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The U.S. Leveraged Loan Market: Risk or Rhetoric?

July 16, 2019

With recent media focus on the leveraged loan market, many misconceptions have surfaced surrounding the asset class. Politicians and financial pundits have taken aim at the loan market, raising concerns over the size and growth of the asset class, structural features (e.g., covenants), and perceived similarities between Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs). These claims deserve further analysis.

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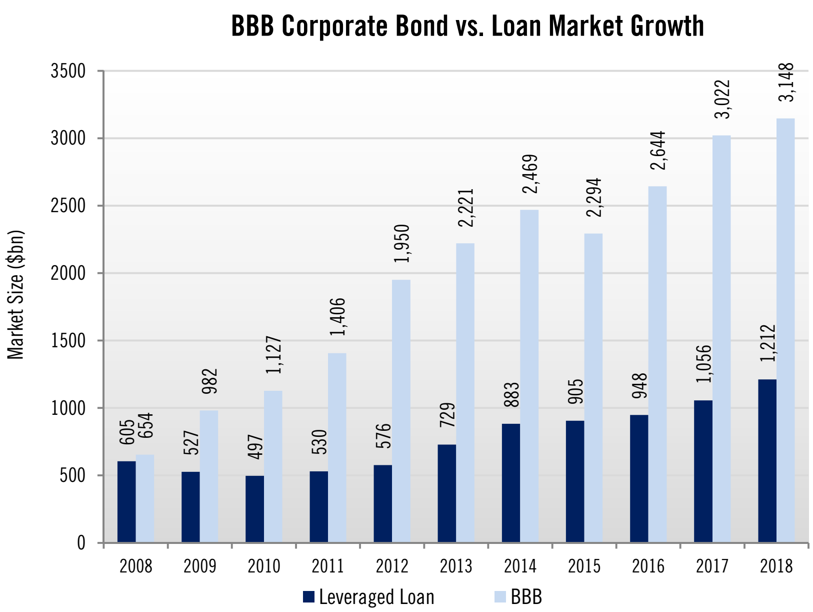
Loan Market Growth: Reaching New Heights

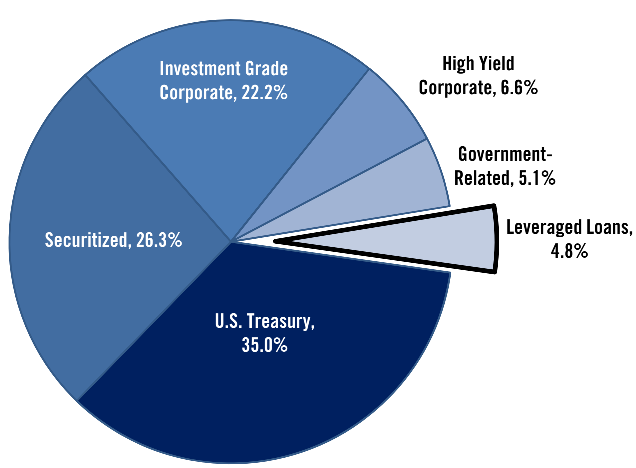
Press coverage of the loan market seems to have increased in lockstep with its growth, as loans outstanding have more than doubled since the end of 2012, from $576 billion to $1.2 trillion. The loan market has been gaining steam on the $1.7 trillion US high yield bond market, after being less than half its size 10 years ago. While this growth is substantial, it is important to offer context since loans comprise less than 5% of the total fixed income markets and are a fraction of the size of the $5 trillion investment grade bond market. For comparison's sake, the loan market has grown by 7% annually from 2008 to 2018, versus 17% for the BBB corporate bond market. Meanwhile, the Dow Jones Industrial Average has more than doubled over the same period as well, growing at an annualized rate of over 10%.[1] We do not believe the growth rate of the loan market, in and of itself, is cause for concern in light of the growth of the broader financial markets. In fact, we see certain benefits including more diversified issuance, a broader investor base that improves liquidity, and improved access to the capital markets for more companies.

Growth and Relative Size of the Loan Market



As of December 31, 2018. Annual Update. Source: J.P. Morgan Research.
Past performance is not a guarantee of future results, Please see Disclaimers for additional, important information.

Fixed Income Market Composition



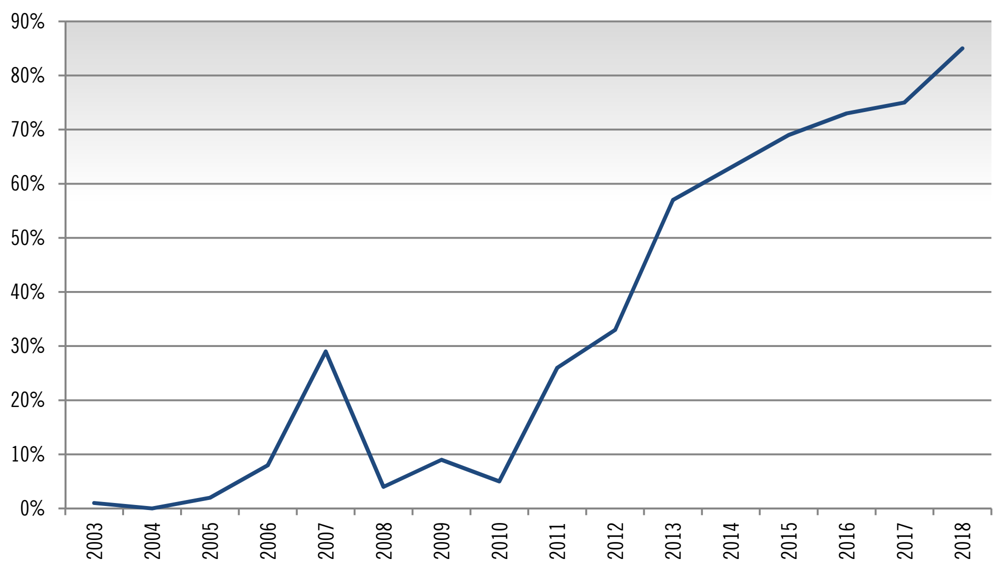
As of July 10, 2019. Source: Barclays

[1] J.P. Morgan

Cov-Lite Apocalypse?

Worries over rising risk in the loan market due to declining covenant quality are perhaps the most prevalent. Although covenant-light (aka "cov-lite") issuance has indeed risen to 80% from less than 20% pre-crisis[2], we believe concerns regarding covenants may be misunderstood. Cov-lite generally refers to the absence of maintenance covenants (e.g., maximum debt-to-EBITDA ratio), not a complete lack of covenants. It is worth noting that corporate bonds have historically been cov-lite. These loans and bonds have other significant incurrence covenant protections, including limitations on adding more debt, paying dividends, and removing collateral from the debt package. Over the past decade, the loan market has shifted to cov-lite as the buyer base migrated to broad syndicates of institutional investors. Ironically, a new issue loan with maintenance covenants in today's market typically conveys a greater degree of issuer risk (often being issued by a smaller company with less access to the capital markets), as evidenced by wider spreads.[3] Additionally, senior bank loans typically enjoy a priority claim over other debt in the capital structure while often being secured by the issuer's collateral.

% of Institutional New Issue Cov-Lite Loans



As of February 28, 2019. Source: Morgan Stanley, LCD.
*Based on pro forma financials at closing of each loan; debt cushion represents share of debt that is subordinated to first-lien term loans.

CLOs versus CDOs: A Case of Mistaken Identity?

The rising popularity of CLOs has also landed this asset class in the media's crosshairs. CLOs are long-term vehicles that provide stable capital to support the loan market and have long been the primary funding source for buying leveraged loans, currently owning more than 60% of issuance. Now a $700 billion market, CLOs have inevitably drawn comparisons to their CDO forebears despite meaningful differences. Whereas CDOs, which were comprised of static portfolios of securitized mortgages, played a material role in the Great Financial Crisis, "CLO structures are much sounder than the structures that were in use during the mortgage credit bubble," according to Jerome Powell.[4] CLOs have many distinguishing features, including their composition of actively managed, continually monitored, and well-diversified pools of loans (typically over 200 loans across more than 30 sectors, with various concentration limits). In stark contrast to CDOs, CLO debt tranches have performed extremely well from a principal loss perspective, having experienced a fraction of the cumulative loss rates prior to, during, and since the financial crisis. *While the cumulative default rate of all U.S. CLO tranches rated by S&P since 1994 is only 0.38%, and AAA CLO investors have never experienced a default, the estimated 10-year cumulative loss rate of AAA global CDOs over roughly the same period was nearly 29%.* Furthermore, each of the CLO defaults was from pre-crisis issues, since which time CLOs have been structured more conservatively, potentially enabling them to withstand heightened stress in the future.

[2] S&P LCD
[3] Credit Suisse
[4] Federal Reserve

Standard & Poor's Rated U.S. CLO Tranches 1994 – 2018

Original Rating	Total Tranches	Defaulted Tranches	Default Rate
AAA	3,108	0	0.00%
AA	1,829	1	0.05%
A	1,820	5	0.27%
BBB	1,653	9	0.54%
Total – Investment Grade	8,410	15	0.15%
BB	1,346	20	1.49%
B	274	3	1.09%
Total – All Tranches	10,030	38	0.38%

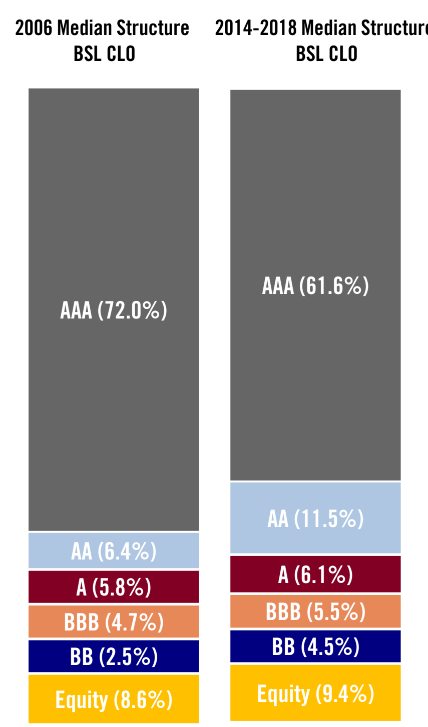
Source: Standard & Poor's Research. Includes all U.S. cash flow CLO tranches have ever been rated as of 7/31/2018. Default rate = number of ratings that had ratings lowered to D/total number of ratings.

Estimated 10 Year Cumulative Loss Rates by Original Rating, 1993-2016

	Global CLO	Global CDO (ex CLO)	U.S. CMBS	U.S. CMBS (ex CRE CDO)
Aaa	0.0%	28.6%	2.6%	0.8%
Aa	0.0%	38.6%	15.1%	12.9%
A	0.0%	42.3%	22.3%	20.2%
Baa	1.0%	50.7%	28.4%	25.6%
Ba	4.3%	47.9%	48.2%	47.5%

Source: Moody's, Wells Fargo Securities.

Due to rating agency methodology changes and investor demand following the crisis, post-crisis CLO structures are more robust as they feature additional credit support, are less levered with more subordination, restrict purchases of certain assets including structured finance issues, and have shorter reinvestment periods. Additionally, CLO warehouses are more conservatively structured, and first-loss risk is more likely to be provided by non-bank investors, which should limit the potential for systemic risks.[5] Because CLOs are funded by long-term, locked-up capital, the vehicles may act as a "shock absorber" in times of loan market stress, as managers are not forced sellers and may be incentivized to purchase discounted loans to enhance equity returns.



As of 12/31/2018. Source: LCD, Wells Fargo.

Liquidity: Oasis or Mirage?

The SEC has been increasingly vocal about liquidity concerns in open-ended loan mutual funds, with Commissioner Jackson saying in March, "As a former banker, I think leveraged loans are an area where investors' liquidity expectations might not match up with reality, and the SEC should do all we can to help investors understand that."[6] Bank loan mutual funds have thus far proven to be well-equipped to meet liquidity demands, passing a major test in December 2018 when there were over $15 billion in outflows driven by a macro sell-off and the Fed's apparent interest rate policy pivot. Even though liquidity in all risk assets historically tends to wane in December, settlement times actually improved in order to meet redemptions during this period. Bank loan fund outflows have continued for 34 consecutive weeks into 2019, totaling

[5] LSTA
[6] Bloomberg

$41 billion from September through June (including ETFs), or 26% of AUM, but despite these headwinds the S&P/LSTA Leveraged Loan Index has returned nearly 6% through the first half of this year.[7] The asset class remains liquid in other regards as well, with $2.9 billion average daily trading volume in the market last year.[8] Additionally, strong demand from the CLO buyer base offers significant levels of liquidity and price support in secondary loan market trading.

"Systemic risk": Fanning the Flames?

The primary concern of regulators appears to be the potential for the leveraged loan market to cause systemic risk to the financial system, but when one gets past the headlines it can be seen that many experienced financial leaders think this is unlikely. Regulators have, for the most part, prudently distinguished credit risk from systemic risk, as Federal Reserve Chairman Jerome Powell testified before Congress on February 27th, "We do not believe it (the leveraged loan market) poses systemic risks, but we do believe it poses a macroeconomic risk, particularly in the event of an economic downturn."[9] Similarly, a Congressional hearing on the matter in June concluded with legislators seemingly of the consensus that while certain risks are rising in the market, the leveraged loan market does not pose a systemic risk.[10] We concur with this consensus given the financial system as a whole looks markedly different today than it did in 2007 with respect to the leveraged finance markets, given its size relative to the broader capital markets and the diverse ownership of leveraged loans.

Conclusions: Be Informed and Remain Vigilant

In conclusion, we do not subscribe to the belief that the loan market will be the cause of broader financial market instability. In our view, loans and CLOs are proven asset classes that warrant consideration in a prudent investor's portfolio. We believe a benign default environment should persist, but macroeconomic and political concerns are present. As such, active management is paramount, and a deep dive into credit is essential. We remain highly selective and cautious with respect to our portfolio construction and aim to avoid pockets of excessive risk in the credit market.

[7] JP Morgan
[8] LSTA
[9] Federal Reserve
[10] S&P LCD

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