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Leveraged lending guidance: is it a dead letter?

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Partners from the New York office of Shearman and Sterling look at the current state of the leveraged lending market and ask if it is really generating systemic risk

Recently, global leaders have been expressed concerns about an impending slowdown in economic growth and the end of the credit cycle. These concerns, among others, have manifested in an increased focus on the perceived possibility of deterioration of loans originated in the leveraged lending market.

For some time now global leaders have expressed concerns about an impending slowdown in economic growth and the end of the credit cycle. These concerns, among others, have manifested in an increased focus on the perceived possibility of deterioration of loans originated in the leveraged lending market. Yet, the world's banking system has illustrated a different narrative, revealing that global financial institutions have actually shown significant growth and resiliency over the last ten years. Given these conflicting narratives, where is the leveraged lending market, actually, on the risk spectrum and is it really generating systemic risk? Is the leveraged lending guidance being enforced by key players and where are regulations headed for this growing market?

Yet, the world's banking system has illustrated a different narrative. In addition to exhibiting significant growth, profitability and resiliency over the last ten years, the total assets in the Banker's Top 1000 World Banks in 2019 soared to $122.8 trillion, while return on assets (ROA) stood at 0.73%. In its annual health checks of the financial strength of the 18 largest banks in the US, the Federal Reserve also recently reported

that American banks are healthy and well-positioned in the marketplace.

So where is the leveraged lending market, actually, in the risk spectrum and is it really generating systemic risk?

In January, the Federal Reserve Board, Federal Deposit Insurance Corporate (FDIC) and the Office of the Comptroller of the Currency (OCC) released a review of the shared national credit (SNC) loans, which found that while risk associated with large syndicated loans has declined, the risk associated with leveraged lending has not improved. The SNC review also found that many leveraged loan transactions possessed increasingly weaker lender rights and stronger reliance on future revenue growth, or anticipated cost savings and synergies, to support borrower repayment capacities. As of last year, nearly 80% of the $1 trillion asset class was "covenant-lite," meaning the deal structures did not include maintenance financial covenants for the borrowers.

Participation from non-bank entities in the leveraged lending market has also risen through purchases of loans, direct underwriting or syndication of exposure. According to the SNC review, much of the risk in the market is being taken on by these non-banks. The increased activity by non-bank lenders is partially viewed with concern to the extent in which their participation could further erode the quality of loans and potentially lead to systemic risk. However, the large pool of non-bank lenders have played an important role in de-risking banks by diversifying lending risk, and the "dry powder" allocated to non-bank lending participants offers enhanced resilience in case of a declining market.

Collateralised loan obligations (CLOs) – the largest group of investors in leveraged loans – constitutes one of the most important non-bank participants in the leveraging lending ecosystem. These securities issuers, which possess robust capital structures, can absorb significant losses in the event of a default that could result in distressed disposal of assets. Yet, in January, S&P Global reported that the securitisation market has been energised with a volume of $1 trillion, suggesting that institutional investors remain confident about the growth of the economy and that the leveraged lending market is not as vulnerable as what has seemingly been reported in recent months.

A dead letter?

These economic indicators and the continued growth of the leveraged lending market then begs the question, is the leveraged lending guidance a dead letter?

While the current administration has chosen more of a laissez-faire stance, by taking a more relaxed approach to the leveraged lending guidance at the highest levels, they have certainly not rendered it invalid or out-of-date. Government watchdogs are still enforcing the guidance insofar as it requires banks to practice their core credit function of assessing the borrower's ability to repay their debts. While banks are demonstrating growing optimism around the borrower's EBITDA expectations such as future cost savings, future synergies and increased future earnings, they have not been offering higher leverage indiscriminately. In fact, the leveraged loan default rate in the US shows that the asset class dipped to 0.93% – it's lowest level in almost seven years and well below the historical average of 2.93% – suggesting that banks are still remaining judicious when originating these loans.

All of this may certainly indicate that the current state of affairs isn't posing an imminent threat to the economic system, but prudential regulators should still keep a watchful eye on activity – and they are.

In June, William Coen, Secretary General of the Basel Committee, an international group of banking supervisory authorities, indicated that regulators are enhancing their scrutiny of the leveraged loan market, but suggested that new regulations weren't currently needed. In July, too, Federal Reserve governor Lael Brainard called for the " active monitoring of leveraged lending".

Similarly, the Financial Stability Board (FSB), an international body comprised of financial regulatory authorities, recently launched an examination of aspects of the leveraged loan market. The Board's Chairman, Randal Quarles, commented in March of this year that the review focusses on identifying the holders of CLOs worldwide, as well as assessing the risks that could result from investors (namely, banks, investment funds, and insurers) withdrawing funds from institutions exposed to CLOs in the event of a severe downturn. He further stated that regulators could take action if the examination's findings reveal actual hazards in the market for leveraged loans.

Echoing the FSB examination, Federal Reserve Chairman Jerome Powell underscored the importance of better identifying what types of institutions hold the bulk of CLOs worldwide, indicating that this information is of particular interest to global regulators. Chairman Powell more recently noted that, while the Federal Reserve is "very carefully" monitoring bank exposures to leveraged lending risks, the greatest risks in this regard are outside of the traditional banking system.

Focus

Overall, then, while regulators have undoubtedly increased their focus on the leveraged loan market, including with respect to non-bank financing, new rules may not yet be on the horizon. In the near term, regulators seem keenly interested in better understanding how CLOs are spread throughout the financial system and what types of institutions – bank or non-bank – hold them.

Perhaps Federal Reserve Chairman Powell summarised it best in his November 2018 speech: "The question for financial stability is whether elevated business bankruptcies and outsized losses would risk undermining the ability of the financial system to perform its critical functions on behalf of households and businesses. For now, my view is that such losses are unlikely to pose a threat to the safety and soundness of the institutions at the core of the system and, instead, are likely to fall on investors in vehicles like collateralised loan obligations with stable funding that present little threat of damaging fire sales."

While the global financial system remains sound at the current moment, cautious optimism seems to be the mantra especially as the leveraged lending market continues to grow.

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