



Economic Letter

Despite Cautionary Guidance, Leveraged Loans Reach New Highs

by Alex Musatov and William Watts

ABSTRACT: Leveraged lending has grown significantly since 2010 as underwriting standards have loosened. Despite regulatory concerns, markets have reached new highs that may hint at a buildup of risk.

Leveraged loans, whose pricing reflects lenders' appetite for the most speculative corporate debt, provide a market indicator of risk-taking.¹ They are widely used to fund mergers and acquisitions and to alter corporate balance sheets, sometimes in conjunction with large one-time dividend payouts. They are particularly important to borrowers lacking solid credit ratings.

Such loans are sometimes a barometer of market appetite for risk and speculative activity. Specifically, market watchers look for three characteristics. One, a rapid increase in overall issuance often signals outsized demand for risky assets. Two, acceptance of a narrow premium over benchmark rates may hint at insufficient pricing of possible default. Finally, a loosening of protective covenants allowing less-creditworthy entities to borrow also may indicate a less risk-averse environment.

Regulators have noted all three during the past 18 months. In response, the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corp. (FDIC) and Board of Governors of the Federal Reserve System (FRS) issued "Interagency Guidance on Leveraged Lending" in March 2013, outlining principles of safe-and-sound leveraged lending activities.² It was the third such advisory since 1990.³

Lending to lower-rated companies has surpassed prerecession levels (*Chart 1*). Underwriting standards—as measured by the strictness of covenants—are looser than they were before the downturn. Although leveraged loans did not play a significant role in the global financial crisis, they are prone to boom-bust cycles. Additionally, because such lending occurs in both public and private financial markets, it may act as a transmitter of financial distress.

Thus, it is useful to examine leveraged lending's role in the financial markets, its performance during credit cycles, the reasons behind regulators' heightened attention and the trends since the most recent regulatory guidance was issued.

Flexible Source of Capital

Leveraged loans have emerged as an important source of financing for lower-rated companies since the debt debuted in the 1970s; annual issuance has grown from roughly \$100 billion in 1989 to \$605 billion in 2013.

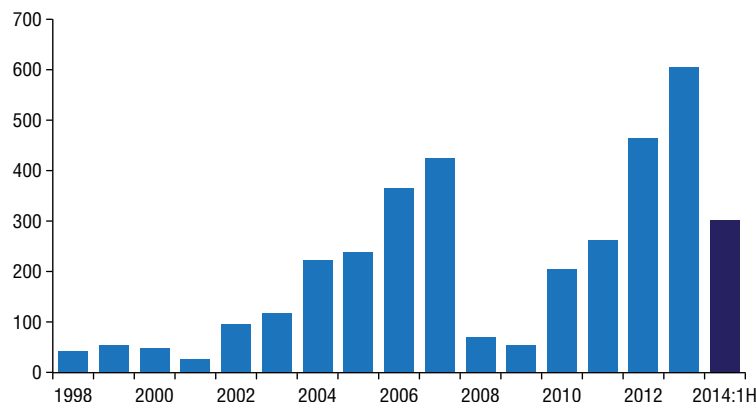
No single definition of a leveraged loan exists, and various rating agencies and regulatory bodies have differing designations that use combinations of the credit rating, the spread over a benchmark rate, and the size of the loan relative to the balance sheet of the borrower (*Table 1*). One useful definition of a leveraged loan is a conceptual

► When two-year Treasury notes yielded 0.45 percent in mid-2014 and investment-grade corporate bonds offered 3.81 percent, leveraged loan yields hovered near 5.33 percent.

Chart 1

Issuance of Leveraged Loans Rebounds from Recession's Lows

Issuance (billions of dollars)



SOURCE: Standard & Poor's Leveraged Commentary and Data.

one: a large, variable-rate loan originated by a group of banks (sometimes called a syndicate) for a corporate borrower who is perceived to be riskier than most.

In general, leveraged loans are secured by specific assets such as property or equipment and, therefore, rank highest in a business's capital structure. Because the debtors are considered riskier than their peers, the loans feature covenants that obligate the borrower to meet strict requirements related to servicing the debt (Table 2). Creditors also demand a premium for the additional risk: When two-year Treasury notes yielded 0.45 percent in mid-2014 and investment-grade corporate bonds offered 3.81 percent, leveraged loan yields hovered near 5.33 percent.⁴

Benefits of Syndication

Because a typical leveraged loan issue is too large for any single lender to keep on its balance sheet, a group of banks may issue the credit, a process known as syndication. The group gauges investor demand and then issues the loan at an interest rate that clears the market. The banks retain portions of the loan on their own books, but the majority of it is packaged for other investors—typically finance companies, insurance companies and hedge funds. Pieces may be combined with other loans, assembled into collateralized loan obligations (CLOs) and sold.

Specific lending arrangements reflect the size of the loan and riskiness of the borrower. In an underwritten deal, the syndicate issues the full amount of the loan and then tries to sell portions to outside investors. Underwritten deals are generally the most attractive loans to borrowers because they ensure that the entire amount of needed capital is raised; the lead bank gets higher fees for the risk of holding the debt while looking for investors.

A “club deal,” used for smaller loans, involves several banks raising the money within the group while splitting the fees charged to the borrower.

Finally, in “best effort” syndication, the arrangers of the loan underwrite less than its entire value and attempt to raise the remainder in the credit market. This type of syndication is generally used for the riskiest borrowers or the most complex loan agreements.

Table 1

Leveraged Loan Definitions Focus on Various Aspects of Risk

Source	Definition
Loan Pricing Corp.	A loan rated B, BB, BB/B or lower.
Standard & Poor's	An unrated loan or a loan rated below BBB-, secured by a first or second lien, with a spread over LIBOR greater than 125 basis points.
Moody's	Loans rated below Baa3 and considered speculative grade.
Bloomberg	Loans that have a spread over LIBOR of at least 250 basis points.
Office of Comptroller of the Currency, Federal Deposit Insurance Corp., Federal Reserve System	Loans in which the borrower's total debt divided by EBITDA or senior debt divided by EBITDA exceeds 4 times EBITDA or 3 times EBITDA, respectively, or other defined levels appropriate to the industry or sector.

NOTE: LIBOR is the London Interbank Offered Rate, and EBITDA stands for earnings before interest, taxes, depreciation and amortization.

Table 2 Maintenance Covenants Reduce Credit Quality Issues

Measure	Covenant
Leverage ratio	The borrower may not exceed a specified ratio of total liabilities to total shareholder value.
Capital expenditures	Limits the amount that the borrower can spend on long-term investments.
Debt service coverage ratio	Maintains a minimum level of cash flow or EBITDA relative to specified expenses such as interest, debt service or fixed charges.
Current ratio	Requires that the borrower maintain a minimum ratio of current (readily realizable) assets to current (short-term) liabilities.

NOTE: EBITDA stands for earnings before interest, taxes, depreciation and amortization.

SOURCE: Authors' research.

Banks diversify their credit risk through syndication by holding slivers of multiple leveraged loans instead of one concentrated exposure to a single debtor. Syndication is also attractive to the debtors because they can access a larger pool of capital than any one single lender could offer.

Booms and Busts

The leveraged buyout boom of 1987–89 marked the first peak in leveraged loan issuance. Noting the rapid entrance of commercial banks into the risky market for leveraged takeovers, the OCC, FDIC and FRS required that banks disclose their holdings of highly leveraged loans to enhance risk reporting. Partly in response, syndicated lending fell to \$11 billion by 1990 after reaching almost \$100 billion in 1988.

As banks eased their exposure in the early 1990s, institutional investors stepped in, allowing leveraged loans to grow again. Helping broaden the investor base were CLOs, offering investors specific risk/reward profiles through the selection of loans and maturities packaged into the debt instrument. This wave of supply drove leveraged lending to a new peak of \$425 billion in 2007.

Beginning in August 2007, amid the early signs of the global financial crisis, leveraged loans experienced increased volatility and illiquidity. Their default rate increased to 12.8 percent in 2009 from a historic low of 3.9 percent two years earlier. CLOs defaulted at a record 10.8 percent rate that same year.⁵ Leveraged borrowing and CLO issuance plummeted.

By 2010, the market was recovering. The loan default rate fell to 1.8 percent in

2010, and the SMi-100 Loan Index (which covers the 100 most widely held institutional debt tranches) increased 54 percent from its December 2008 low.

Looking for Froth

Since the crisis, the volume of leveraged lending has reached new highs. Historically low interest rates have encouraged firms to refinance existing debt and to make new acquisitions. Because leveraged loans offer variable rates, their payments reset to higher levels as benchmark rates rise, providing investors with a hedge.

As of April 2014, leveraged loan funds (mutual funds that invest in leveraged loans) had experienced a stretch of 95 consecutive weeks of inflows totaling \$81.2 bil-

lion. Demand has narrowed yield spreads on leveraged bonds over Treasuries: The S&P/LSTA U.S. Leveraged Loans 100 Index yielded about 4.9 percentage points more than the two-year Treasury note in July, down from 6.85 percentage points in 2012.⁶

A worrisome accompanying trend is the significant increase in the issuance of so-called covenant-lite loans, which offer fewer constraints on the borrower. Close to 40 percent of leveraged loans fit this criterion in 2013, up from less than 25 percent the prior year (*Chart 2*).

New Guidance

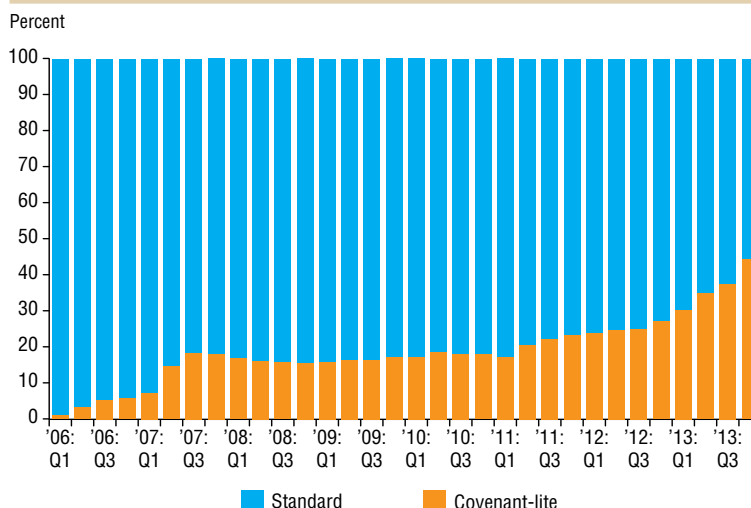
Regulators' joint statement in March 2013 sought to restrain the underwriting of loans that would push a borrower's debt beyond six times free cash flow.⁷ This was done to limit banks' exposure to highly leveraged positions and, ultimately, to promote financial stability.

The initial guidance had only a brief damping effect, with issuance growing again through late 2013. When the Federal Reserve reiterated in January 2014 that it would pay particular attention to banks' adherence to this guidance, a string of large leveraged deals was canceled.

Risks Remain

Despite the recent guidance, the broader leveraged loan market has slowed little, especially among the largest banks,

Chart 2 Share of Covenant-Lite Issuance Rising



SOURCE: S&P/LSTA U.S. Leveraged Loans 100 Index.

which held nearly \$270 billion on their books as of first quarter 2014. The 61 banks that reported owning such loans a year earlier saw their exposure grow 65 percent.⁸ Through June 24, total leveraged loan issuance stood at \$303 billion, the third-highest first half on record.⁹

Still, other important measures of leveraged lending suggest a healthy market. The annualized default rate on loans is expected to remain below 2 percent through 2014, despite a temporary spike to 4.6 percent in April following the widely anticipated default of Dallas-based Energy Future Holdings Corp. (Chart 3).¹⁰ Spreads on leveraged loans have narrowed, and the growth outlook for companies taking on this debt is better now than during the last decade.

Nevertheless, the broad loosening of covenants and increase in deal leverage merit the ongoing attention of policymakers, especially with an eye toward potential risks associated with a probable upward trend for interest rates as the Federal Reserve reduces the size of its balance sheet.

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Notes

¹ See "Semianual Monetary Policy Report to the Congress," by Janet L. Yellen, remarks before the Committee

on Banking, Housing and Urban Affairs, U.S. Senate, July 15, 2014, www.federalreserve.gov/newsevents/testimony/yellen20140715a.htm.

² See "Interagency Guidance on Leveraged Lending," SR Letter 13-3, Federal Reserve System, March 21, 2013.

³ See "Interagency Guidance on Leveraged Financing," SR Letter 01-9, Federal Reserve System, April 9, 2001, and "Banking Circular BC-242," Comptroller of the Currency, Oct. 30, 1989.

⁴ Although the loans are typically issued for five to six years, they are often prepaid and refinanced within 24 months. Two-year Treasuries, therefore, best match the duration risk. See "More Loans Come with Few Strings Attached," by Katy Burne, *Wall Street Journal*, June 12, 2014.

⁵ See Standard & Poor's Leveraged Commentary and Data, www.lcdcomps.com/d/public/default1011.html.

⁶ The S&P/LSTA U.S. Leveraged Loans 100 Index is a leading measure of the leverage loan market and is a product of Standard & Poor's in conjunction with the Loan Syndications and Trading Association.

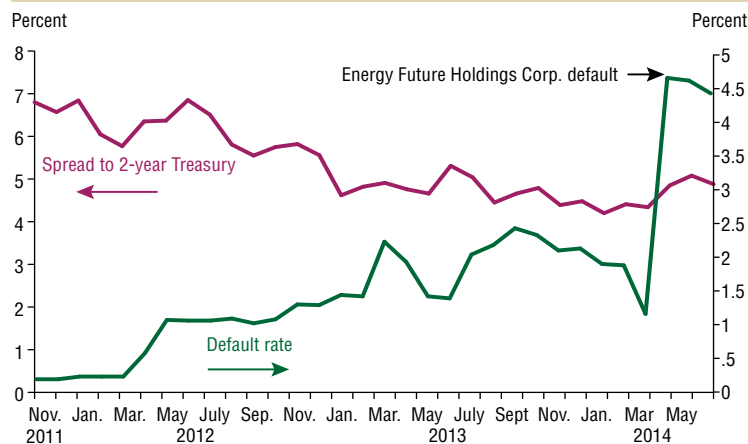
⁷ See "Proposed Guidance on Leveraged Lending with Request for Public Comment," Comptroller of the Currency, Federal Reserve System and Federal Deposit Insurance Corp., March 30, 2012, www.federalregister.gov/articles/2012/03/30/2012-7620/proposed-guidance-on-leveraged-lending. Specifically, the rule places the limit at six times EBITDA (earnings before interest, taxes, depreciation and amortization).

⁸ See Quarterly Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council, March 31, 2014.

⁹ According to Standard & Poor's Leveraged Commentary and Data.

¹⁰ See "May 2014: U.S. Leveraged Loan Market Analysis," by Steve Miller, *Forbes*, May 19, 2014.

Chart 3 Leveraged Loan Spreads Decline Despite Default Spike



NOTE: The large default of Energy Future Holdings (formerly TXU) was widely expected; the default rate has already begun to decline.

SOURCE: S&P Capital IQ.

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