Banks / Global Economy

The risk of the growing market of leveraged loans

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Leveraged loans are granted to entities with considerable amounts of debt, that is, according to the European Central Bank (ECB), those with a debt-to-income ratio before interest and tax of more than four. This leveraged loans market and the market relating to securitization processes using these loans as underlying assets (CLOs — collateralized loan obligations) has experienced a significant growth in recent years, reaching historical highs. The low interest rate environment prompted the increase in demand for this type of asset, which offers alternative higher returns. The further continuation of the recently announced accommodative monetary policies, announced by the main central banks, could prolong their growth. But what is the problem? The rapid expansion of this market has been accompanied by a considerable relaxation of lending standards. It should be noted that this market is mainly concentrated in the United States, the United Kingdom and within the eurozone, in France and Germany. In Spain and Italy, numbers have been much lower and, additionally, they have experienced a strong deleveraging since the last crisis.

The rapid growth of leveraged loan markets in recent years has contributed to the excessive accumulation of corporate debt in some advanced economies. In fact, according to data from the Bank for International Settlements, the ratio of loans granted to non-financial corporations to GDP has increased to 91% in 2018 (from 85% in 2007) for these economies. The eurozone showed a more notable increase, from 92% in 2007 to 105% in 2018, but with diverse changes between countries (on the one hand, France is above average, with 141% in 2018, while Italy and Spain are below average with 93% and 70%, respectively). Finally, the United States is also above pre-crisis levels.

Regarding credit standards, leveraged loans are being granted to borrowers with increasing leverage (with a debt-to-EBITDA that is higher than the levels seen in 2007). Furthermore, traditional covenants protecting investors from unexpected loss have been relaxed in recent years. In particular, covenant-lite transactions have reached a historic high (about 80% of new issuances). These factors (lower protection and lower creditworthiness of borrowers) could undermine recovery rates in a recession, causing greater losses than in previous crises. It is obvious that this deterioration of underwriting standards is unprecedented and the reaction of leveraged loan markets under a more stressed economic scenario is uncertain.

Although the accelerated growth of the leveraged loan market may be comparable to the subprime mortgage market, there are many differences between the two. On the one hand, these are loans extended to diversified sectors and markets, rather than being concentrated in just one. On the other hand, only one third of leveraged loans are securitized, while the rest are distributed to non-bank direct investors (investment funds, pension funds, insurance companies, etc.), or are held by banks. The deposit entities hold in their balance sheets the lower-risk tranches (the most senior would have collection priority) and, unlike 2007, their capitalization levels are higher thanks to the regulatory reform implemented after the crisis. Therefore, the transmission to the broader economy of a risk event should be more contained than in the past. However, this should not lead to complacency, as the most risky portion of these loans rest into less regulated entities, where buffers to absorb unexpected losses are lower since they are not subject to the same regulations. Undoubtedly, the accumulation of excessive leverage in some firms and the increased exposure to leveraged loans of non-bank entities add uncertainty on how this may affect the corporate sector and, consequently, the rest of the economy.

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