RESEARCH

Banking Watch

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Economic Analysis

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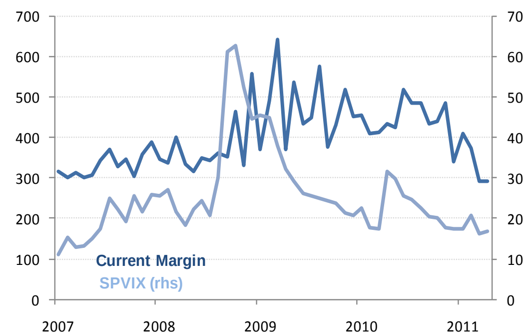
Are Leverage and C&I Debt Markets Overheating In 2011?

- Leveraged loan issuance continues to shift to lower risk debt refinancing and project finance rather than leveraged buyouts and acquisitions
- Bank C&I delinquency rates are declining and debt charge-offs are improving indicating strengthening financial balance sheets
- Our analysis of margins and issuance across commercial paper, corporate bonds, leveraged loans and bank lending does not suggest overheating

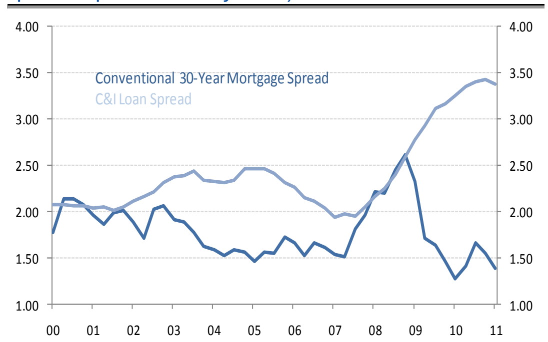
Prior to the financial innovation of the last decade, corporate borrowing had three distinct forms: commercial paper, bonds, and commercial and industrial (C&I) loans. Financial innovation created complex debt vehicles that allowed nonfinancial entities to also engage in higher risk corporate lending. Syndicated loans and collateralized debt obligations (CDOs) facilitated the formation of a leverage bubble in 2007-2008. An Influx of nontraditional financial firms, with low risk aversion and who were unburdened by internal leverage requirements imposed upon banks, flooded into the non-traditional debt markets fueling a run up in leveraged loan issuance. Institutional lending shifted following the collapse in 2007-2008. The institutional lenders, which once sought high returns regardless of risk, are now lending in a more benign leveraged loan environment. The shift is due in part to uncertain market conditions and low yields, prompting companies to refinance debt and focus on capital reinvestment. In addition, suppliers of leveraged funds are not eager to return to high volume speculative investment, with a noticeable absence of nonfinancial firms.   However, C&I lending has rapidly expanded in the past few months, raising concerns that in combination with strong capital inflows into high-yield markets, there is a credit binge looming.

Chart 1
Current Margin & S&P Volatility



Source: Federal Reserve and BBVA Research

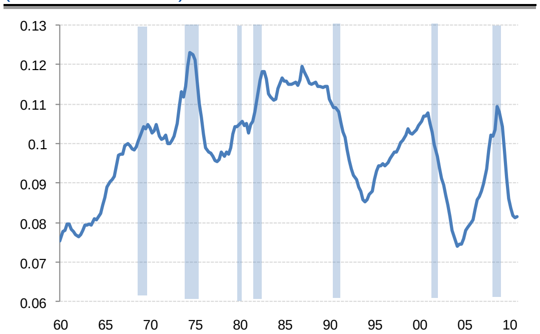
Chart 2
C&I Loans and Mortgage Spread
(C&I = Spread over Intended Fed Funds rate & Mortgage spread= Spread over 10-yr note)



Source: Federal Reserve

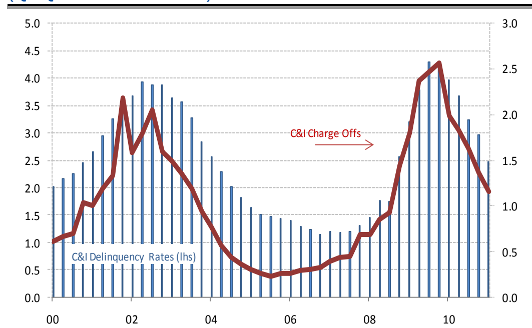
Our analysis suggests that the current debt binge will not likely overheat the traditional debt markets and commercial paper, C&I loans, or corporate bonds will stabilize. Commercial paper issuance is well below pre-recession levels and with abundant supply and limited demand it is unlikely to change in the near future, given a moderate growth trajectory. Also, nonfinancial corporate bond markets are on a stable trajectory with little change from pre-recessionary levels, eliminating worries of institutional binging. However, the C&I loan market has bounced back after its $356bn decline from the peak established in October 2008, growing 3.2% YoY in May. Concerns over the growth of C&I seem inappropriate when compared with the ratio of credit outstanding to GDP. From a historical perspective, the C&I debt to GDP ratio was 8% in 1Q11, which is below the average ratio of 9%. It appears current corporate strategies are focused on long-term stability rather than purely leveraging their capital. This is apparent in both the run up in C&I lending and the fundamental shift in leveraged lending from leveraged buyouts to capital reinvestment and debt refinance. Furthermore, both C&I delinquency rates and charge-off rates are declining, suggesting that the risk in this loan category is steadily improving. It appears these markets are making intrinsic corrections without the need for policy intervention.

Chart 3
C&I Loans as a Fraction of GDP
(shaded=recession)



Source: Bloomberg

Chart 4
C&I Delinquency Rates & Charge Off's
(QoQ Annualized Rate)



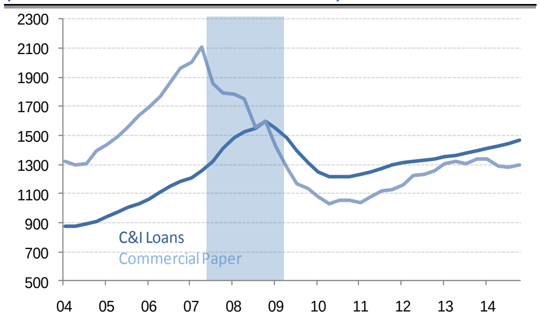
Source: Federal Reserve

Additionally, a growing concern has emerged that institutional investors are shifting to high-yield leveraged loan markets, in search of above-market returns, indicating a possible glut in leverage supply of funds. However, a recent exodus of capital and weak corporate demand are both facilitating the moderation in leveraged markets, maintaining what appears to be a more sustainable path. Prior to 2007-2008, institutional investors flooded the leveraged loan market. Financial innovation in the form of more complex syndicated loans and CDOs facilitated the expansion of a risky investment pool. However, today's institutional investors, after the disastrous fallout in 2007-8, are not returning to old habits. At the close of 2007, the largest year for institutional leveraged lending, 37.7% of the aggregate market was composed of high risk leverage buyouts and acquisitions; today the institutional leveraged loan issuance is nearly 1/10th the volume of 2007 and issuance is more conservative in nature, funding to a stronger demand base. For example, issuance today involves more secured debt and project refinancing, comprising 39.3% of the total issuance so far this year as opposed to 13.2 % in 2007. In addition, an analysis of margins over the past three years shows a strong relationship with market conditions such as the S&P500 volatility index. As the financial system normalizes, we would expect spreads to normalize as well. It is hard to extract causal margin equilibrium mechanisms due to its many fluid parts, but margins prior to the expansion in 2002 were on average 375bp over the LIBOR.[1] Due to current market conditions (increased traditional credit liquidity) we expect a medium-term equilibrium spread to be stable at 325-350bp. However, when the Fed begins to tighten credit, we believe 350-375bp is a more sustainable spread over LIBOR.

1 The LIBOR rate averages 4.6% per year during our sample period.(Source Institutional Demand Pressure and the Cost of Leveraged Loans, Ivashina and Sun)

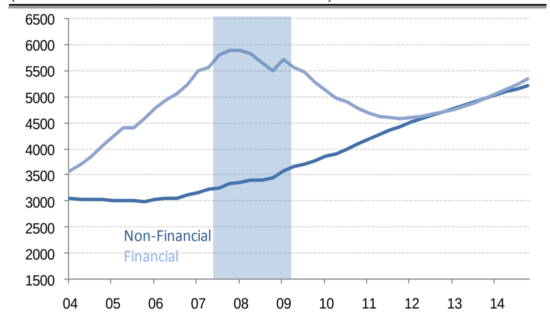
Bottom line: Our analysis does not suggest there is instability in either traditional or non-traditional lending markets. Institutional leveraged issuance is declining, C&I spreads are incentivizing banks to extend corporate loans, and commercial paper remains lackluster, despite a recent stirring of growth in the market. Further diversification away from CRE could prompt traditional lenders to increase leveraged activity; however, increased regulatory requirements imposed upon these players will deter any speculative run-up in the near future. In regards to leveraged loans, the current margins are tight, but the low volume of institutional leveraged issuance assuages worries of good money chasing after bad.

Chart 5
Commercial Paper and C& Loan Issuance
($Bn w/forecasts, shaded=recession)



Source: BBVA Research

Chart 6
Financial & Non-Financial Bond
($Bn w/forecasts, shaded=recession)



Source: BBVA Research