STATE OF THE LEVERAGED LENDING MARKET

Risk, regulations, and a rebound in leveraged lending were discussed at a recent event held by RMA's New York Chapter.

BY FRANK DEVLIN

THE NEW YORK Chapter of RMA's recent panel discussion, "Leveraged Lending: Current Outlook and Risk Considerations," was held a few months into an uptick in the leveraged loan market. The market had been down in 2016, then began a mid-first-quarter turnaround that continued through mid-April, when the discussion was held. But the future held uncertainty for banks—not only because of macroeconomic

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issues, but also because of competition from shadow banks and new rules affecting collateralized loan obligations.

Impact of Leveraged Lending Guidance

While they generally praised the 2013 Interagency Guidance on Leveraged Lending, the panelists said the regulatory guidelines drive some business away from traditional channels to nonbanks that do not have to comply.

Among other things, the guidance addressed leverage parameters and the amount of time it should take to pay back half of a loan amount.

After the guidance was issued, "there was a time when all of us in the industry were going through clarification," said Robyn Roof, managing director and head of loan syndicate, sales, and research at Keybanc Capital Markets Inc. "They were guidelines, so they are subject to interpretation.

"As I was arranging loans and looking out to the community of banks I saw a tiered approach. It was the bigger institutions that got the focus first, then it was the middle-tier institutions," Roof said. "In the last nine months or so it's affecting the community banks. Each bank has had to ask the question, 'What does this mean?' Each bank is affected a little differently based on how the processes work, how their policies are written, and the size of the portfolio."

Adam Pilsbury, Shared National Credit coordinator for the Federal Reserve, said the guidance was issued to keep pace with what was happening in the marketplace.

"We saw underwriting practices and risk tolerance were going in the wrong direction," said Pilsbury, who noted that his comments at the event did not necessarily reflect the views of the Federal Reserve System. "Leverage was getting higher and controls were getting weaker. We didn't see the necessary support for some of the decisions in terms of assessing the risk of individual loans."

Panel moderator Meredith Coffey noted that there was "a very substantial decrease" in the percentage of loans levered more than six times after the guidance was issued. Coffey, executive vice president, research and analysis for the Loan Syndications and Trading Association, said the decrease occurred between 2014 and 2015.

"The leveraged lending guidance has had a positive effect on our market overall," said Thomas W. Cole, co-head of U.S. leveraged finance at Citigroup. However, Cole spoke of a "non-level playing field," as the guidance does not apply to nonbanks.

Banks are "going to lose market share," he said, adding that borrowers compare financing terms from regulated and unregulated lenders and look to "maximize leverage."

"It's very hard to compete," he said. "All we've been trying to say is give us transparency, give us clarity, and give us consistency amongst the competitors in

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the marketplace and we'll deal with any rules or regulations."

Still, he said, "maybe normal market forces will help work this out" as some shadow banks sustain losses on aggressive deals. "The leveraged lending business hasn't worked out great for some of the fringe institutions," he said.

Another factor working in the banks' favor is that "all else equal, [borrowers] love to deal with regulated banks," Cole said. "They want big multinational institutions that can provide ideas on how to grow businesses with M&A, and they are not going to get that from unregulated banks."

Providing a regulator's perspective on the impact of the guidance, Pilsbury said that "firms have gotten better at projecting cash flows to support repayment capacity and calculate EBITDA. A six-and-a-half [times leverage] deal today is not as risky as in 2013 on average." Nevertheless, he said, "We still think the risk-taking in the leveraged loan market is high. We are very much focused on that. We've seen deals that are coming to the market that are right up to the line. We will continue to focus on whether they are underwritten well or not."

Does Covenant Lite Really Mean Heavier Risk?

Another area of concern is the continued prevalence of covenant-lite deals, Pilsbury said. "I'm not seeing major changes there," he said. "My concern level is still high."

But David Frey, portfolio manager and head of the broadly syndicated loan and CLO business at HPS Investment Partners, said covenant-lite loans are not necessarily more risky. "It is a case-by-case thing," he said. "It's not that covenant-lite loans are bad and loans with maintenance covenants are good.

"Covenant lite means you have an incurrence test, not a maintenance test," he said. "A maintenance test is a ratio you have to meet every quarter. You have to be in compliance with that number. An incurrence test means at the time you undertake an action, you need to be in compliance with the covenant. It's still a test. It's just measured differently. For example, if you want to take on more debt you can only do that if you are in compliance with a certain covenant.

"Empirical data does not appear to indicate that loss given defaults or recover rates are worse in deals that have covenant-lite structures," said Frey, who is chair of the Loan Syndications and Trading Association.

Pilsbury agreed that "you have to look at it deal by deal and you have to look at the contract."

However, he said, "when you are looking at tranches of debt, incurrence tests can apply to a single tranche in a capital structure. If you don't consider that in the context of the overall debt and the ability to borrow through incremental facilities combined with already existing high leverage then you're not understanding the total picture."

Additionally, Pilsbury said, "We haven't seen what happens after a major downturn with the characteristics we're seeing in covenant-lite deals right now."

The Secondary Market and Liquidity

Frey said there was another factor that makes covenant-lite loans less risky than they might appear: the secondary market. "When I started in this business 27 years ago," he said, leveraged loans were "a buy-and-hold product. You underwrote the loan or participated in syndication. You put the loan on the balance sheet. You owned it. If there were problems, they transferred it to the workout group and the workout group tried to recover value. There was nothing else you could do. The only trigger you had for protection at that time was if the borrower blew a covenant.

"Today, there is an $880 billion syndicated loan market. It turns over about 80% a year. If you have a credit that underperforms, you can sell it…take a five- or 10-point loss now and potentially make it up on buying something else that's down five or 10 points."

Coffey said that in early February, when the secondary market was down, average bids had dropped from about 98 cents on the dollar in 2015 to less than 90 cents. The number had since rebounded to about 92 cents, she said, but "there is concern that secondary market liquidity is drying up, particularly in the fixed-income space and loan space."

"Liquidity continues to get more difficult in all of the fixed-income markets, loans being no different," Frey said. Earlier in the year, he said, "some of it was just negative sentiment—anything that had to do with energy, retail, metals, and mining. No one wanted to touch anything that was CCC-rated or second lien."

One of HPS's holdings "wasn't an energy company but had the word 'energy' in its name. It was a credit we know and like," Frey said. "It was performing well and all of a sudden it was down 17 points for no apparent reason. I don't know why, other than it had 'energy' in its name at a time when energy companies were extremely out of favor." Like the market itself, the value of the loan has since rebounded, he said.

A new rule regarding collateralized loan obligations (CLOs) is another threat to liquidity, the panelists said. Starting in December, CLO managers—important buyers in the syndicated loan market—will have to own 5% of the value of each CLO.

Frey said the risk-retention rule is already having an effect on CLO issuance, which, at the time of the panel discussion, was "about 75% to 80% below year-to-date issuance last year. Certainly market conditions are a factor, but the regulatory issue is a big factor." (Note: By midsummer, issuance had picked up somewhat, but was down about 50% year-to-date.)

"If you issue a $500 million CLO, you have to come up with $25 million," he said. "It changes what is a fee-for-service business and makes it very capital intensive. Most managers are not set up for that kind of activity. The question is: When companies need financing, when the existing $880 billion of loans that are out there need to be refinanced, who's there to buy that paper on the refinance if the CLOs are out of their investment period? There's no new CLO issuance, banks aren't buying, and retail isn't buying."

"CLOS are a great, stable component of the market because there isn't a lot of forced selling" compared to the rest of the secondary market, Cole said. As forced selling becomes a bigger part of the market that will "exacerbate volatility. The unintended consequence of risk-retention rules in the CLO market could be more volatility in the secondary loan market.

"It's going to impact price," he said.

Despite the concerns expressed by the panel, Roof said that her company's leveraged lending portfolios are generally performing. "There may be individual companies having issues, but outside oil and gas the portfolios are holding up well," she said.

Pilsbury had a similar but guarded perspective. "We are not seeing broad deterioration" in portfolios, he said. But when it comes to loans with potential weaknesses (special mention loans) or well-defined weaknesses (substandard loans) "leveraged loans are more than a majority of the loans we consider high risk in those categories. It's still the highest risk portfolio that I in my role and others in their roles at other agencies see in exams. Those characteristics are still there." ®

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