Six Key Risks In Leveraged Lending For Financial Institutions

November 26, 2018

Key Takeaways

- The syndicated leveraged loan market has grown larger and riskier over the last year with higher borrower leverage and lower levels of financial maintenance covenants.
- The direct leveraged loan market, where business development companies and other nonbanks compete, has also likely grown substantially in recent years.
- CLOs, loan mutual funds, and other nonbanks remain the largest investors in syndicated leveraged loans and face a variety of credit, market, and liquidity risks.
- Banks also could suffer losses on leveraged loans and commitments, although these amounts are not so easily determined due to poor disclosure.

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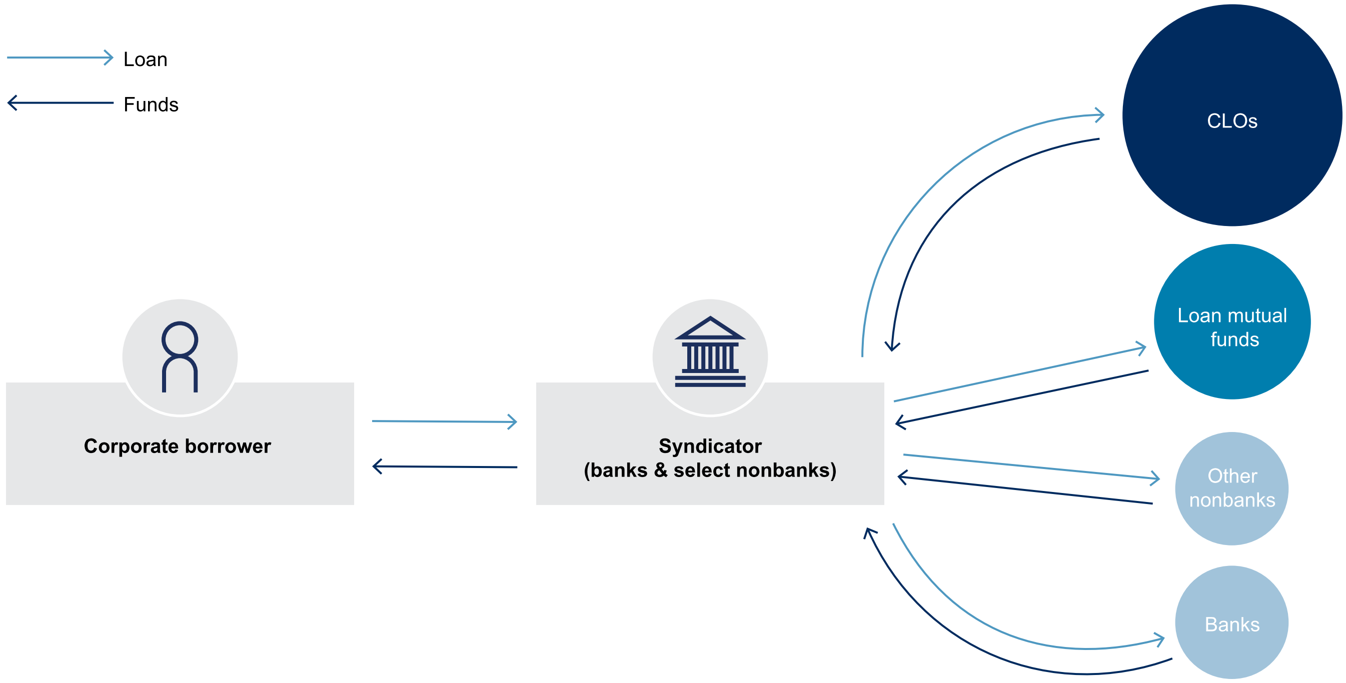
In the past few years, leveraged loan issuance in the U.S. capital markets has surged, increasing risks for those who syndicate and hold these corporate loans. Roughly a year ago, S&P Global Ratings published a commentary examining the exposures of rated banks and a variety of nonbank financial institutions to leveraged lending (see "Could Banks, Asset Managers, Or Nonbanks End Up Holding The Bag In The Leveraged Loan Market?," Nov. 29, 2017). Since then, the leveraged loan market has only grown larger and frothier. Considering recent developments, we've updated our analysis, highlighting six key risks we see for financial institutions.

When the credit cycle turns, these risks could result in credit, market, and liquidity challenges for some of the financial institutions we rate. While we wouldn't expect widespread downgrades--since most financial institutions we rate have limited or no leveraged lending exposure--we could lower ratings on the entities active in this area.

Chart 1

Risks In Syndicated Leveraged Lending



Key risks	Key risks	Key risks
- Elevated leverage - Reduced debt service coverage - Refinancing risk	- Liquidity, market and credit risk from committing to fund and syndicate loans - Liquidity and credit risk from extending longer-term revolving facilities to the borrower at the time of syndication	- Credit risk on the loans they purchase - Credit and market risk for those that invest in the lower tranches of CLOs - Market and liquidity risk for entities and vehicles that offer their investors daily liquidity (e.g., loan mutual funds) or that have mark-to-market risks (e.g., BDCs)

Source: S&P Global Ratings.

1. The Market Is Experiencing Continued Growth And Rising Risks

The leveraged loan space has grown even larger and riskier over the last year. Outstanding leveraged loans (see the Appendix for our definition of a leveraged loan) originated in the syndication market reached about $1.1 trillion as of Sept. 30, 2018, up from about $960 billion at year-end 2017 and almost double the peak reached in 2008, according to data from S&P Global's Leveraged Commentary & Data (LCD). Even though rising interest rates seemed to finally slow volumes in the third quarter of this year, issuances of loans for leveraged buyouts remained strong, and the proportion of loans rated in the 'B' category or below rose materially. More than 80% of new issue corporate ratings assigned by S&P Global Ratings have been in that category.

In addition, the leverage levels of new borrowers in the syndication market have inched higher over the last year, even with pervasive borrower-friendly adjustments to EBITDA. "Covenant-lite" loans--that have bond-like incurrence covenants but lack significant maintenance covenants--also remain very prevalent, making up about 85% of volume year to date (see chart 2). The looser covenants will give more flexibility to borrowers who come under distress, potentially at the expense of debtholders. The higher leverage and weaker covenants will likely reduce recovery rates on defaulted loans. In fact, since the beginning of 2017, the recovery ratings that we have assigned to new first-lien loans in the U.S. reflect recovery estimates, on average, of 65%, down from 75% prior to that.

Bank regulators have expressed concern that the high growth of leveraged lending could cause systemic risks in the banking sector and broader financial system. The additional scrutiny they have applied to banks that syndicate and hold these loans likely contributed to the temporary slowing in the market in 2015 and perhaps has prevented volumes from reaching even higher.

Notably, the Federal Reserve, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp. (FDIC) in March 2013 published updated leveraged lending guidance, citing "periods of tremendous growth" and debt agreements that had "relatively limited lender protection." Those updated guidelines didn't seem to slow the market initially, and bank participants likely interpreted them differently. Therefore, regulators followed up in November 2014 with more specific guidance in a "Frequently Asked Questions" pertaining to the 2013 guidance.

That FAQ reinforced and clarified the 2013 guidance. It reminded banks that loans syndicated or held with "excessive levels of leverage" (typically greater than 6x) would "raise supervisory concerns." That FAQ plus additional regulatory scrutiny on leveraged loans in general appeared to slow issuance in 2015. A 2017 study by the Fed, "Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance," indicated that the most closely supervised large banks slowed activity and ceded some of the market to nonbanks after the FAQ.

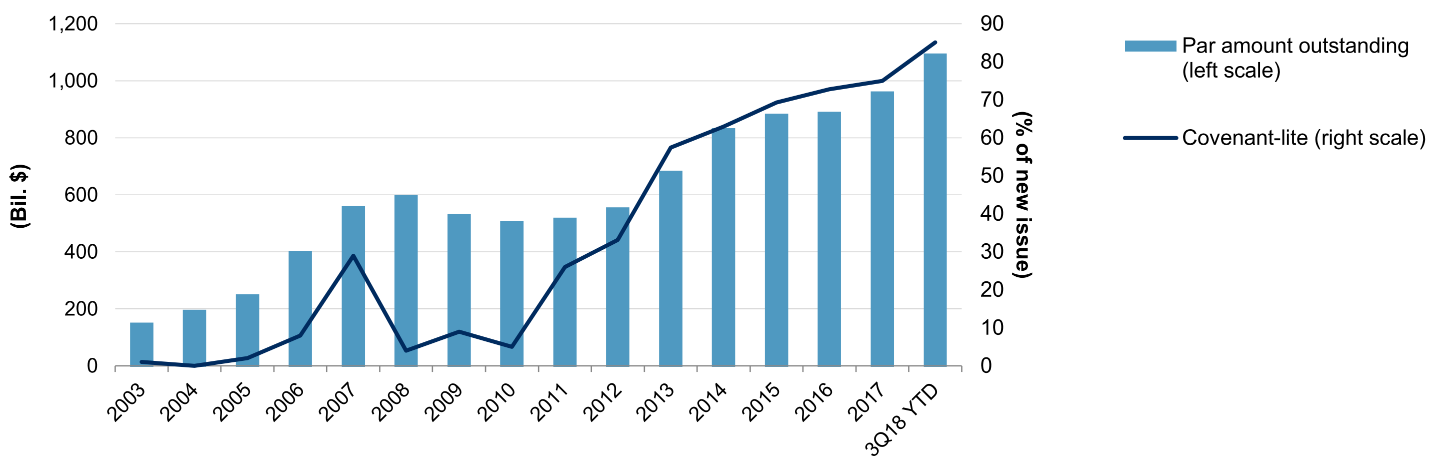
Still, the syndication market has clearly remained very active. What's more, the General Accounting Office (GAO) determined that the interagency guidance was effectively a "rule" that should have been first submitted to Congress for review under the Congressional Review Act. It is unclear whether that determination allowed banks to incrementally pay less heed to the guidance.

On top of the syndication market, leveraged loans originated in the direct lending market by institutional investors--such as asset managers, business development companies (BDCs), insurance companies, pension funds, and others (directly on balance sheet or through funds)--have also likely grown significantly in recent years. These financial institutions lend directly to the borrower rather than purchasing the loan through a syndication.

Tighter regulations and more risk aversion by the banks have likely facilitated such growth by nonbank lenders. Because of the private nature of such lending, we do not have access to comprehensive data on such loans. However, Ares, a major player in this market, recently estimated that outstanding direct loans exceeded $900 billion in the U.S. This is separate from the $1.1 trillion of syndicated loans. We believe direct loans, on average, are made to smaller borrowers (usually middle-market borrowers) than in the syndicated loan market and carry higher yields. The borrowers are probably riskier than the typical syndicated loan borrowers, but the loans are typically structured with greater lender protections.

Chart 2

Outstanding Leveraged Loans And Covenant-Lite Percentage



Source: LCD.

Table 1

Distribution Of Syndicated Large Corporate Transactions By Debt/EBITDA Ratio

Leverage (%)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<4.00x	53.7	43.8	35.9	31.5	28.7	30.3	21.9	22.7	19.5	13.4
4.00x-4.99x	22.6	22.6	26.6	29.0	22.6	24.9	32.6	27.6	24.3	20.6
5.00x-5.99x	17.9	19.2	21.8	23.1	21.5	26.2	24.4	27.6	28.0	32.0
6.00x-6.99x	5.4	10.4	13.4	12.3	19.9	16.5	17.6	18.6	22.0	24.7
7.00x or higher	0.4	4.0	2.4	4.1	7.3	2.2	3.4	3.4	6.2	9.3

Source: LCD.

2. Investors In CLO Subordinated Tranches, Loan Mutual Funds, And Other Nonbanks Have Some Of The Highest Risks

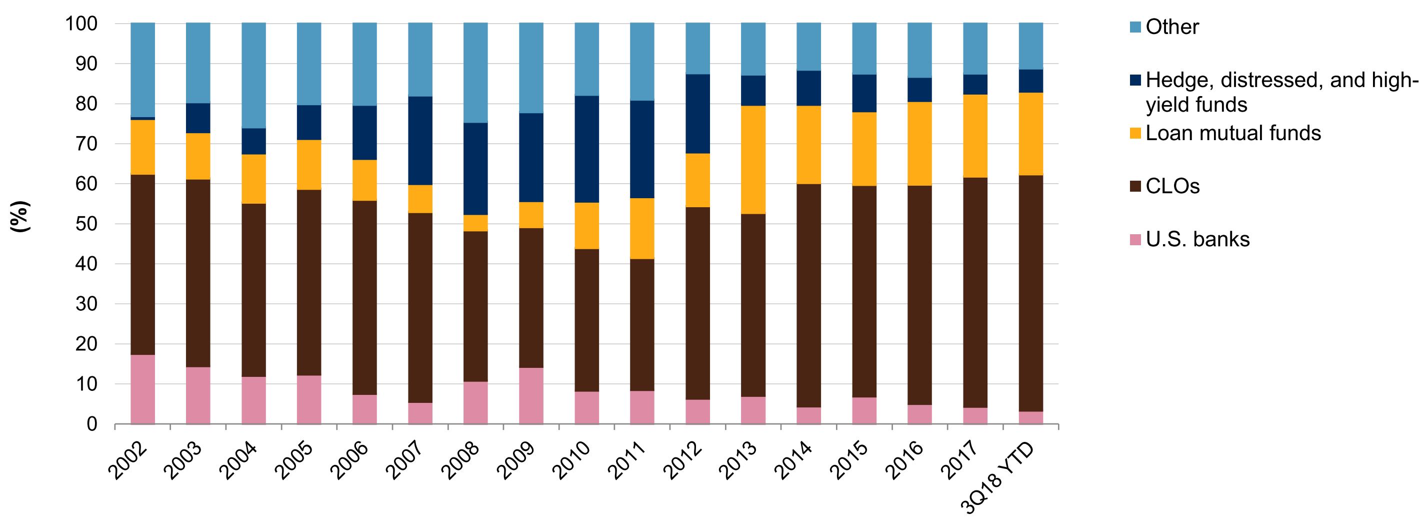
CLOs, loan mutual funds, and other nonbanks continue to purchase most syndicated leveraged loans, leaving their investors bearing much of the market's leveraged loan risk. Collateralized loan obligations (CLOs) and loan mutual funds have continued to purchase about 60% and 20%, respectively, of syndicated leveraged loan volumes, according to LCD data (see chart 3). Banks in the U.S. and globally have purchased less than 10% of new issuance this year, with a variety of funds, insurance companies, finance companies, and others buying the remainder.

Because of this, we believe investors in the lower-rated tranches of CLOs hold some of the greatest risks in the leveraged loan market. It is unclear who those investors are, but anecdotal evidence indicates certain funds and insurance companies hold some of the risk. Banks invest in

CLOs, but most of their exposure is in the highest-rated tranches, where investors have much greater protection against economic downturns than in the subordinated tranches.

Chart 3

Primary Investors In New Issues Of Leveraged Loans



Note: Only includes highly leveraged loans (those with a spread over LIBOR of at least 225 basis points).
Source: LCD.

3. Banks Are Not Immune To Problems In Leveraged Lending

Banks are not immune to problems in this market due to balance sheet loans, unfunded commitments, and syndication activity, although these amounts are not so easily determined due to poor disclosure. Based on the data we have collected from rated banks, we believe on-balance-sheet leveraged loans--or what the FDIC defines as "higher-risk commercial and industrial loans" (see the Appendix for definition)--make up less than 10% of total funded loans for most banks we rate, making this risk manageable for most banks. That said, banks have some other notable risks and could also suffer losses on:

- Off-balance-sheet commitments to syndicate leveraged loans,
- Off-balance-sheet committed funding facilities extended to leveraged borrowers, and
- Off-balance-sheet committed funding facilities extended to vehicles with leveraged loan concentrations (e.g., loan mutual funds).

In addition, if leveraged loan volumes dry up, the bank syndicators will see a drop in revenue, likely from a reduction in both advisory and debt underwriting fees.

Considering off-balance-sheet commitments, it becomes clear that banks have higher exposure to leveraged lending than that indicated solely by the leveraged loans they hold on balance sheet.

We don't have enough data to precisely calculate the total exposure, but we believe it is likely at least a few hundred billion, with much of that in unfunded commitments. Most of that exposure in dollar terms is concentrated at the large banks that have significant capital markets operations, but leveraged exposures can exceed 10% of the loans of some regional banks.

We believe the large banks have built their leveraged exposures in large part through their syndication activities. U.S.-based banks including Bank of America Corp., JPMorgan Chase & Co., Wells Fargo & Co., Goldman Sachs Group Inc., Citigroup Inc., and Morgan Stanley tend to be the largest syndicators of leveraged loans, many of which end up in CLOs and loan mutual funds. Regional banks like SunTrust Banks Inc. and PNC Financial Services Group Inc. play a smaller, but not insignificant, role. Jefferies Finance LLC is a large nonbank syndicator. Likewise, certain foreign banks also have been significant players globally, including Barclays, Credit Suisse, Deutsche Bank, and Royal Bank of Canada. The European banks sometimes rank higher than some of the large U.S. players on industry league tables for leveraged loans.

Also, a bank that leads a syndication typically offers the borrower a revolving credit facility, meaning that the most active syndicators end up with the largest unfunded commitments to leveraged borrowers. We believe that such commitments for the banks listed above can be significant. JPMorgan, Goldman, and Morgan Stanley disclose their exposures to speculative-grade corporate borrowers, although they do not disclose how much of that relates to leveraged loans. Most other banks disclose even less.

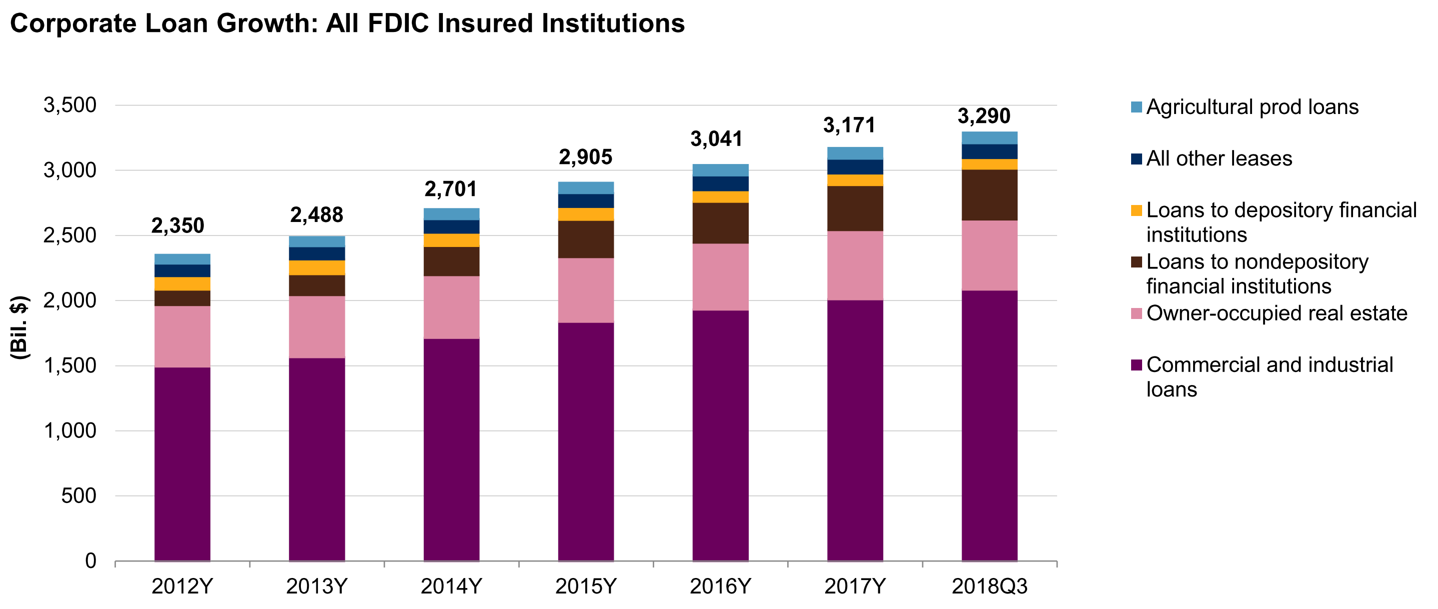
Banks that lead syndications also face market, credit, and liquidity risks associated with the syndication commitment. In many syndications, those banks make a firm commitment to fund the loans at certain terms--even if they have trouble syndicating to other investors. At any moment, a given bank could have committed to fund several billion dollars worth of loans in anticipation of full syndication. If market conditions weaken between the time of commitment and syndication, the bank could be forced to sell the loan at a depressed price. Otherwise, it could choose to extend a significant amount of liquidity to fund the loan, hold it on balance sheet, and bear the associated credit risk.

Banks and other originators protect against these risks in a variety of ways. First, certain types of loans, particularly those for refinancing, require only a "best efforts" commitment rather than a firm commitment. (A loan to finance a merger would require a firm commitment.) Originators also typically build flexibility into the pricing and terms of the loan. For instance, an originator may commit to fund a loan with an interest rate of LIBOR plus 300 basis points (bps), but with flexibility of additional 50 bps. If it could not syndicate at the 300 bps spread, it could increase the pricing by 50 bps in order to entice more market interest.

4. Banks' Other Corporate Loans Could Take A Hit In A Downturn

In addition to leveraged loans, banks also hold large amounts of other types of corporate loans, which could also be affected by the increased leverage in corporate America. FDIC-insured banks in the U.S. held $3.3 trillion of corporate loans, accounting for 33% of their total loans (see chart 4). Loans they classify as commercial and industrial (C&I) made up the largest piece of that (21% of the 33%). Loans collateralized by real estate owned by commercial borrowers, loans to nondepository financial institutions, commercial leases, loans to other banks, and agricultural production loans accounted for the remainder. Together, these commercial loans have a 5% compounded annual growth rate since 2012.

Chart 4



In a recession, we would expect leveraged loans generally to experience higher defaults and lower recoveries than other types of commercial loans. Still, these other types of commercial loans might also see a significant rise in defaults. For instance, in the financial crisis, the net charge-offs of C&I loans for all FDIC-insured banks collectively reached 1.77% of average loans in 2009 and 2.37% in 2010. They were only 0.28% in the first half of 2018.

Higher-risk C&I, or leveraged loans, make up a portion of C&I loans. Other cash-flow loans that do not meet the higher-risk C&I definition probably make up a material portion as well. For instance, this could include loans to a leveraged borrower that are used for corporate purposes other than a merger or acquisition, a leveraged buyout, or a capital distribution. It also would include loans to less-leveraged borrowers, such as those with less than 3x debt to EBITDA. Corporate loans secured by a variety of types of assets (e.g., receivables, inventory, or equipment) also likely make up a significant portion of C&I loans.

Banks generally do not disclose what portion of their C&I loans are to speculative-grade or unrated borrowers. However, given the $2.1 trillion of outstanding C&I loans, it seems plausible that banks have at least several hundred billion dollars of loans to such borrowers. Table 2 shows the corporate loans and commitments of six of the global systemically important banks, according to their SEC filings. Most of those institutions don't disclose their speculative-grade loans and commitments. Those that do show collectively more than $300 billion of speculative-grade exposure (loans and commitments).

Table 2

Corporate Loans And Commitments Of Large Banks

(Bil. $)

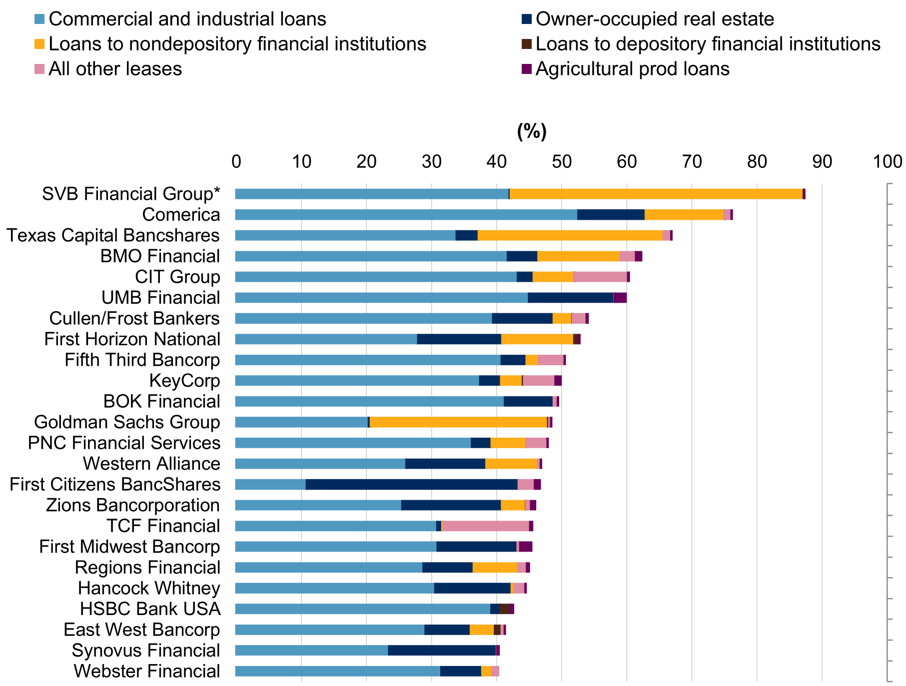
		--Corporate loans--		--Corp commitments--		--Total exposure--	
	Leveraged exposure	Speculative grade	Total	Speculative grade	Total	Speculative grade	Total
JPMorgan Chase	N/A	99.5	423.8	100.0	397.3	199.5	821.2
Bank of America	N/A	N/A	381.7	N/A	406.5	N/A	N/A
Wells Fargo	N/A	N/A	338.0	N/A	330.3	N/A	668.3
Citigroup	N/A	65.8	318.1	N/A	307.2	N/A	625.3
Goldman Sachs	N/A	43.2	69.8	38.0	126.5	81.1	196.3
Morgan Stanley	N/A	30.0	50.5	32.4	97.9	62.5	148.4

Note: Bank of America's commitments include all loan commitments except home equity lines of credit. Citigroup's corporate loan commitments also include consumer commitments other than on residential real estate and credit cards. Goldman Sachs' exposure includes all exposure other than Marcus loans and purchased credit impaired loans. Morgan Stanley's speculative-grade exposures include unrated loans and commitments. N/A--Not applicable.

For further clues of what banks could be most exposed to a downturn in general corporate credit quality, we also have looked at banks with especially large exposures to commercial loans (see chart 5). The Fed, in its Dodd-Frank Act Stress Test, provides another gauge of risk in commercial lending. It reports the loss rates on C&I loans for the banks it subjects to that stress test (see table 3).

Chart 5

Rated Banks With Commercial Loans > 40% Of Total Loans



*SVB's loans to nondepository financial institutions also include loans for purchasing or carrying securities.

Table 3

Fed Projected Loss Rates On C&I Loans In DFAST (Q1 2018-Q1 2020)

(As A Percent Of Average Balance Of Small- And Medium-Size Enterprise Loans And Corporate Cards)	
Barclays US LLC	24.4
Goldman Sachs Group Inc.	16.9
Discover Financial Services	15.1
Capital One Financial Corp.	12.9
RBC USA Holdco Corp.	12.8
Morgan Stanley	11.3
JPMorgan Chase & Co.	11.0
American Express Co.	10.6
BNP Paribas USA Inc.	10.4
U.S. Bancorp	10.2
MUFG Americas Holdings Corp.	8.2
BBVA Compass Bancshares Inc.	8.1
HSBC North America Holdings Inc.	7.5

Table 3

Fed Projected Loss Rates On C&I Loans In DFAST (Q1 2018-Q1 2020) (cont.)

Regions Financial Corp.	7.5
BMO Financial Corp.	7.3
State Street Corp.	7.3
TD Group US Holdings LLC	7.3
Citizens Financial Group Inc.	7.2
UBS Americas Holding LLC	7.2
PNC Financial Services Group Inc.	7.0
Wells Fargo & Co.	6.8
KeyCorp	6.7
BB&T Corp.	6.2
Huntington Bancshares Inc.	6.1
Fifth Third Bancorp	5.9
M&T Bank Corporation	5.8
Santander Holdings USA Inc.	5.8
Bank of America Corp.	5.6
Northern Trust Corp.	5.5
SunTrust Banks Inc.	5.5
Ally Financial Inc.	5.4
Citigroup Inc.	5.1
Bank of New York Mellon Corp.	3.1
DB USA Corp.	2.4
Credit Suisse Holdings (USA) Inc.	0.0
Participating bank holding companies--median	7.2

C&I--Commercial and industrial. DFAST--Dodd-Frank Act Stress Test.

5. BDCs And Other Commercial Lenders' Focus On Leveraged Lending Leaves Them Vulnerable To Weakening Market Conditions

A concentration in leveraged lending could put some direct lenders, such as BDCs, at the greatest risk from a decline in conditions if their underwriting has been subpar. BDCs and a few other commercial lenders we rate would probably be the most exposed to a downturn in leveraged lending since they focus almost exclusively on this area. We believe many direct lenders have underwritten loans with more lender protections than in the syndication market, which could be an important offsetting factor.

We have expressed caution over the last two years about the BDC sector because of intense competition and growth in leveraged lending. Exacerbating this is the regulatory change passed earlier this year (Small Business Credit Availability Act) that effectively allows BDCs the option to double their leverage. As a result, we've taken several negative rating actions on BDCs, including Apollo Investment Corp., Ares Capital Corp., Goldman Sachs BDC, Hercules Capital Inc., PennantPark Investment Corp., and Solar Capital Ltd. We continue to believe our ratings on BDCs will diverge through the next credit cycle as it becomes clearer who has had the best borrower selection and underwriting.

We believe that a rise in losses in the leveraged loan market would also hurt other nonbank lenders, such as Jefferies Finance. Jefferies Finance focuses on syndicating leveraged loans and bears the associated liquidity risk as well as the attendant credit risk. We believe our rating on Jefferies Finance already reflects the risk of some deterioration in leveraged lending.

6. A Surge In Redemption Requests Could Hurt Liquidity For Some Companies

A fallout in leveraged lending could also cause liquidity issues for some companies and funds, perhaps forcing them to rapidly sell loans at depressed prices. Loan mutual funds had about $180 billion in assets under management as of Aug. 31, 2018, up from $115 billion two years ago, according to LCD data. These types of funds had assets under management of roughly $50 billion or less until about 2012 when they saw a surge of new funds, particularly from retail investors in search of yield.

The great majority of these funds are open-ended, allowing investors to demand redemption daily. If investors became greatly concerned about leveraged loan credit quality, there could be a sharp increase in redemptions. The funds might have to sell loans--a process that typically includes a long settlement period--to meet those redemption requests, potentially sharply driving down market prices for these loans. These funds often hold some level of cash and securities as well as back-up facilities with banks. However, a large wave of redemptions could exhaust these sources, forcing the funds to sell loans rapidly at depressed prices.

Asset managers like OppenheimerFunds, Lord Abbett, Fidelity, Eaton Vance Corp., and Blackrock Inc., among several others, manage loan mutual funds. We do not see this as a large risk for most of the asset managers we rate because such funds tend to be a very small portion of their assets under management. Still, there could be reputational risk, at a minimum, for any asset manager that suffers large redemptions in a loan mutual fund, particularly if it has to sell loans at depressed prices to meet redemptions.

BDCs could also face liquidity pressure if their leveraged loans decline in quality. BDCs mark their loans to market and face regulatory leverage constraints. Many BDCs derive at least a portion of their funding from facilities that include covenants linked to those regulatory leverage limits. If breached, the BDC may face acceleration of a portion of its debt.

Appendix: Defining A Leveraged Loan

The definition of a leveraged loan is somewhat amorphous. Different participants have different definitions depending on factors such as our ratings on the borrower, its ratio of debt to EBITDA, and the proportion of its capital structure the loan accounts for, among other factors.

For the purposes of this article, we rely on data from Leveraged Commentary & Data (LCD), an S&P Global unit that follows the leveraged loan market, as well as public and confidential data from banks. We believe LCD's definition of a leveraged loan probably does not differ substantially from what the FDIC has termed "higher-risk C&I loans," which are reported confidentially on bank call report filings. It is important to note that LCD only publishes data on the broadly syndicated leveraged loans, and directly originated leveraged loans are excluded from that data set.

The FDIC definition of leveraged loans is fairly detailed but essentially captures loans that are:

- Unsecured, cash flow-based loans;
- More than $5 million in size;
- Account for more than 20% of the borrower's debt;
- Made to borrowers with a ratio of senior debt to EBITDA of more than 3x or total debt of more than 4x; and
- Used to finance a buyout, merger or acquisition, or a capital distribution (or is a loan that has refinanced a prior loan originated for one of those purposes).

The FDIC's definition of a higher-risk C&I loan is narrower than the definition used in the interagency guidelines by U.S. regulators on leveraged lending.

This report does not constitute a rating action.