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Regulatory Alert

Financial Services Regulatory Insight Center

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Focus on leveraged lending risks

Heightened public policy and regulatory attention is being directed toward potential risks in leveraged lending activity.

Key points

— Congress, regulators, international standards setters, and financial markets participants are discussing the potential for the leveraged lending market to pose systemic risk.

— Features of the leveraged lending market that are adding to the discussion include:

  – An increasing volume of leveraged loans
  – Elevated levels of creditor leverage (i.e., business debt)
  – An easing in underwriting standards and transaction constraints (i.e., covenants)
  – A shift toward nonbank financial entities, such as collateralized loan obligations (CLOs) and mutual funds, which are not subject to the capital or risk retention requirements applicable to regulated banks
  – A statement by the federal banking agencies that they would not enforce numerical thresholds in their 2013 Guidance on Leveraged Lending.

— There is consensus that more information on the investors in and holdings of CLO tranches is needed to better understand the leveraged loan market and its related risks.

Definition of Leveraged Lending

In their March 2013 *Interagency Guidance on Leveraged Lending*, the Federal banking agencies state that numerous definitions of leveraged lending exist throughout the financial services industry but they commonly contain some combination of the following:

— Business debt where the proceeds are used for buyouts, acquisitions, or capital distributions.

— Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.

— A business borrower recognized in the debt markets as a highly leveraged firm.

— Transactions where the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.

Discussion issues

Leveraged lending and its potential to contribute to systemic risk has been highlighted by recent Congressional hearings (most recently, a House Financial Services Committee hearing, *Emerging Threats to Stability; Considering the Systemic Risk of Leveraged Lending*, June 4, 2019) and regulatory releases (including reports from the Federal Reserve and OCC). In general, the law makers and standards setters largely acknowledge that the volume of leveraged lending is increasing and with it the level of indebtedness for high yield companies is also rising. Meanwhile, the related underwriting standards and transaction constraints are easing. Within each group, however, there is disagreement as to whether this market poses systemic risk.

Those who advocate the potential for systemic risk discuss:

— The increased participation of nonbank entities, such as CLOs and mutual funds, that are not subject to capital, liquidity, and other requirements imposed on federal banking entities. Banks hold less than 10 percent of the leveraged lending market.

— Certain similarities between the CLO markets and the collateralized debt obligations (CDOs) markets that were central to the 2007/2008 financial crisis (e.g., leveraged loans are securitized into CLOs just as mortgages and mortgaged-backed securities were packaged into CDOs, the securitization structures include junior/senior tranches and a reliance on credit rating agencies, and, at present, underwriting standards are weakening).

— The prevalence of "covenant-lite" transactions. Covenant-lite loans permit greater leverage by borrowers and remove an early warning system for lenders.

— The limited availability/transparency of information for CLO tranches, investors, trading activity, and pricing making it difficult to assess and manage related risk.

— Increased reliance on revenue growth or anticipated cost savings to support borrower repayment in conjunction with concerns that the economy may slow to trend growth or experience a deeper slowdown. Many heavily leveraged firms might not be able to service loans, causing larger corporate defaults than those seen in recent recessions.

— The high percentage of new leveraged loans that narrowly qualify as investment grade.

— An exemption from the credit risk retention requirements under Regulation RR provided CLOs. (In February 2018, a U.S. Court of Appeals ruled that open-market CLOs are exempt from the risk retention rules under Regulation RR, which require securitizers to hold 5 percent of their "deal," finding that investment managers of CLOs were not securitizers under the rule.)

— The "unenforceability" of the federal banking regulators' guidance.

Those who do not advocate the potential for systemic risk highlight the following:

— Most of the credit risk associated with leveraged loans is outside the federal banking system.

— The size of the leveraged lending market is relatively small compared to the size of other corporate debt markets (the Federal Reserve estimates approximately $1.1 trillion of leveraged loans were outstanding through the end of 2018 compared to total nonfinancial corporate business credit of $9.7 trillion and total household credit of $15.6 trillion).

— The credit performance of leveraged loans has remained solid even though credit standards for new leveraged loans appear to have further deteriorated and the overall strictness of loan covenants is near its weakest level.

— "CLOs have stable funding: Investors commit funds for lengthy periods so they cannot, through withdrawals, force CLOs to sell assets at distressed prices." (Federal Reserve Chair Powell, May 20, 2019)

— Banks and other financial institutions have "sizeable" loss-absorbing buffers.

— Losses in the leveraged loan market are more likely to be recession amplifiers than a source of systemic risk.

— Bank underwriting practices and risk management are much stronger than before the 2007/2008 financial crisis.

— The federal banking agencies continue to actively monitor and assess risks from leveraged lending.

Both sides recommend efforts to better understand the leveraged lending market by:

— Expanding their current level of knowledge about the market, particularly the vulnerability of financial institutions to potential losses and the possible strains on market liquidity and prices should defaults increase or investors exit investment vehicles holding leveraged loans.

— Strengthening data collections and reporting to facilitate monitoring by the regulatory agencies, the Office of Financial Research and/or the Financial Stability Oversight Council.

— Expecting banking institutions to assess their direct and indirect exposure to business debt markets.

- Implementing industry-wide risk management practices.

KPMG Perspective

Leveraged loan borrowers that become overextended are vulnerable to any slowdown in revenues that prevent debt repayment as well as to a seizure of capital markets that prevents debt rollover. These firms are also vulnerable to a rising rate environment, either from Federal Reserve Board rate increases or from wider spreads (a.k.a. market induced increases).

The termination of the risk retention rules for open-market CLOs means that banks will be exposed to more risk. Given that the leveraged lending market is moving into the "shadow banking" sector, the scope of this risk is less easy to establish.

The world's asset allocators are looking for yield, so demand from investors is driving the issuance of riskier assets (similar to the investor dynamics before the financial crisis). As the leveraged lending rules in Europe are "real" rules and the U.S. regulators' rules are generally unenforced guidelines, we can expect that, going forward, businesses will raise capital in the United States, possibly further raising the risk to U.S. financial markets.

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