Leveraged Loans – The New Subprime Mortgages?

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by Maria Davis

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We see financial crises coming, like approaching storms. We see the clouds, but we may fail to properly judge the severity they forebode. Such is the case with leveraged loans.

The 2008-2009 financial crisis

Let's take the 2008-2009 financial crisis. Households were borrowing too much, subprime mortgages had been identified as being problematic, and everyone had heard about "liar" loans. The issues were well-known, but one had to make a judgment about severity. Former Fed Chair Ben Bernanke expected that a blow-up of the subprime sector of the mortgage market could be contained. In a May 2007 speech he confidently stated: "[T]he effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system".[1] After all, the subprime mortgage market was only a small slice[2] of the mortgage market.

Not a big problem was Bernanke's verdict.

Present situation

We face a situation where business debt is at historic highs relative to the size of the economy. And the recent growth in business debt has been concentrated in riskier forms of debt: Leveraged loans, often repackaged into collateralized loan obligations (CLOs).[3]

Last November, Senator Elizabeth Warren voiced her concerns about leveraged lending activities in a letter addressed to the Secretary of the Treasury, the chairs of the Federal Reserve Board, the Securities and Exchange Commission and the Federal Deposit Insurance Corporation, as well as to the Office of the Comptroller of the Currency.[4] "I am concerned that the large leveraged lending market exhibits many of the characteristics of the pre-2008 subprime mortgage market. These loans are generally poorly underwritten and include few protections for lenders and investors. Many of the loans are securitized and sold to investors, spreading the risk of default throughout the system and allowing the loan originators to pass the risk of poor underwriting on to investors."

She also pointed to a number of experts who had recently raised red flags about the leveraged loan market: "Former Federal Reserve Chair Janet Yellen said in October that she is 'worried about the systemic risks associated with these loans,' in part because '[t]here has been a huge deterioration in standards' and 'covenants have been loosened.' … And the Bank of England noted in October that the global leveraged loan market is bigger than the U.S. subprime mortgage market in 2006, and that like the American subprime market in the pre-crisis period, 'underwriting standards [have] weakened.'"

Fed Chair Jerome Powell's assessment

In a recent speech,[5] Powell observed: "[B]usiness debt is near record levels, and recent issuance has been concentrated in the riskiest segments. As a result, some businesses may come under severe financial strain if the economy deteriorates. A highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments."

Nevertheless, Powell felt confident to state that "as of now, business debt does not present the kind of elevated risks to the

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stability of the financial system that would lead to broad harm to households and business should conditions deteriorate."

Like Bernanke assessing the risk of subprime mortgages in the runup to the financial crisis, Powell evidently believes that the leveraged loan/CLO beast can be contained.

Will history repeat itself?

A weather forecast is inherently imprecise; but when the weather forecasting systems do not have all the weather data, the actual weather can turn out much different from what was forecasted. Let's think of the lack of data as blind spots. Blind spots also exist in the leveraged loan sector, resulting from the involvement of several regulatory agencies with different supervisory roles and from the fact that much of the borrowing takes place outside the banking system. Another blind spot: Fed Chair Powell admits that there is insufficient insight regarding the parties that bear the ultimate risk associated with CLOs. CLOs hold a majority of the leveraged loans outstanding, about 62%.[6] If Powell believes we have insufficient insight into the parties that bear the ultimate risk and – accordingly – the interconnections between them, how can he be confident that things won't spin out of control like in the 2008-2009 financial crisis?

At current, the Fed chairman appears to be content to monitor the dark clouds on the horizon – the leveraged loan activities – rather than actively working towards disseminating the clouds – curbing excesses and taking aim at loose underwriting standards. Only time will tell whether Powell's wait-and-monitor approach is a sufficient response to the current risks, or whether leveraged loans will be at the heart of another major financial storm.

Leveraged loans in client portfolios

I have looked at leveraged loans from a macro and policy response perspective, rather than from an individual investor's point of view. Some investors and their advisors may wonder whether – after so much bashing in the news – leveraged loans/CLOs may be attractive buys at this point.

Here is my take: While leveraged loans in the short run may have a higher yield than investment-grade bonds[7], there is an outsized risk associated with that additional return. There have already been alarming signs of liquidity issues and large investor outflows from the leveraged loan market over the past year.[8] If leveraged loans will indeed turn out to be the new subprime mortgages, they will unravel at some point. I would leave that segment of the credit market alone until the risk-reward ratio gets better – much better.

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[1] Then Federal Reserve Bank Chairman Ben S. Bernanke, "The Subprime Mortgage Market", speech, May 17, 2007, https://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm

[2] Ibid. In 2007, about 7 ½ million first-lien subprime mortgages were outstanding, accounting for approximately 14 percent of all first-lien mortgages, based on data from the Mortgage Bankers Association.

[3] Federal Reserve Bank Chairman Jerome H. Powell, "Business Debt and Our Dynamic Financial System", speech, May 20, 2019, https://www.federalreserve.gov/newsevents/speech/files/powell20190520a.pdf

[4] Senator Elizabeth Warren, Letter to the U.S. Department of the Treasury, Secretary Mnuchin, the Federal Reserve Board, Chairman Powell, the Office of the Comptroller of the Currency, Comptroller Otting, The Securities and Exchange Commission, Chairman Clayton, and the Federal Deposit Insurance Corporation, Chairman McWilliams, November 14, 2018, https://www.warren.senate.gov/imo/media/doc/2018.11.14%20Letter%20to%20Regulators%20on%20Leveraged%20Lending.pdf

[5] Federal Reserve Bank Chairman Jerome H. Powell, "Business Debt and Our Dynamic Financial System", speech, May 20, 2019, https://www.federalreserve.gov/newsevents/speech/files/powell20190520a.pdf

[6] Federal Reserve Bank Chairman Jerome H. Powell, "Business Debt and Our Dynamic Financial System", speech, May 20, 2019, https://www.federalreserve.gov/newsevents/speech/files/powell20190520a.pdf

[7] As an example, the 30-day SEC yield for the Blackstone leverage-loan ETF, SRLN, currently stands at 5.58%; the 30-day SEC

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yield for the Vanguard Total Bond Market ETF, BND, which holds a cross-section of investment-grade bonds, is 2.76%.

[8] Tyler Durden wrote an excellent article on that topic last December. https://www.zerohedge.com/news/2018-12-13/wheels-come-leveraged-loan-market-banks-unable-offload-loans-amid-record-outflows

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