Should we be afraid of US leveraged loans?

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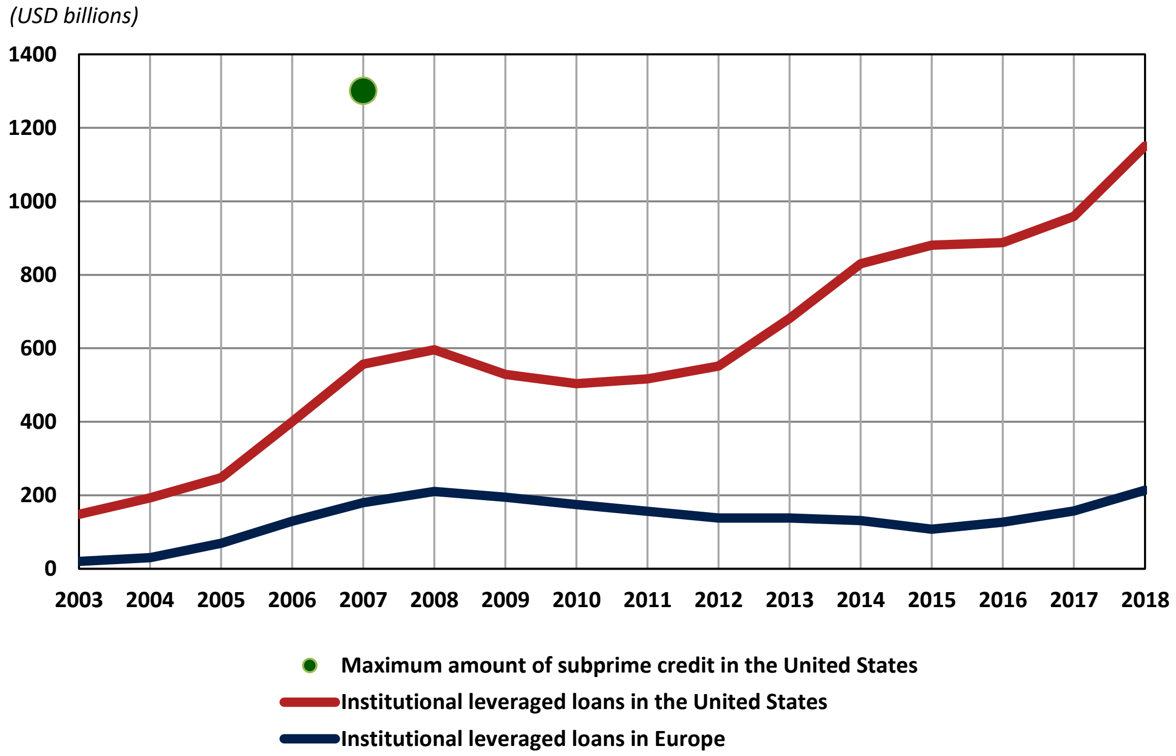
Leveraged loans are loans extended to highly indebted companies. Their strong growth in the US over the last five years and their packaging into securitised financial products bear a number of similarities with the subprime market that triggered the 2008 crisis. While the comparison is debatable, the risks posed by the leveraged loan market to financial stability should not be ignored.

Chart 1: Outstanding amount of institutional leveraged loans in the United States and in Europe



Sources: S&P LCD and Bloomberg data, Banque de France calculations. Estimates as to the exact size of the market differ due to insufficient data and the lack of a standard definition.

The boom in the leveraged loan market

While there is no universally accepted definition, leveraged loans are generally considered to be loans extended by financial institutions to corporations that already have significant levels of debt. The US Federal Reserve (Fed) and the European Central Bank (ECB) define them as any loan granted to a company whose outstanding debt is more than four times its annual earnings.

US non-financial corporate debt has exceeded its 2008 peak and now stands at over 46% of GDP, while the leveraged component of this debt hit an all-time high of USD 1.8 trillion at end-2018 (3/4 of the global outstanding). These USD 1.8 trillion can be broken down into USD 1.2 trillion of institutional loans (see Chart 1) (up 20% in 2018) and USD 600 billion of non-institutional loans. The former generally take the form of large, public syndicated loans owned by the non-bank sector, while the latter are generally owned by banks. In Europe, the institutional leveraged loan market is much smaller than in the United States, with an outstanding amount of around USD 200 billion at end-2018.

Leveraged loans are benefiting from a number of favourable factors

First, the persistently low interest rate environment has prompted a search for yield among investors, and leveraged loans have thus attracted interest due to their higher returns. In contrast with the high-yield bond market, which has seen more limited growth, the leveraged loan market has been boosted by the financing needs of companies that occasionally struggle to issue debt on the bond market. In addition, the tightening of monetary policy in the United States since 2015 has also proved beneficial, as leveraged loans are issued at floating interest rates. Moreover, in the event of a default, owners of leveraged loans are reimbursed ahead of other investors such as holders of the company's bonds.

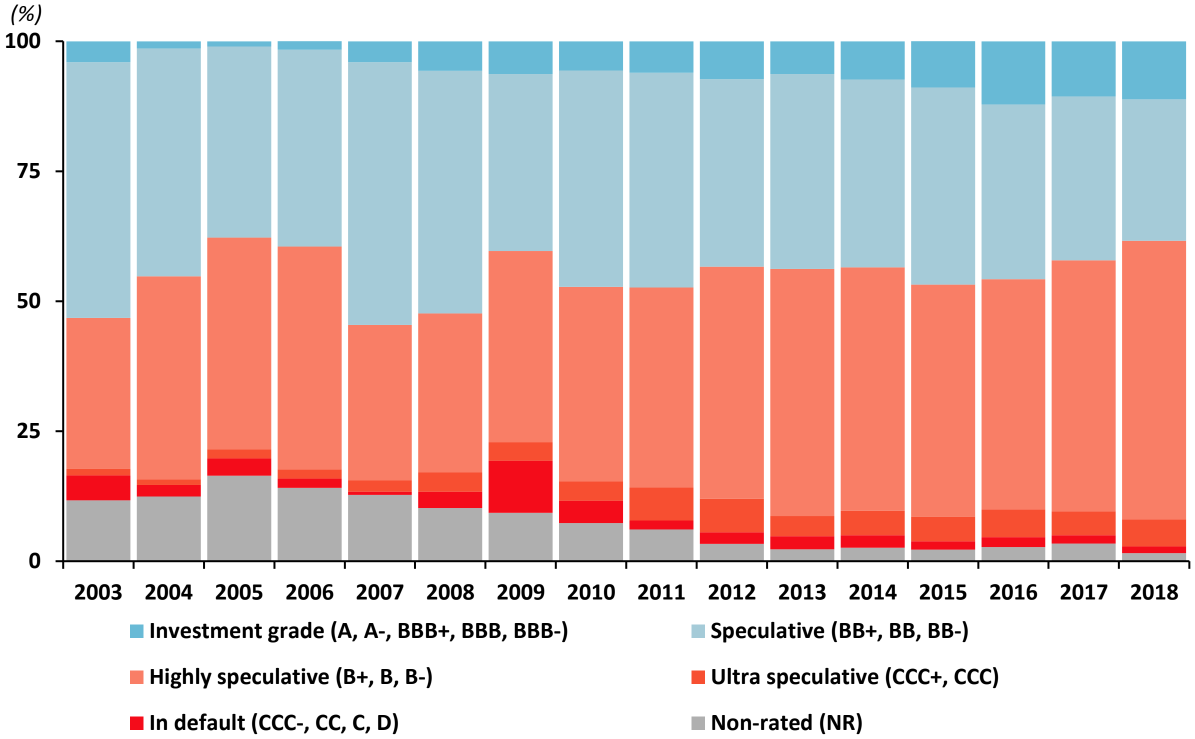
Demand has also been buoyed by the sharp rise in the issuance of securities backed by a pool of leveraged loans (collateralised loan obligations or CLOs). Around a third of outstanding leveraged loans in the United States are now held through CLOs.

Given the attractiveness of leveraged loans for investors, the market is also currently benefiting from a shift in the balance of power towards borrowers. Covenant-lite loans, which are loans issued with fewer restrictions on the borrower and fewer protections for the lender, are now the norm. So-called covenant-lite loans accounted for more than 80% of new loans arranged for institutional investors in the United States in 2018.

A vulnerable market?

The credit quality of leveraged loans, which are by definition generally rated as speculative, has further deteriorated in the United States since the financial crisis (see Chart 2). The share of institutional leveraged loans classified as “highly speculative” (rated B+, B and B-) has increased from 30% in 2007 to 54% in 2018.

Chart 2: Rating of institutional leveraged loans in the United States



Source: S&P LCD and Banque de France calculations.

Companies that issue leveraged loans are by definition heavily indebted. This makes them highly vulnerable to an increase in the cost of debt or a reduction in the credit supply, especially in the event of a macroeconomic or financial shock that could potentially increase their risk of default.

The leveraged loan market is also characterised by a strong presence of non-bank investors (CLOs, investment funds, pension funds, insurers, hedge funds). While banks have been urged by regulators to reduce their risk exposure since the financial crisis, non-bank investors have benefited from a less strict regulatory environment, enabling them to increase their share in this market.

Another vulnerability is the reduction of subordinated debt – that is the debt that can absorb losses before more senior tranches – thereby reducing expected recovery rates and thus investor protection.

In addition, a significant share of these loans has not been used to finance productive investment, which would have improved the borrower's profitability; it has instead been used to finance mergers and acquisitions, share buybacks, or to pay dividends (Adrian et al., 2018).

Subprimes vs leveraged loans: similar but not the same

Concerns about leveraged loans have been fuelled by the apparent similarities with the subprime mortgages that triggered the 2008 crisis:

- deteriorated solvency of the debtor, be it a household or a company;
- strong growth in the securitisation of these speculative loans;
- similar outstanding amounts : USD 1.2 trillion of institutional leveraged loans at end-2018 (around 12% of total US corporate debt) compared to USD 1.1 trillion of subprime mortgages at end-2006 (around 13% of total mortgage loans).

However, several differences remain:

- Banks appear to be less directly exposed to leveraged loans than they were to the subprimes in 2007-08.
- The collateral is not residential property: leveraged loans offer a larger diversity of sectors. However, if investors came to perceive leveraged loans as a separate, standalone asset class, then the benefit of this sectoral diversification would be lost.
- The securitisation market appears to be smaller: it is estimated that about a third of leveraged loans are securitised, compared to 80% for subprimes in 2007. Furthermore, liquidity risk for CLO is limited, as the maturity of the liabilities is generally longer than the average maturity of the assets.

Although any comparison with the subprime market remains questionable, leveraged loans still pose a number of risks to financial stability. The presence of Exchange Traded Funds and Mutual Funds means that retail investors have access to these loans in the United States – although they still only account for a minority of investors. Moreover, these structures present a maturity mismatch between their assets and their liabilities. Investors can redeem their fund shares very quickly, whereas underlying assets (leveraged loans) tend to have much longer transaction times. In the event of a macroeconomic or financial shock, a widespread deterioration in the credit quality of leveraged loans could trigger a mass sell-off by investors, leading to a fall in prices in the secondary market.

In light of these vulnerabilities, the leveraged loan market could potentially act as an amplifier of a macroeconomic or financial shock in the United States. After the Bank for International Settlements and the International Monetary Fund, the US Fed also raised awareness about this issue, while at the same time considering that leveraged loans do not pose a systemic risk.