

ANALYTICAL ARTICLES

Economic Bulletin

4/2019

BANCO DE **ESPAÑA**
Eurosistema

LEVERAGED LOANS: DEFINITION AND MARKET
DEVELOPMENT

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ABSTRACT

Over the past decade, the volume of leveraged loans has grown to reach its highest level since the end of the crisis. Growth has been more contained in Spain, which accounted for 5% of the total volume of such lending in Europe in the period 2016-2018.

The terms and conditions of leveraged loans have become less restrictive and a large proportion is distributed among institutional investors worldwide, in the form of collateralised loan obligations (CLOs).

This originate-to-distribute model poses potential risks for the financial system. In the event of a cyclical downturn the losses in this market could be significant, in particular, owing to the relaxation of investor protections. In addition, given the importance of these loans as a source of corporate financing, a rise in defaults would have adverse effects on the real economy.

Keywords: leveraged loans, CLO, syndicated loans.

JEL codes: G23, G15, G32.

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Introduction

Leveraged loans are syndicated loans granted to businesses with a high credit-risk profile. Syndicated loans emerged in the 1980s with the company takeover boom in the United States. Since a group of lenders (syndicate) grants a single loan with a single set of terms and conditions, these loans are less costly for the borrower and more efficient to administer than bilateral loans.

The classification of a syndicated loan as leveraged depends on the market participant and data source. Generally, the criteria are based on the loan's credit rating and interest margin.² *Ceteris paribus*, a highly indebted borrower will have a poorer credit rating and will be required to pay a higher interest margin.

In the capital structure, leveraged loans are secured senior debt, backed by all the borrower's assets and also by specific assets. Another important characteristic of these loans is the inclusion in the loan agreement of covenants to control the financial structure of the borrower and avoid its deterioration over the life of the loan, which bolster the lenders' position.

Following the financial crisis and in a low interest rate environment, many institutional investors have found that leveraged loans are an opportunity to earn higher yields.³ In this setting of increased investor demand, businesses with greater credit risk have found a less costly means of obtaining financing. In addition, many of these leveraged loans have been securitised and distributed in the form of collateralised loan obligations (CLOs). The increase in this business has been accompanied by some

1 The author is grateful for the comments of J. Ayuso, Á. Estrada, J. Ibáñez, R. Gimeno, E. González, A. van Rixtel, E. Rodríguez de Codes and F. Sáez, and for technical support from R. Pascual. Any errors are the author's sole responsibility.

2 A loan is normally classified as leveraged if the rating is below investment grade (less than BBB-) or if the interest margin over the benchmark rate is greater than 150-175 bp. These thresholds may vary slightly, depending on the source

3 See B. Gruic, A. van Rixtel and J. Sobrun (2014), "Signs of recovery in structured finance and leveraged loan markets", *BIS Quarterly Review*, December.

relaxation of the contractual covenants, with an increase in covenant-lite loans. Thus, in 2017 and 2018, the volume of leveraged loans originated (in particular, covenant-lite loans) reached record levels, exceeding \$1 trillion per year.

The growth of covenant-lite loans and the potential incentive problem associated with the originate-to-distribute model – which proved so decisive in the triggering of the last financial crisis – warrant analysis of this market and the potential risks it may pose for financial stability. This article aims to increase understanding of how this type of corporate debt has developed. In particular, it focuses on the main characteristics of the leveraged loan market and its evolution in the United States and Europe, concluding with details of the situation of this market in Spain.

Structure and main characteristics

Leveraged loans are structured and administered by one or more banks (arrangers), who are responsible for raising financing and handling the crafting of the agreement and its terms and conditions. The arrangers normally analyse the market to gauge the potential appetite for the loan and the interest margin that would make it attractive to potential lenders.⁴

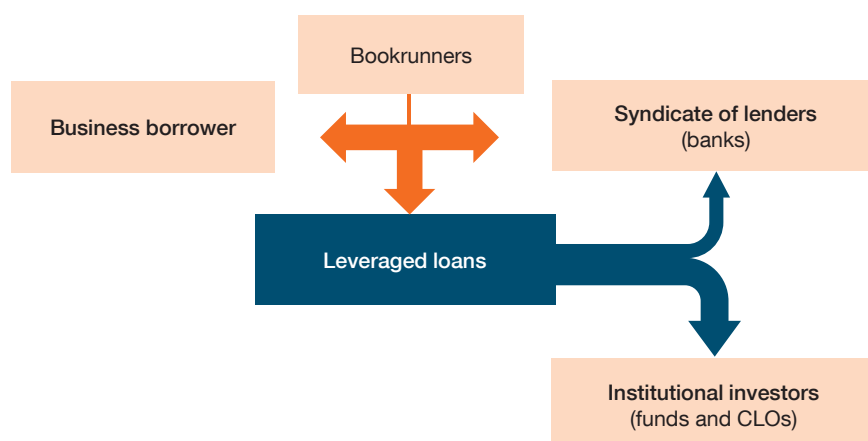
The financing is channelled through banks and financial institutions that do not normally keep loans on their balance sheet, but instead distribute them among institutional investors, such as insurers, loan funds, hedge funds, pension funds and CLOs. The latter are structured through special purpose vehicles that package the loans and issue tranches of asset-backed bonds with different credit ratings, including top-rated issues (AAA).⁵

Leveraged loans are made up of different types of credits or contracts, depending on who is going to be the final holder of the tranche. Thus, tranches historically aimed at banks (called pro-rata tranches because they were syndicated for distribution on a pro-rata basis among the participating entities) are made up of revolving credit lines and amortising term loans (known as term loan As or TLAs). At the same time, the tranches aimed at institutional investors are made up of term loans, the principal of which, unlike in the case of TLAs, is only repaid upon maturity and are called term loan Bs (TLBs), TLCs, etc.

4 See Leveraged Commentary & Data (2018), *LCD Loan Primer*, S&P Global Market Intelligence, New York, and S.J. Antczak, D.J. Lucas, and F.J. Fabozzi (2009), *Leveraged Finance: Concepts, Methods, and Trading of High-Yield Bonds, Loans, and Derivatives*, John Wiley & Sons, New York.

5 See S. Criado and A. van Rixtel (2008), *Structured finance and the financial turmoil of 2007-2008: an introductory overview*, Occasional Papers, No. 0808, Banco de España.

Figure 1
SIMPLIFIED REPRESENTATION OF THE MARKET



SOURCE: Devised by author.

In recent years, the institutional tranches have been differentiated from the pro-rata tranches especially by the relaxation of some of the clauses traditionally included in leveraged loan agreements to periodically control the financial performance of the borrower (maintenance covenants) and so reduce the insolvency risk. These covenant-lite loans, with less restrictive clauses, do not include, for example, quarterly requirements for minimum cash flow levels or maximum leverage levels; in addition, they are simpler and faster to arrange, which facilitates their subsequent distribution in the form of CLOs.

Evolution of the market in the United States and Europe

In the United States, the total volume of leveraged loan origination reached record levels in 2017 and 2018, of \$1.4 trillion and \$1.2 trillion, respectively, up 180% from 2010 (see Chart 1.1, red bar). In Europe, although the size of the market is much smaller, the total volume rose by 100% from 2010 to \$0.25 trillion in 2018 (see Chart 1.2). However, activity in both regions slowed in 2019 Q1.⁶

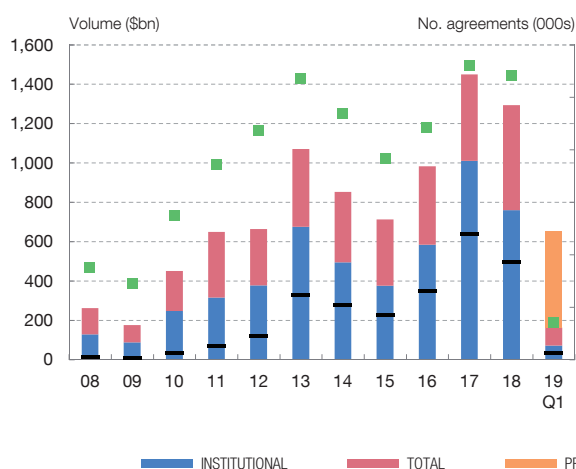
Within total loans, institutional loans have posted higher growth (see Charts 1.1 and 1.2, blue bars). In 2017 and 2018, this type of loan accounted for 70% and 60%,

⁶ This analysis was based on Bloomberg data. As these instruments are not traded on organised markets, the data may vary from one supplier to another; however, the market trends are comparable. Other sources consulted, for the purposes of comparison, were Leveraged Commentary & Data and Dealogic.

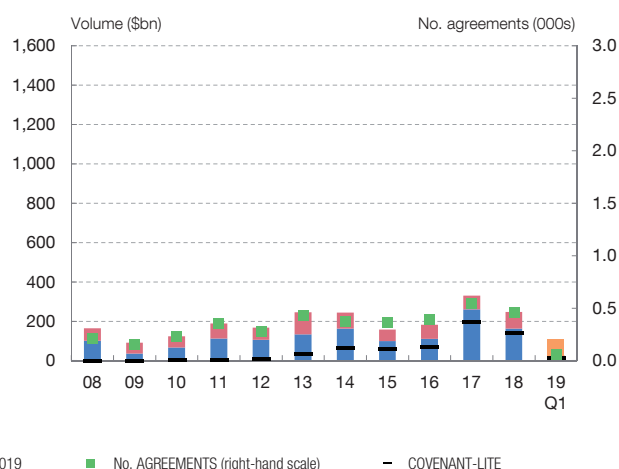
Chart 1

VOLUME AND TYPE OF LOANS

1 UNITED STATES



2 EUROPE



SOURCE: Bloomberg.

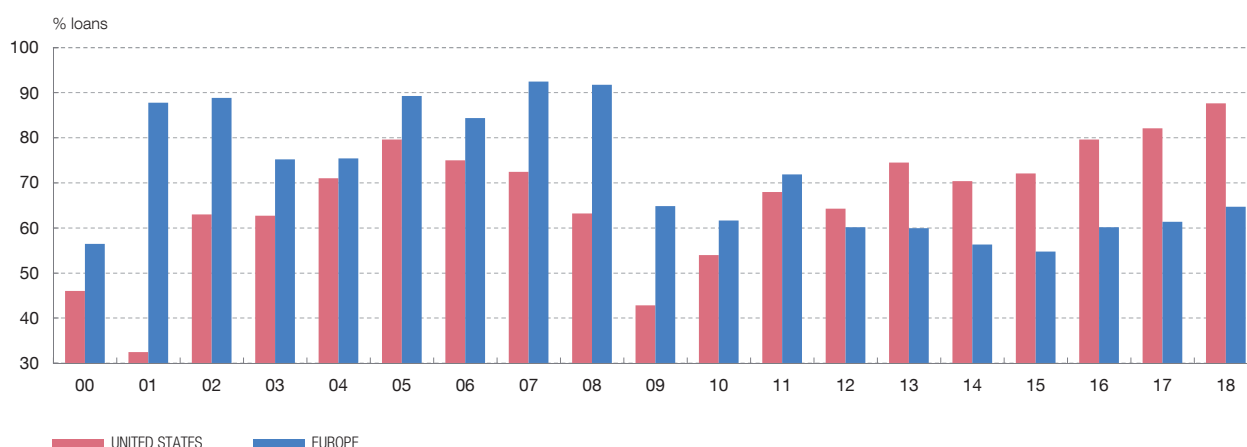
respectively, of all loans granted in the United States, and 65% and 80% in Europe. At the same time, the covenant-lite segment in the United States has increased from around 8% in 2010 to around 40%. In Europe, where these transactions were practically non-existent until 2012, they accounted for 57% of the total volume of lending in 2018 (see Charts 1.1 and 1.2, black lines).

In the United States, the ratio of the volume of leveraged loans to the sum of the volume of high-yield fixed-rate bonds and leveraged loans has been growing since 2009, when leveraged loans accounted for less than 50% of the total volume, and reached more than 85% in 2018. By contrast, this ratio has remained relatively steady in Europe since 2009, at around 60% (see Chart 2).

There exists a relationship between the structure of interest rates and the type of debt that high-risk businesses use. From the borrower’s viewpoint, there is greater issuance of fixed-rate bonds when expectations of interest rate rises exist, and a tendency to increase the use of variable rate loans, taking on more interest rate risk, if the curve flattens (becomes less steep) owing to expectations of a decline in the cost of debt (see Chart 3). At end-2018 there were expectations of rate rises, which may partly explain the low activity in 2019 Q1 (see Chart 1).

In recent years steps have also been taken in the area of regulation. In the United States and Europe, guidelines have been issued for supervised institutions on admissible lending to leveraged businesses. Rather than curbing these instruments,

Chart 2

LEVERAGED LOANS AS A PERCENTAGE OF TOTAL HIGH YIELD DEBT

SOURCE: Bloomberg.

these guidelines have led to a shift in the entities holding them towards non-bank institutions.⁷ In 2018, the US regulators opted to limit the extent to which these guidelines are binding, facilitating the financing of these loans again.⁸ Also, there have been some changes in the level of CLO risk retention. Following a court judgment in February 2018, CLOs have been exempt from the Dodd-Frank regulation and managers no longer have to retain 5% of the credit risk of the securitised assets, whereas in Europe this is still mandatory.⁹

Observing the distribution of the outstanding amount of loans by holder, the predominance of special purpose companies that manage CLOs is notable. These hold 65% of the total amount of leveraged loans in the United States and 78% in Europe. Also, of the loans distributed to CLOs, a very high percentage (82% in Europe and 67% in the United States) are covenant-lite loans (see Chart 4).

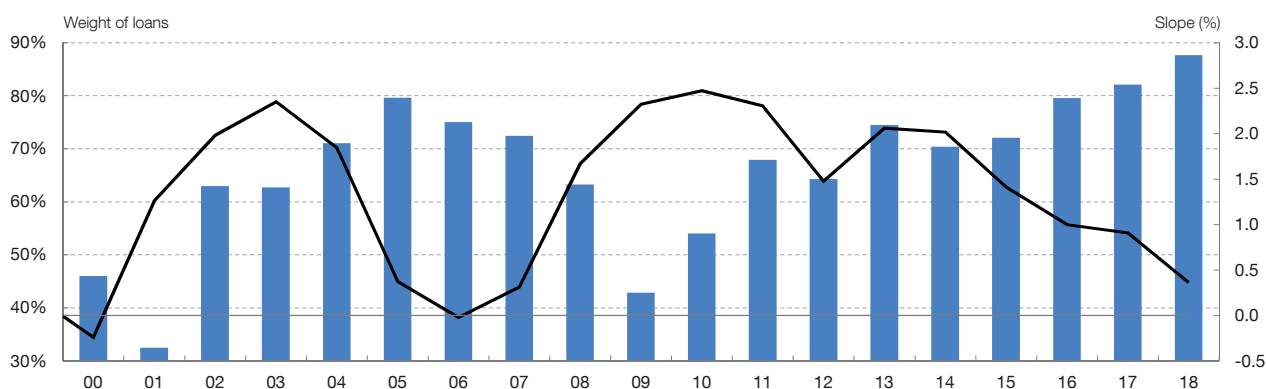
This “generate to distribute” modus operandi increases uncertainty regarding the extent and distribution of exposure to these loans among non-bank financial institutions and regarding the interconnections between these institutions and banks.

7 See S. Kim, M.C. Plosser and J.A.C. Santos, (2017) *Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance*, Federal Reserve Bank of New York Staff Reports, No. 815.

8 In the United States, these guidelines were set out in 2013 in the Interagency Guidance on Leveraged Lending; but subsequently, in 2018, the extent to which they are binding was limited. In Europe, the European Central Bank published its *Guidance on leveraged transactions* in 2017.

9 In the European Union, these decisions on the retention of CLO risks have been included within the broader regulation of securitisation, as part of the development plan for a Capital Market Union (Regulation (EU) 2017/2402).

Chart 3

WEIGHT OF LEVERAGED LOANS AND YIELD CURVE SLOPE (a)

SOURCE: Bloomberg.

a The slope of the yield curve (black line) has been calculated as the average over the last twelve months of the spread between the ten-year and two-year yields.

In turn, a proportion of the securitisations in the form of CLOs are purchased by investors outside the jurisdictions in which they are originated. On recent Federal Reserve estimates, approximately 50% of the most senior and highest-rated tranches (AAA) of new CLO issues are held by US and Japanese banks, the latter seeking higher returns than those offered on their domestic market. At the same time, fund managers, insurance companies and other more specialised investors are the most active purchasers of the junior, high-risk tranches.¹⁰

The relaxation of investor protection in covenant-lite loans enables borrower firms to increase their leverage, which also raises the potential losses in the event of default. In fact, recovery rates in the event of default have fallen to 69%, from their average pre-crisis level of 82%.¹¹ Currently, the default rate on leveraged loans in the United States (the main market) is low, although it has increased slightly, from 2% in 2017 to 2.5% in 2018.¹²

Analysing loans between 2016 and 2019, credit is found not to be highly concentrated in specific sectors, although loans to businesses in the consumer discretionary, technology, financial, health and telecommunications sectors stand out (see Chart 5).

10 See Board of Governors of the Federal Reserve System (2019), *Financial Stability Report*, May, and A. Park (2019), *Those \$700B in US CLOs: Who holds them, what risk they pose*, S&P Global Market Intelligence.

11 T. Adrian, F. Natalucci and T. Piontek, (2018) "Sounding the Alarm on Leveraged Lending", IMF Blog.

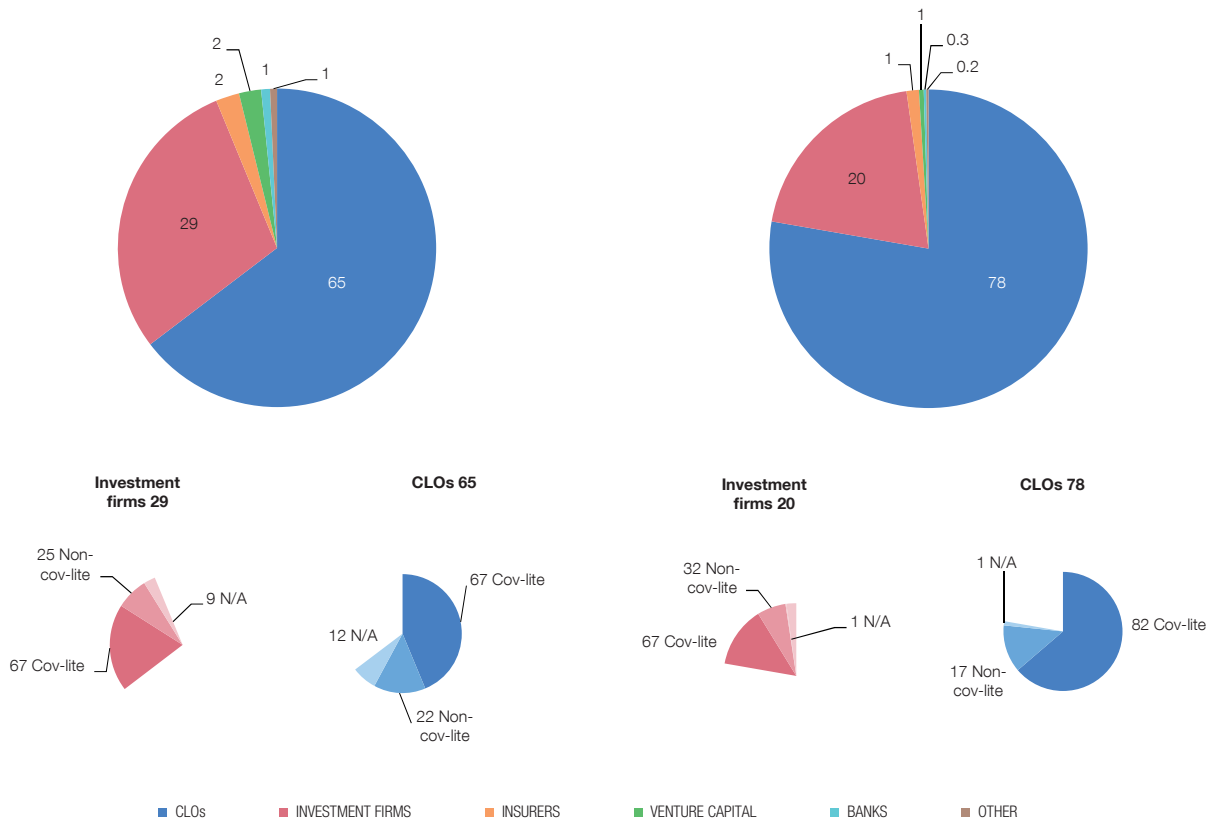
12 T. Goel (2018), "The rise of leveraged loans: a risky resurgence?", *BIS Quarterly Review*, September, pp. 10-11.

Chart 4

DISTRIBUTION OF OUTSTANDING AMOUNT BY TYPE OF MANAGEMENT COMPANY (%)

1 UNITED STATES

2 EUROPE



SOURCE: Bloomberg. Date of analysis: 31.3.2019.

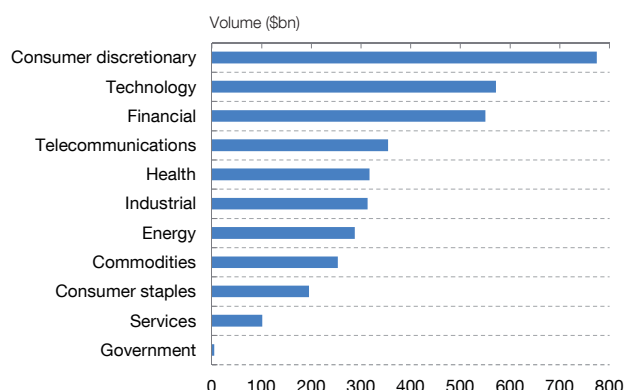
For the time being, default rates are contained in this market and concentration risk is not high, but future tensions in the event of an economic slowdown cannot be ruled out. If there were an increase in defaults, the cost of debt for businesses with high credit risk would rise and their chances of being refinanced would be reduced, amplifying the economic contraction. Moreover, in the event of a deterioration in their credit quality, many of the investors exposed to these loans – or to securities backed by them – might suffer significant losses. As a result, regulators and international agencies have started to monitor the possible risks associated with the relaxation of leveraged loan covenants and the boom in the originate-to-distribute modus operandi.¹³

13 Apart from those already mentioned, see, for example, “A Decade after the Global Financial Crisis: Are We Safer?”, *Global Financial Stability Report*, IMF, October 2018, or M. Carney (2018), “True Finance - Ten years after the financial crisis”, *Economic Club of New York*.

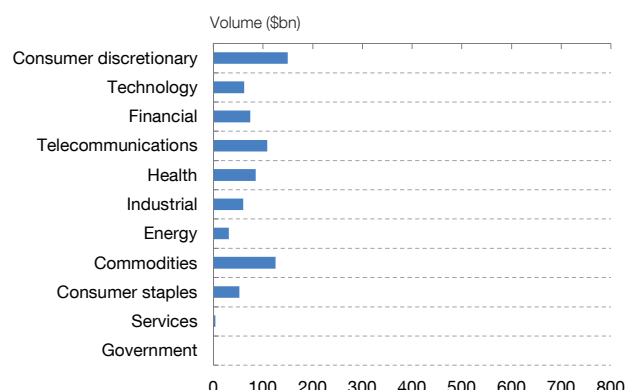
Chart 5

DISTRIBUTION BY SECTOR FOR THE PERIOD 2016-2018

1 UNITED STATES



2 EUROPE



SOURCE: Bloomberg.

The leveraged loan market in Spain

The trends in the market for leveraged loans originated in Spain show certain similarities to the United States and to Europe as a whole. For the period 2016-2018, of the \$0.65 trillion of such lending in Europe, only 5% (\$32 billion) was to businesses in Spain, well behind the United Kingdom which, with 18% of the total volume (approximately \$120 billion), was the most active country (see Chart 6).

Observing the volume of transactions in Spain since 2008 it can be seen that activity in 2018 (\$11 billion) is somewhat below the annual average for the last 10 years (around \$15 billion). However, in line with the rest of Europe, there has been a significant increase in the covenant-lite segment which, having been practically non-existent up to 2016, accounted for 54% of the total volume of institutional loans in 2017, and 75% in 2018 (see Chart 7).

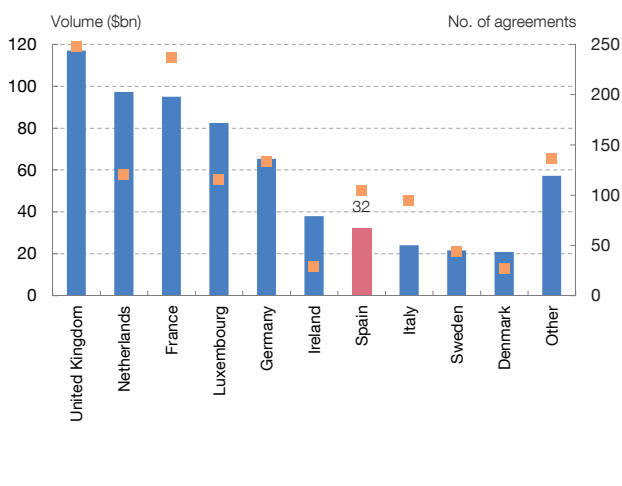
In Spain, CLOs represent 80% of the investment in leveraged loans and 53% of these loans are covenant-lite, in line with the securitisation activity in other jurisdictions (see Chart 8). Also, activity is not highly concentrated in any specific sector in the period 2016-2018, although lending to the consumer discretionary, health and telecommunications sectors stands out (see Chart 9).

Following the growth of this market, Spanish institutions have acted as bookrunners in a larger volume of transactions in Spain since 2016. In the period 2016-2018, the market share of Spanish banks stood between 16% and 45% of the total volume of

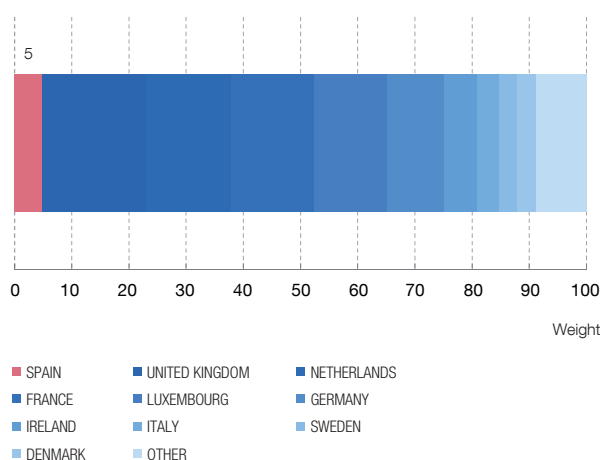
Chart 6

DISTRIBUTION OF THE VOLUME IN EUROPE BY COUNTRY OF BORROWER FOR THE PERIOD 2016-2018

1 VOLUME AND NUMBER OF AGREEMENTS



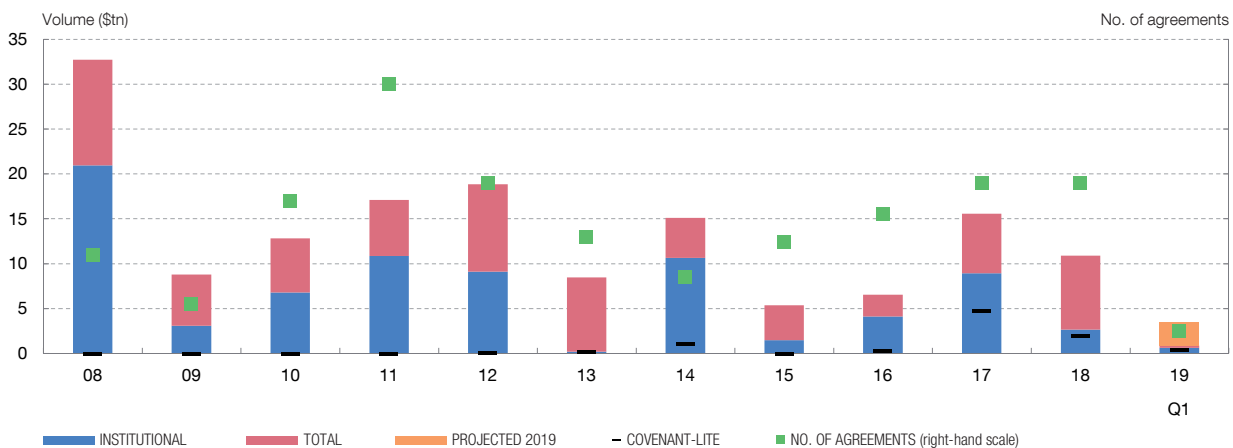
2 WEIGHT (% OF TOTAL VOLUME)



SOURCE: Bloomberg.

Chart 7

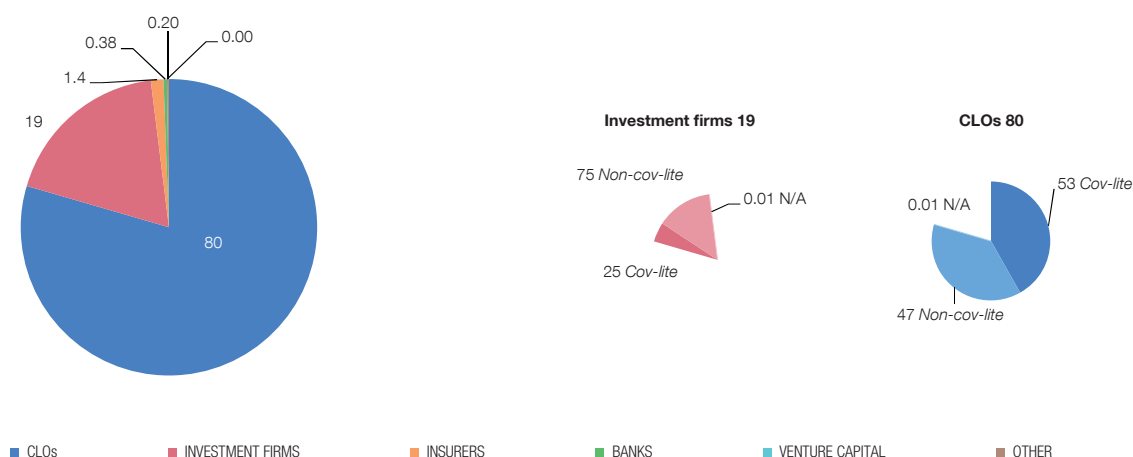
DEVELOPMENT OF THE MARKET IN SPAIN



SOURCE: Bloomberg.

Chart 8

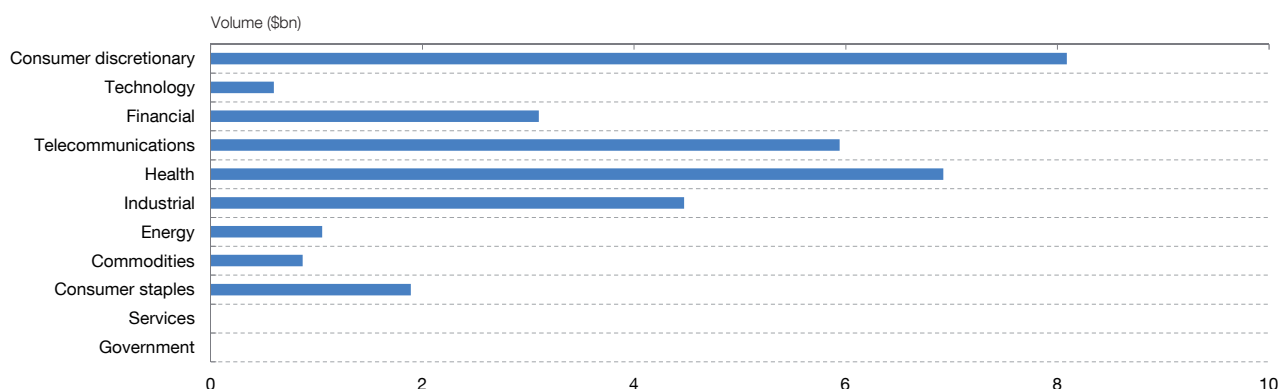
DISTRIBUTION OF OUTSTANDING BALANCE IN SPAIN BY TYPE OF MANAGEMENT COMPANY (%)



SOURCE: Bloomberg.

Chart 9

DISTRIBUTION BY SECTOR FOR SPAIN FOR THE PERIOD 2016-2018



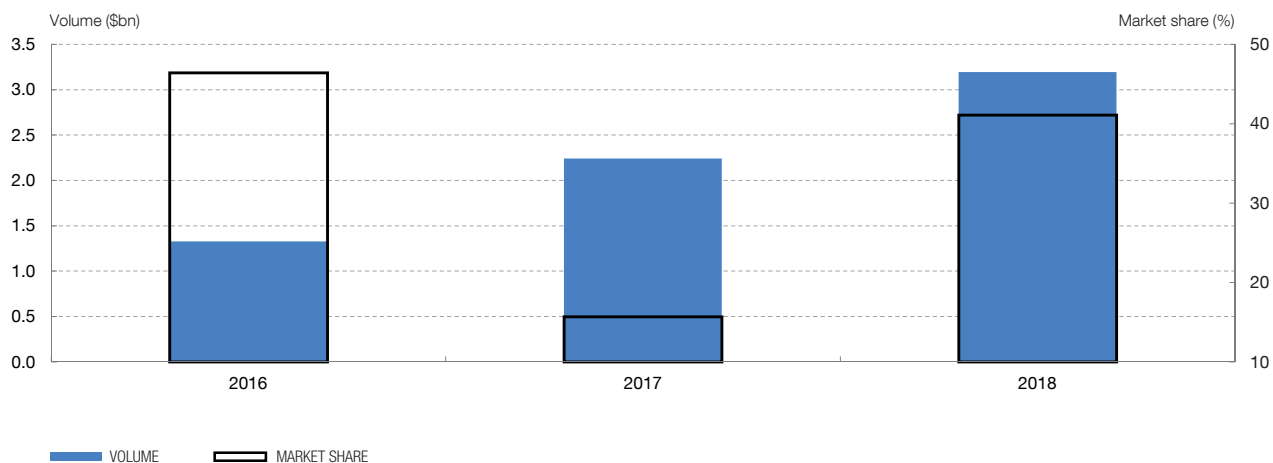
SOURCE: Bloomberg.

leveraged loans granted in Spain (see Chart 10). Despite the increase in this activity in terms of volume granted during the period 2016-2018, the risk profile of the loans granted to businesses has been significantly reduced since the crisis, the most leveraged borrowers having a lower relative weight in the total corporate lending of Spanish institutions.¹⁴

¹⁴ See, *Finacial Stability Report*, Spring 2019, Banco de España.

Chart 10

SPANISH BANKS ACTING AS BOOKRUNNERS IN THE PERIOD 2016-2018



SOURCE: Bloomberg.

Finally, although leveraged loan origination volumes in Europe are not a cause for concern at the moment, it is important that future developments, especially as regards the originate-to-distribute model and the potential effects of sudden price corrections on the most exposed institutional investors, be monitored.

10.10.2019.