BRIEFING

European Parliament

Leveraged finance: a supervisory concern in the Banking Union?

The increased volume of "leveraged finance" in the banking sector has recently led US, EU, and international supervisory authorities to caution against related financial stability risks. This briefing summarises (i) the concept of leveraged finance, (ii) the warnings that the different supervisory authorities have issued, (iii) the market developments, (iv) key financial stability risks, (v) and the related actions taken so far by the ECB.

The ECB has issued guidance on leveraged finance, which seems less effective than expected. As leveraged finance is provided both by banks and non-banks, the issue has been raised as to whether and how cross-sector standards should be implemented. The FSB is currently further investigating leveraged finance to identify ultimate risk holders with a view to publishing a report by autumn 2019. The SSM has not disclosed so far the extent to which banks are exposed in the Banking Union and there is little information of who holds these instruments. Leveraged instruments are still commonly linked to the so called "shadow banking sector" (currently referred as non-bank financial intermediation). This briefing is focussed on "leveraged finance" and does not cover leverage risks in asset management.

The concept of leveraged finance

The concept of "leveraged finance" refers, in this briefing, to transactions that entail an elevated risk for the lenders or investors providing the funds, and it comprises:

- leveraged loans - loans to highly indebted firms or to firms that are owned by financial sponsors (private equity investment firms), and
- high yield bonds - bonds issued by firms with a non-investment grade credit rating, by highly indebted firms, or by firms with otherwise elevated risk (e.g. start-ups).

Leveraged loans are typically used to finance a buyout, merger or acquisition. The business model of private equity investors is to buy firms with comparatively small amounts of own equity, financing the rest of the purchase price with debt (leveraged loans). Those loans are deemed risky because the accumulated debt amounts to a multiple of the firms' annual earnings and cash flows. A firm's repayment capacity is usually calculated as the ratio of earnings before interest, tax, depreciation and amortisation (EBITDA) to its total debt. If future earnings or assumed cost savings are overestimated, or interest rate changes underestimated, the firm's actual repayment capacity can be harmed and lead to defaults.

In the past, leveraged loans used to be protected by contractual clauses (maintenance and standstill covenants) that allowed lenders (banks) to monitor the borrowing firm's performance and take action, like forcing the sale of assets, if earnings deteriorated. However, underwriting standards for leveraged loans

Economic Governance Support Unit (EGOV)
Authors: J. Deslandes, C. Dias and M. Magnus
Directorate-General for Internal Policies
PE 634.369 - March 2019

EN

have deteriorated, so that at present loans with looser rules, known as "covenant-lite", make up for the majority of newly issued leveraged loans.

For the purpose of delineating "high yield bonds" from other bonds, one usually refers to the credit rating of the issuer as being non-investment grade, i.e. to a credit rating below the category BBB- or Baa3 on the rating scales used by the "Big Three" credit rating agencies (Moody's, S&P and Fitch Ratings). For non-rated issuers, the issuers' repayment capacity can likewise be used. High yield spreads on the financial market in general reflect the investors' perception that the higher risks associated with those bonds need to be sufficiently compensated for.

Recently issued warnings

The United States (US) have the largest leveraged finance market. Warnings about potential risks that leveraged finance may pose to financial stability, have particularly been raised in relation to US market developments both by US authorities and credit agencies:

- In an interview held in October 2018, the **former US Federal Reserve Chair** Janet Yellen expressed her concerns about the significant growth of leveraged loans in particular in the "covenant-lite" form. She warned "*If we have a downturn in the economy, there are a lot of firms that will go bankrupt, I think, because of this debt. It would probably worsen a downturn*."
- The Federal Reserve's Financial Stability Report of November 2018 in particular finds that "*Spreads on high-yield corporate bonds and leveraged loans over benchmark rates are near the low ends of their ranges since the financial crisis*".
- In its Semi-annual Risk Perspective of December 2018, the **Office of the Comptroller of the Currency** finds that "*the bank operating environment poses a number of challenges that elevate risks for banks. These challenges include [...] leveraged loans*".
- Also referring to the situation in the US, the credit rating agency **Moody's** pointed in a press announcement published in January 2019 to their observation that in the third quarter of 2018, the covenant quality of US leveraged loans reached a new record worst on its Loan Covenant Quality Indicator scale, leaving investors exposed to greater risks than ever before.

International institutions have emphasised risks to financial stability at global level:

- The **International Monetary Fund** (IMF) issued a strong warning ("Sounding the Alarm on Leveraged Lending"): "*We warned in the most recent Global Financial Stability Report of October 2018 that speculative excesses in some financial markets may be approaching a threatening level. For evidence, look no further than the $1.3 trillion global market for so-called leverage loans [...]*". That estimation of $1.3 trillion has been recently challenged as highly underestimated (see below).
- The **Bank of International Settlements** (BIS) highlighted in September 2018 the key risks to financial stability that those market developments entail should a downturn materialise (see below "Financial stability risks")
- The **Financial Stability Board** (FSB) stressed in February 2019 that leveraged loans "*warrant close monitoring given the potential for spillovers to other markets*".

The **European Central Bank** (ECB) also cautioned against the development of leveraged loans in the Eurozone. In 2018, the ECB has addressed the topic of leveraged finance twice in its bi-annual Financial Stability Reviews:

- In the ECB May 2018 Financial Stability Review, the ECB cautioned that "*Signs of potential mispricing are also evident in the larger leveraged loan market. [...] a significant relaxation of underwriting standards for US and European leveraged loans has been observed in recent years. This increases the*

likelihood that defaults will be delayed and recovery rates will be lower should the creditworthiness of the borrowers deteriorate." The ECB's Financial Stability Report points to contagion risk (May 2018, p. 78): "*The likelihood of international contagion and system-wide spillovers is elevated in the context of a global search for yield*."

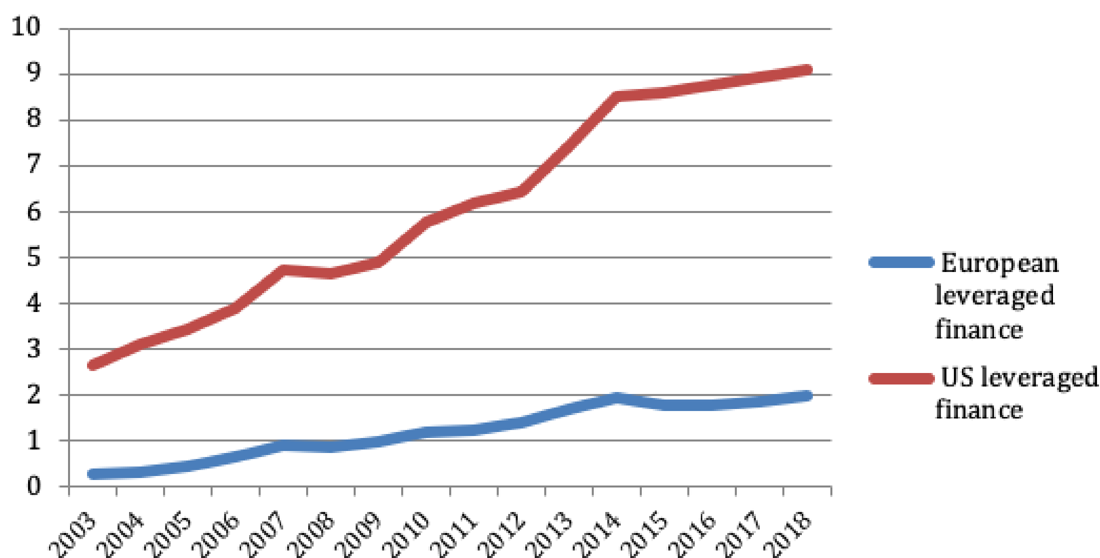
- The ECB November 2018 Financial Stability Review adds (p. 10) that "*leveraged loan markets continue to expand amid compressed spreads and weakening underwriting standards*".

Market developments

While there is a crescendo of supervisory warnings against the risks of leveraged finance, there is little information publically available about the exact exposure of the Banking Union's financial sector, banks and non-banks. This section briefly summarises some related aggregate data.

In the Bank for International Settlements' September 2018 quarterly review, data show that leveraged finance, comprised of high-yield bond and leveraged loans, has since the global financial crisis approximately doubled in size both in the US and in the EU, though in absolute terms the US exposure is much higher.

Chart 1: Leveraged finance in Europe and the US (US$ trillion)

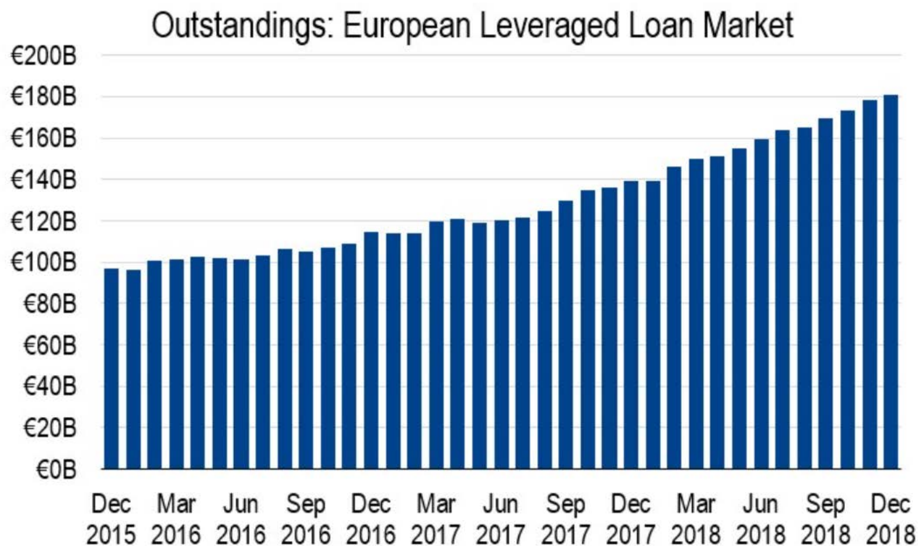


Source: D. Schoenmaeker, based on BIS (2018)

In January 2019, the Bank of England estimated that the leveraged loan market was much broader than the $1.3tn referred to in IMF publications. That $1.3tn figure refers to loans underlying the indices tracking the leveraged loan market. According to the Bank of England, including less-liquid loans that are not tracked in those indices, non-bank investors hold about $1.8tn of leveraged loans, and the total size of the market is $2.2tn if one includes lending facilities held by banks. All in all, the leveraged loans market accounts to 9% of all advanced-economy corporate credit, according to estimates of the Bank of England. ECB data points to roughly €2 trillion.

According to the FSB, the exact size of the leveraged loan market is in any case difficult to estimate given the lack of data for many private transactions (FSB, Global Monitoring Report on Non-Bank Financial Intermediation 2018, February 2019). The credit rating agency Standard and Poor's reports that the European leveraged loan market[1] has reached a record high in 2018 (see chart 2).

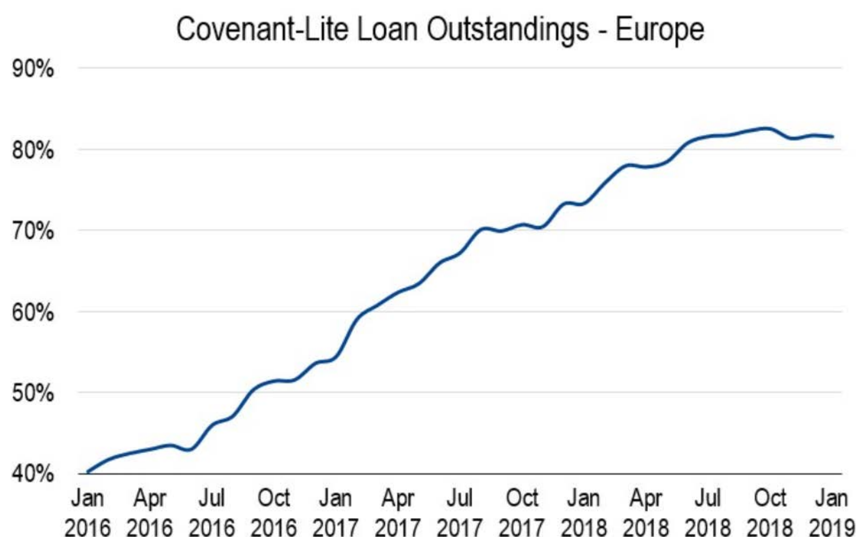
Chart 2: European Leveraged Loan market at a record high in 2018



Source: Leveraged Commentary & Data (LCD), an offering of S&P Global Market Intelligence, 11.01.2019

A situation that may be particularly worrying for supervisors is that underwriting standards for leveraged loans have significantly deteriorated in the recent past. Standard and Poor's reports that covenant-lite credits now account for 81.6% of all outstanding leveraged loans in Europe, nearly double the rate seen only three years ago (see chart 3):

Chart 3: Share of covenant-lite leveraged loans in Europe



Source: Leveraged Commentary & Data (LCD), an offering of S&P Global Market Intelligence, 26.02.2019

[1] Data from Standard and Poor's is based on leverage loans indices and therefore does not include all leveraged loans (i.e. the less liquid ones).

The following may explain those market developments:

- The prospect of interest rate rises increases the relative appeal of leveraged loans, which - unlike most high-yield bonds - offer a return that is indexed to the interbank rate (on the other hand, interest rises of indexed loan can in particular become a problem for those firms that are highly leveraged, driving up default rates);
- According to the BIS, developments in the securitisation market contributed to the growth in leveraged loans, as originator banks are finding it easier to take them out of their own balance sheet and sell them to other investors by means of securitisation in form of collateralised loan obligations (CLOs). In the US, further to a February 2018 court ruling, "retention requirements" (i.e. the requirement to keep a certain part of such securitisation on originator's own balance sheet) no longer apply. The CLO issuance in the U.S. has risen over 60% just since 2016[2];
- A loosening of underwriting standards that make it practically easier for banks to arrange those loans (there is less need to monitor whether the loan taking firm complies with the requirements);
- More broadly, as noted by the BIS, "*the leveraged credit market has been buoyed by a favourable macroeconomic background and strong equity markets. Corporate restructurings such as mergers, acquisitions and leveraged buyouts have accounted for close to 40% of US institutional leveraged loan issuance since 2015*".

Risks to financial stability

Risks of leveraged finance include (i) credit risk, including throughout off-balance sheet commitments (contagion), where appropriate"; (ii) reputation risks; (iii) funding and market liquidity risk. In addition, the scarcity of data relating to where the risks are effectively held further increase financial stability concerns[3].

In terms of credit risk, the default rate of US institutional leveraged loans is currently moderate. It increased from around 2% in mid-2017 to 2.5% in June 2018, according to the BIS. Nevertheless, as emphasised by the BIS, where the FED monetary policy would further normalise, borrowers' services costs are expected to increase, given the floating rate feature of leveraged loans. This could trigger defaults and subsequent losses for banks that hold these loans on their balance sheets or for investors, such as pension funds, insurance companies, and asset managers, to whom banks transfer the risk namely in the form of collateralised loan obligations (CLOs) backed by leveraged loans.

According to the Bank of England Financial Stability Report, risks are evenly distributed across the financial sector: one-third of leveraged loans are held by banks, one-third by insurers, and pension funds and the remaining one-third by hedge funds and open-ended investment funds.

In addition to loans held by banks, banks 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*)" according to S&P Global. In the same vein, an IMF warning stressed in November 2018

[2] Moody's 'From covenants to cushions: Top 10 credit challenges CLOs face today'

[3] The ECB Financial Stability Report of November 2018 mentions "*Investors in leveraged finance remain exposed to the risk of a sharp repricing and developments in the sector may spill over more widely (...) Beyond direct holdings, funding for CLO loan warehousing and other facilities provided to other investors represent additional channels through which some banks are exposed to the leveraged loan market. At the global level, risks extend more broadly to high-yield debt markets, considering the record-high leverage of high-yield corporates, the growth of direct lending outside the traditional bank syndication channel and the progressively larger unsophisticated high-yield investor base*."

that *"it is unclear whether institutional investors retain a link to the banking sector, which could inflict losses at banks during market disruptions"*.

Contagion and interconnectedness may expose banks to reputation risks arising from distressed market conditions affecting lenders of leveraged instruments. These risks are, nevertheless, difficult to measure and to assess. Leveraged instruments are still commonly linked to the so called "shadow banking sector"[4] (currently referred as *non-bank financial intermediation*).

Leveraged loans also entail funding and market liquidity risks. Downgrades of borrowers hit by a downturn or higher costs on their debts may result in investors dumping that debt. For the BIS, "*the relative illiquidity of leveraged loan markets could exacerbate the resulting price impact. Moreover, given that mutual funds are a major buyer, mark-to-market losses could spur fund redemptions, induce fire sales and further depress prices. These dynamics may affect not only investors holding these loans, but also the broader economy by blocking the flow of funds to the leveraged credit market*" thus spurring contagion across interconnected institutions. Such contagion effect is also relevant when institutions' portfolios are less diversified and contain similar assets.

Against this background, Bank of England's Financial Stability Report of November 2018 took some comfort of the fact that the **UK banks direct exposure to leveraged lending is comparatively small:** "*Given the loosening of underwriting standards, investors in leveraged loans — including through CLOs [collateralised loan obligations] — are at increasing risk of loss. CLOs are held mainly by non-bank investors, although international banks are estimated to hold around a third of the outstanding stock, mainly the less risky tranches. UK banks, in contrast, only have small holdings of CLOs and their domestic corporate lending has not shifted materially towards higher-risk borrowers. UK banks' exposures to leveraged lending were tested in the 2018 stress test*".

In contrast, the **SSM has not disclosed information** assessing the risks to which Banking Union banks are exposed, including in stress scenarios.

The **Financial Stability Board** (FSB) has recently launched an examination of the leveraged loan market to further identify risks and possible contagion effects. That report, to be published in autumn 2019, is expected to further analyse the degree to which banks, including SSM banks, are exposed to leveraged finance risks. This particularly requires further understanding the ultimate risk holders. As noted by the FSB February 2019 report, "*Given these developments, the complexity and lack of transparency (i.e. data constraints) of the leveraged loan market, as well as the potential of spillovers to other markets, it is important to consider enhancing data/information collection so as to have clearer view of the market and its risks. For example, while CLOs and other funds are intermediate vehicles redistributing risks, it is important to understand who the ultimate risk holders are. The potential impact on financial stability depends, in part, on whether entities that ultimately hold these risks have the capacity to withstand potentially significant price changes or defaults, and, if not, whether those ultimate risk holders are of systemic importance*".

[4] FSB defined shadow banking as "credit intermediation that involves entities and activities (fully or partly) outside the regular banking system".

Actions taken by the European Central Bank

The ECB/SSM adopted in May 2017 a guidance on leveraged transactions[5]. In that guidance, leveraged transaction are defined as all types of loans where the borrower's post-financing level of leverage exceeds a total debt to EBITDA ratio of 4.0 times, and all loans where the borrower is owned by a financial sponsor (private equity firm).

Some transactions, however, are explicitly excluded from that definition, namely loans with natural persons, credit institutions, investment firms, public sector entities and financial sector entities; loans below EUR 5 million; loans to small and medium-sized enterprises - except where the borrower is owned by a financial sponsor; loans classified as specialised lending (project finance, real estate, and commodities financing); trade finance; and loans to investment-grade borrowers.

That guidance particularly asks banks to prepare regular comprehensive reports for the senior management about trends in the leveraged markets and characteristics of a credit institution's leveraged transactions. Banks need to define their "risk appetite", meaning that senior management has to define, review and endorse at least annually the limits allocated to leveraged transactions. Exemptions and increases in limits need to be duly justified.

Specifically for the context of syndicated leveraged transactions (i.e. those offered by a group of lenders) that guidance furthermore sets out that high levels of leverage – defined as the ratio of Total Debt to EBITDA exceeding 6.0 times at deal inception – should remain exceptional (and a potential exception should be duly justified), since for most industries leverage levels in excess of 6.0 times Total Debt to EBITDA raise concerns.

In its May 2018 Financial stability review, the ECB notes that "*Increasing exposures towards some riskier segments (e.g. consumer lending, leveraged loans) warrant closer monitoring*". However, the ECB has so far not disclosed data in relation to banks' exposure to leveraged finance (on-balance sheet or off-balance sheet commitments).

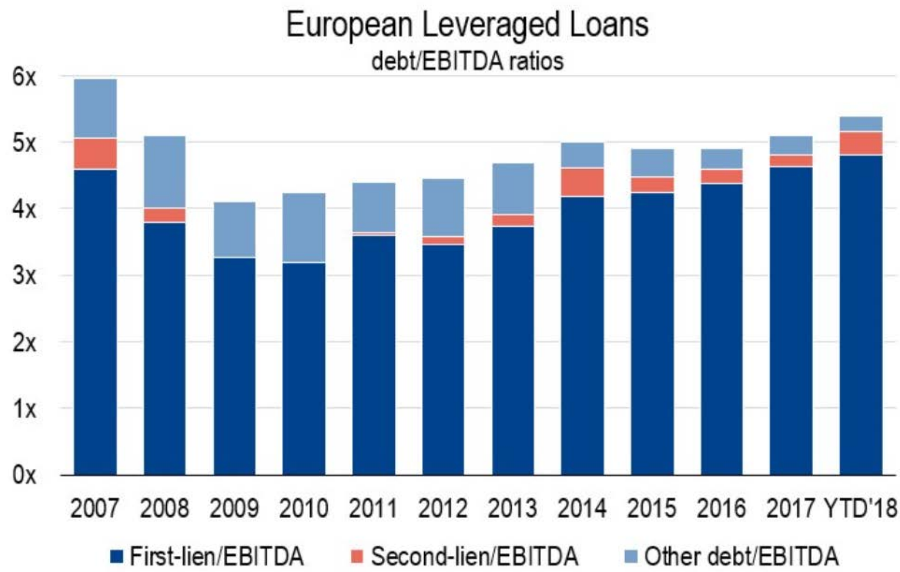
Recent aggregate data from the credit rating agency Standard and Poor's, however, reports that the leverage of European leveraged loans continues to tick higher, rising to a multiple of 5.4 times EBITDA in November 2018, the highest value since the multiple of 6 times in 2007 before the onset of the financial crisis (see chart 4).

The Standard and Poor's article moreover states that the ECB's guidelines on leverage were "*already deemed toothless by the European market*". An analysis by Bloomberg is likewise critical: "*But for all the internal debate and management oversight within European banks, it's hard to see a difference in the market overall. The ECB didn't draw a line in the sand on leverage ratios but the guidelines do indicate that six times earnings should "remain exceptional*". In the same vein, Moody's already stated in June 2017 that the ECB's leveraged transactions guidance "*is unlikely to curb issuance*".

The effectiveness of underwriting standards imposed to banks (and not to other sectors) have been questioned by the IMF: "*there is evidence that these actions have contributed to a shift of activities from banks to institutional investors*". Policymakers were therefore invited to "*develop new tools to address deteriorating underwriting standards*". In that respect, in a February 2018, D. Schoenmaker (Professor of Banking and Finance at University Rotterdam) suggested applying underwriting standards across the board: "*the guidance on leveraged finance for the borrowing companies (gross debt should not exceed six times EBITDA) should be given to all suppliers of finance*".

[5] Other supervisory attempts to limit the risk stemming from leveraged transactions well predate the financial crisis. In January 1999, for example, the Basle Committee on Banking Supervision issued the guidance "Sound Practices for Banks' Interactions with Highly Leveraged Institutions".

Chart 4: Multiples of leveraged loans in Europe



Source: Leveraged Commentary & Data (LCD), an offering of S&P Global Market Intelligence, 28.11.2018

Disclaimer and Copyright

The content of this document is the sole responsibility of the author and any opinions expressed therein do not necessarily represent the official position of the European Parliament. It is addressed to the Members and staff of the EP for their parliamentary work. Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy. © European Union, 2019. Contact: egov@ep.europa.eu

This document is available on the Internet at: www.europarl.europa.eu/supporting-analyses