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Resurgent US leveraged finance market

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Executive Summary

The US leveraged finance market has resumed growing against a backdrop of booming demand from investors seeking higher yields in a low interest-rate environment. Such investor trends are a key focal point in terms of the outlook for the leveraged finance market.

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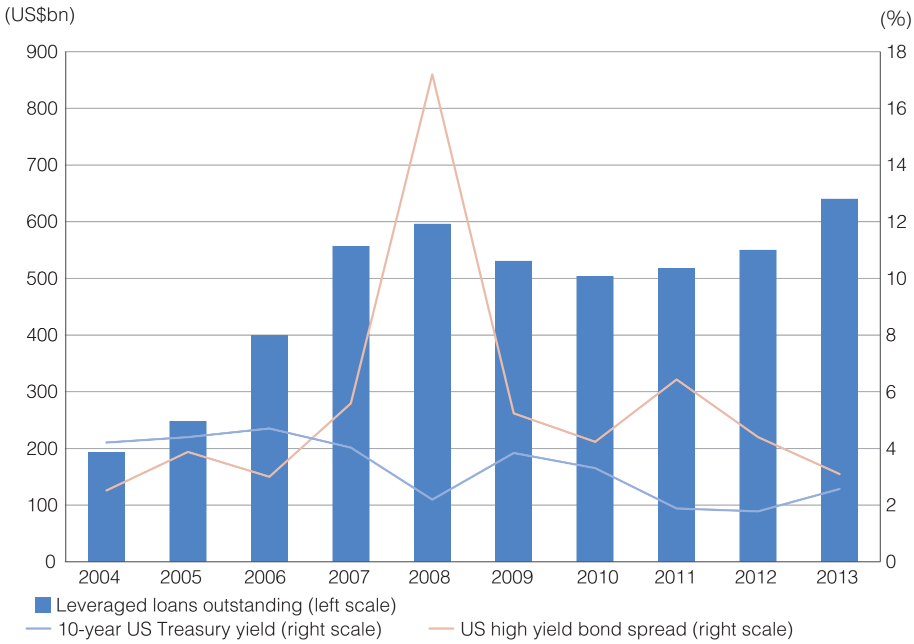
Recent market and investor trends

The US leveraged finance[1] market, which expanded preceding the 2008 global financial crisis, has recently resumed growing. After peaking at an all-time record level in 2008, US leveraged loans[2] outstanding dipped in 2009-10 before embarking on a renewed growth trend from 2011. In 2013, US leveraged loans outstanding surpassed their 2008 peak, setting a new all-time record, (see exhibit).

Exhibit: Leveraged loans outstanding and 10-year US Treasury yield



Note: All data are year-end values except for 2013 data, which are as of October 31, 2013.

Source: Yield data are from Bloomberg; outstanding loan data are from "Risk Retention for CLOs: A square peg in a round hole?" (Oliver Wyman); Spreads are Barclays US Corporate High Yield YTW spreads over 10-year UST yield.

NOTE

1) The term "leveraged finance" generally encompasses high-yield corporate bonds issued by, and leveraged loans to, non-investment-grade companies.

2) Leveraged loans broadly comprise pro-rata tranches (mainly loans extended through short-term revolving credit facilities) and institutional tranches (mainly longer-term loans). The discussion herein pertains to institutional tranches only.

Leveraged finance's resurgence from its temporary post-crisis downturn is primarily attributable to robust demand from investors. With interest rates at historical lows as a result of large-scale monetary accommodation in developed countries, most notably the Fed's QE3 program, yield-hungry investors are increasing portfolio allocations to relatively high-risk leveraged loans and high-yield corporate bonds. In fact, issuers have benefited from increasingly advantageous terms, including tighter spreads, as issuance has increased, implying that investors are eagerly buying these products.

What specific types of investors are increasing their allocations to these products? In terms of investor activity in the US leveraged loan market since the financial crisis, two main trends stand out. The first is that collateralized loan obligations[3)] (CLOs), a major source of demand for leveraged loans, are making a comeback. After expanding from the latter half of the 1990s, CLO issuance temporarily ground to a halt after the financial crisis. Recently, however, CLOs are undergoing a revival as an asset class, largely by virtue of solid recovery in their performance, which had deteriorated during the financial crisis. In 2013, CLO issuance exceeded US$80 billion[4)], its third highest annual total on record behind 2006 and 2007. The second trend is growth in investment in leveraged loans by retail investors through loan mutual funds. Inflows to the leveraged loan market from retail investors increased substantially in 2013, particularly when US government bond yields turned upward. Leveraged loans being floating-rate instruments, growth in such retail inflows was presumably driven mainly by retail investors hedging against the risk of rising interest rates.

3) CLOs are securitizations of financial institutions' loan receivables.

4) According to Forbes and other media sources.

Regulatory response

From corporate borrowers' standpoint, growth in the leveraged finance market and reduction in borrowing costs are favorable trends, but regulatory authorities are exhibiting concern. Specific regulatory actions include a March 2013 revision of guidelines for highly leveraged bank loans by the US Federal Reserve, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency. The revised guidelines impose stricter underwriting and risk management standards on lenders. Although the effectiveness of the guidelines themselves is questionable, US regulatory authorities not only revised the guidelines, they are also reportedly seeking more stringent compliance from large banks individually[5)].

5) According to Bloomberg and other media sources.

Such regulatory action is a response to growing credit risk. As the leveraged finance market has grown, borrowers' debt-to-equity ratios have risen and origination of loans with lenient financial covenants have increased. In response to these trends, which likewise occurred before the financial crisis, regulatory authorities are stepping up their vigilance.

Future outlook and focal points

Amid such regulatory action and growth in credit risk, some are warning about the outlook for the US leveraged finance market. Near term, however, the market's recent growth trend would persist, given that investor demand is still strong. New CLO issuance has been buoyant in 2014 to date. From a longer-term perspective, the leveraged finance market's recent growth rate is most likely unsustainable. The market can reasonably be expected to eventually reach an inflection point and enter a downturn.

The timing of this inflection point and the catalyst that triggers it are important, but even more important is the severity of the downturn that ensues. Ideally, the market's current growth trend would peak at some point and new issuance would gradually downshift. However, if the inflection point leads to a steep downturn in the wake of overexpansion of the market, major problems could arise. From such a standpoint, current conditions seem to harbor several latent risks besides growing credit risk.

One risk factor is retail investors' foray into the leveraged loan market. Retail capital flows historically tend to be unstable. While retail investors' growing involvement in the leveraged loan market has been helping to drive the market's expansion, it could become a source of market instability when the tide turns.

Another risk factor is the emergence of new non-bank lenders amid regulatory tightening in the banking sector. Specifically, some investment managers previously engaged mainly in private equity investment have been setting up funds to provide financing for highly leveraged acquisitions. Even as the regulatory authorities clamp down on banks, risk is shifting to less regulated subsectors of the financial system. From a systemic standpoint, this shift is undermining safeguards against excessive risk-taking.

Besides, as we learned from the financial crisis, the activities of investors that make leveraged investments funded with a short-term borrowings should be closely monitored. Such leveraged investment is difficult to quantify, but today's artificially low short-term interest rates constitute a powerful inducement to leverage investments.

Investor trends such as those discussed above will remain a key focal point in terms of the outlook for the US leveraged finance market.

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