Structured Finance and Commercial Banks' Emergence as Loan Conduits

The emergence of *structured finance* products over twenty-five years ago enabled major commercial banks and investment houses to develop higher volumes of real estate, credit cards, automobiles and other asset-based loans in new and often more profitable ways. Historically, lenders normally generated these types of loans as *portfolio loans*, where the bank kept and monitored these loans on its own balance sheet and at its own risk. But beginning in the late 1980's, banks began to investigate taking an *intermediary* or *conduit* role for certain types of loan portfolios. When generating loans which met the advance underwriting criteria of large investors, banks and loan originators recognized they could simultaneously generate large fees <u>and also</u> promptly move these 'tailored' loan portfolios off the bank's books, by pre-packaging them for investor third parties.

Commercial Banks Move Structured Finance Loans Off-Balance Sheet

Rather than generating a loan and holding it many years to maturity, banks were now able to adopt this new c*onduit* role by repeating the loan generation process many times within shorter timeframes. Very importantly, banks were thus able to shift many loan and credit risks off of their own balance sheets and to the ultimate buyers. Through the process, participating banks were also able to enhance their internal returns and to provide more liquidity and credit products into the debt markets. Independent rating agencies also took on an expanded role in the process by conferring investment grades on types of portfolios and to specific tranches or sections within those portfolios. With the added benefit of both credit default swap (CDS) insurance and interest rate swap products (whereby the parties could address protections under fixed rate loans if interest rates were to rise, for example) an enormous new debt market need was met. Bank loans that were underwritten and funded in specific ways could be 'packaged' and re-sold though securities markets.

Thus, the collateralized loan obligation (CLO) industry emerged, with banks using their existing staffing and resources to generate asset-backed loans, with independent rating agencies helping to measure the default risks of various pools and types of loans, and with large investors finding major and reliable pools of 'securitized' interest-yielding assets to acquire. Beginning in the mid-1980s and accelerating during the residential and commercial real estate booms, the US CLO markets grew to a peak level of nearly $100 Billion in annual transaction volume by 2006. They re-approached these levels in 2014 as markets again gravitated toward CLO products.

Douglas E Johnston, Jr. djohnston@fivemanagement.net

Doug Johnston is a finance expert witness specializing in Commercial Banking & Lending, Private Equity, and International Business. Early in his career he was named as the youngest bank president in Texas, and thereafter he established multiple bank offices in both Texas and California. Expanding into Corporate Finance and Mergers & Acquisitions, he became EVP-Finance and a 'Founding Father' of the largest private company in Los Angeles. As a C-Level executive, he has 'hands-on' due diligence and documentation experience with lenders, investors, buyers and sellers involving hundreds of businesses engaged in the technology, service, commercial real estate, entertainment, and manufacturing sectors across the US as well as in Europe.