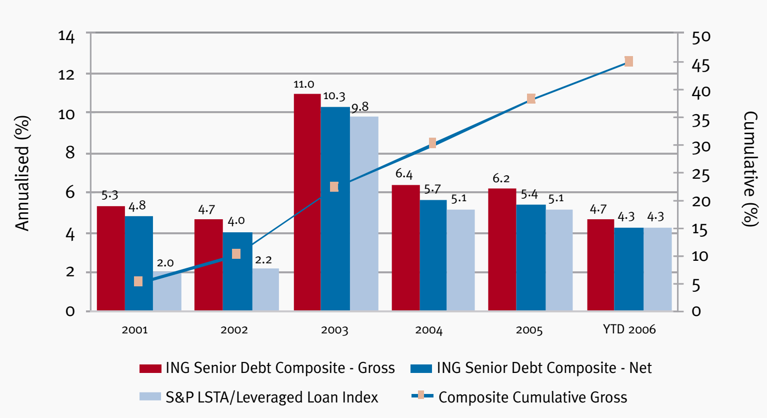
"INSTITUTIONAL INVESTORS ARE INVESTING IN SENIOR BANK LOANS BECAUSE OF THEIR UNIQUE RISK/RETURN CHARACTERISTICS (LOW VOLATILITY VS RELATIVE HIGH RETURNS) AND DIVERSIFICATION (LOW CORRELATION VS OTHER ASSET CLASSES)"

Figure Six: Correlation to Other Asset Classes

Asset Class	Correlation Coefficient
Citigroup High Yield Cash Pay (LOC)	0.58
Lehman 1-3 Year US Treasury	-0.3
Lehman US Aggregate	-0.15
Lehman US Treasury	-0.21
Lehman US Treasury Bellwethers: 3mo.	-0.06
MSCI EAFE - Gross Return	0.27
Russell 2000 - Total Return	0.36
S&P 500 - Total Return	0.19
S&P/LSTA Leveraged Loan Index	1

Source: Credit Suisse

Figure Seven: ING Senior Debt Composite Performance



Source: ING Investment Management; S&P/LSTA

risk-adjusted total return with relative low volatility. Within the senior bank loans asset class, a security selection approach focused on top tier quality non-investment grade loans (B to BB+) implemented by experienced credit analysts within a disciplined research and risk management framework can produce superior long-term, risk-adjusted performance.

Since credit risk is the primary risk to a portfolio of senior bank loans, the portfolio management teams of sector specialists combine fundamental credit analysis with extreme diversification and an emphasis on highly liquid loans to construct the portfolios.

The ING Senior Debt Composite has industry leading alpha ratios and sharp ratios and significantly lower default rates than the benchmark S&P/LSTA index. As shown in figure seven, their strategy has also produced returns that have consistently outperformed the benchmark on a gross returns basis.

The developments in the European loan market have triggered interest from European institutional investors, and have created opportunities for further diversification. This has led to the establishment of ING International (II) – Senior Bank Loans Euro, a euro-denominated senior bank loan fund, in September 2005 and the establishment of the ING Senior Debt Team Europe in early 2006.

Based on the low correlation, excellent risk/returns characteristics and low volatility, an investment in senior loans enhances your risk return profile and thereby deserves a place in your portfolio.

Marten-Pieter van Harten, product specialist fixed income at ING Investment Management

[1] When talking about loans in this article, it only refers to non-investment grade senior bank loans