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SEC's Leveraged Loan Market Outlook

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On September 19, the Securities and Exchange Commission's Investor Advisory Committee held a hearing to discuss the risks of increased leverage in the loan market and the potential impact leveraged loans and collateralized loan obligations (CLOs) could have on the broader economy. The Committee sought to identify systematic risks to the market, noting areas of concern and recognizing regulatory implications. The risks identified by panelists included covenant-lite loans, regulatory capital arbitrage, and inconsistent definitions of EBITDA. In conjunction with these risks, panelists identified potential remedies, such as SEC regulation of loans as securities and rating agency regulation.

The leveraged loan and CLO markets are performing well, and there appears to be more discipline on overall leverage levels than there was in the years leading up to the 2007 financial crisis. Concern, however, remains among financial regulators. These concerns can be distilled into three elements:

- Covenant-lite loans have eliminated the early warning system that would alert a lender to a borrower's declining economic health and removed the ability for a lender to reassess the loan or potentially intervene before a borrower defaulted.

- Regulatory capital arbitrage has allowed institutions to manipulate levels of risk and capital, and increased competition among rating agencies has led to rating shopping and raised questions regarding the accuracy of leveraged loan ratings.

- Inconsistent definitions of EBITDA across loan agreements make the ability to assess the true health of the leveraged loan market difficult.

Analysis

Current State of the Leveraged Loan Market

The panel gave an overview of the current state of the leveraged loan market. The total of outstanding leveraged loans is estimated to be just under $2 trillion dollars. Of the $2 trillion in outstanding loans, $1.3 trillion is held by institutional lenders. In 2019, the average leveraged transaction has total leverage of 5.5 times, with approximately 4.6 times coming from first lien loans. Although leverage levels have been drifting higher, there is not a wholesale return to the 8.0 or 9.0 times, and sometimes higher, leverage that existed in 2007. Further, looking at the highest 20 percent of leveraged borrowers, today, the average leverage is about 7.75 times, with approximately 5.25 times coming from the first lien. By comparison, before the 2007 financial crisis, the highest 20 percent of leveraged borrowers had an average leverage of about 8.5 times, with approximately 5.6 times coming from the first lien.

Generally, there is more discipline on overall leverage levels in the current market than 12 years ago. Of the 15 most recent large leveraged buyouts, there was only one deal with leverage more than 7.5 times. In contrast, in 2007, 10 of the 15 largest deals had leverage of that magnitude. Today, to conduct deals, large equity checks are required, with average equity percentage now reaching the high thirties (as opposed to the low twenties in 2007). Default rates remain low.

A panelist at the Committee meeting opined that the most significant factor that could affect the loan market on a systematic basis is the large supply of loans for sale, which, if it were to exceed demand, could result in the repricing of the market. The primary component of that supply is the forward calendar of fully committed transactions because this is the portion of the calendar that has to close, regardless of market conditions. Arguing for the health of the market, he pointed to the fact that, in June 2007, the committed calendar for leveraged finance (loans and bonds together) reached $485 billion, with a large percentage of that market held in “weak” or “at risk” holders, such as open-end mutual funds, total return swaps, mark-to-market CLOs, and warehouses. Conversely, today, the committed calendar is only $60 billion and has not exceeded $100 billion since the financial crisis. Moreover, there are far fewer weak holders, both notionally and as a percentage of the market. Total return swaps have dramatically decreased; open-end and mutual funds are up from 2007, but down from their recent peak last year; mark-to-market CLOs no longer exist, and the number of CLO warehouses has been significantly reduced.

George Oldfield, an economic consultant, expressed his view of the current state of the market with more skepticism, saying, “I think the market is moving into an area, or a regime, which could provide some concern for regulators, because, in some regards, it resembles the market for mortgages in the early 2000s.” High-risk loans are now securitized, and groups of investors previously abstaining from the market have been able to take interest in corporate credits. Specifically, a potential area of concern is “enhanced CLOs” that are designed to take advantage of failures of other CLOs.

Elisabeth de Fontenay of Duke University School of Law views the state of the current economy positively and negatively. Leveraged loans and CLOs have performed fairly well. The syndicated loan market is a very large, fairly liquid capital market that has grown spectacularly quickly. However, the market has escaped virtually all regulation. Particularly, leveraged loans are not currently treated as securities, so they are not subject to security regulation. This could lead the leveraged loan market to overheat moving forward.

Erik Gerding of the University of Colorado Law School views the current leveraged loan market as outdated. Specifically, any trading of CLO securities does not occur on exchanges or trading platforms where one could see deep and liquid prices; rather, investors go to a handful of dealers in these markets and receive a price indication from the dealer. These dealer markets are opaque, which impairs price discovery and deprives investors, financial markets and regulators of the best means of measuring the risk of CLO securities.

Current Risks of the Leveraged Loan Market

Covenant-Lite Loans

Several of the panelists identified covenant-lite loans as a potential risk to the leveraged loan market. The increase of covenant-lite loans has stemmed from the continued low interest environment, where borrowers have tremendous bargaining power. Borrowers use this power not only to obtain lower pricing, but also looser covenants. As a result, according to de Fontenay, there has been a decline in underwriting standards. Gerding added that, if lenders were to insist on not using covenant-lite loans, they would not be able to secure any deals.

Conversely, another panelist noted, "Covenant-lite does not mean no covenants;" financial covenants still exist. He asserted that the most important factor for credit performance is the amount of initial leverage and the ability of the borrower to generate cash for debt service to reduce that leverage. Oldfield said proper due diligence at each step of the transaction could mitigate the risks of covenant-lite loans.

Regulatory Capital Arbitrage

The panelists identified regulatory capital arbitrage, which consists of techniques to invest in riskier assets while holding capital levels the same, or lowering capital levels while keeping risk the same, as a potential risk to the leveraged loan market. Bank and insurance regulations require firms to maintain certain levels of capital as a cushion against financial losses and as a device to mitigate risk of financial institution failure and financial crisis. Gerding stated that, by engaging in regulatory capital arbitrage, banks, insurance companies and other regulated financial institutions are exposing themselves, their investors and capital markets to dangerous levels of risk disguised from investors, counter-parties and regulators.

Because CLOs have to invest in syndicated loans, and investors want AAA-rated assets, this creates a source of demand for CLOs that is independent of the quality of the underlying loans. The low interest rate environment exacerbates this problem by increasing competition among rating agencies, allowing CLO developers to shop between different agencies to find the most favorable rating. Oldfield observed that sponsors of deals are having some tranches of a deal rated by some agencies and others in the same deal rated by different agencies in order to achieve satisfactory ratings.

Gerding added that, in conjunction with rating shopping, there is reason to be concerned that CLO developers are reverse engineering rating methodologies to align more risk into investment grade tranches. Specifically, rating drafts are first given to arrangers, investment banks and investors. From there, the structure is manipulated and a new draft rating is given until the right result is reached.

Inconsistent Definitions of EBITDA

Beyond the visible risks, the panelists observed that it may be more difficult than many realize to assess the current leveraged buyout market. Comparisons of debt to EBITDA in leveraged buyout transactions, especially when used in covenants, are not transparent because EBITDA is not defined uniformly across loan agreements. EBITDA can be defined in dramatically expansive ways, resulting in the possibility that the amount of leverage is considerably higher than what is reported. Without this information, lenders and institutional investors often cannot calculate leverage on their own to assess the health of the market.

Potential Reforms

SEC Regulation of Loans as Securities

One potential reform posed to the panel by the Committee was whether the SEC should have statutory power to regulate securitized instruments. Generally, the panel felt that loans should not be regulated by the SEC, or SEC regulation largely would not have an effect. De Fontenay suggested that, as a practical matter, if loans were treated as securities, they would qualify for exceptions from registrations. This means that there would be very little mandatory disclosure. In fact, there is likely better disclosure in the debt market than the equity market. Even further, additional disclosure may not have an effect on the leveraged loan market if investors are buying leveraged loans not because of their potential to provide a yield in a low-interest environment, but rather in an attempt to get a AAA rating with a product that actually has some risk (i.e., for purpose of regulatory capital arbitrage).

Rating Agency Regulation

Gerding highlighted the need for disclosure surrounding the rating process. Disclosure may include identifying how the deal was structured to take rating methodologies into account. However, there is danger in having too much disclosure or too much standardization in the rating agency industry. If one were to know exactly what the tests were for ratings, it would be simple to reverse engineer the agency's methodologies. One solution, Gerding suggested, would be to require ratings from more than one rating agency.

De Fontenay opined that the problem may not be with rating agencies misleading investors into purchasing exceedingly risky loans; rather, the problem could be the regulatory structure that rewards financial institutions for having safe assets on their balance sheets. When faced with this question of whether modifications should be made to the banking regulatory scheme in order to disincentive banks from only holding AAA debts, Gerding responded that he did not believe this was the sole answer. In response to each of the three Basel decisions, banks have found a way to manipulate rules, noting that capital arbitrage is a recent manifestation of this manipulation.

Increased Disclosure and Information Sharing

The panel stressed the need for increased disclosure and an overall increase in information gathering and sharing between market actors. Institutional investors in CLOs should know whether securities are actively traded, how prices in the secondary market are set, and the extent to which securities are purchased for the purpose of regulatory arbitrage.

Beyond disclosure, there is the need for information sharing between financial regulators. Gerding pointed to FINRA's TRACE system as a model to improve and promote price transparency in CLOs and other markets. Additionally, he stated that the exception for CLOs in the Volker Rule fueled explosive growth of CLOs. Gerding urged that, until there is ample evidence that the systemic risk from these markets is muted, financial regulators should not expand this exception any further, as the Loan Syndications and Trading Association has advocated. Gerding advised the SEC to help financial regulators develop institutional mechanisms for sustained and deep collaboration in spotting and tracking the emergence of financial risks.

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