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Leveraged finance boom draws scrutiny from regulators

The leveraged finance market has seen explosive growth in recent years, benefiting from high interest rates and strong risk appetites, reflected in tight credit spreads. But with the size of this market now estimated by some at around USD 2 trillion globally, the boom is prompting heightened regulatory scrutiny, as regulators seek to address potential vulnerabilities and risks.

Leveraged finance represents the riskiest end of the fixed income market, involving the extension of bonds and loans to companies with substantial debt levels. For investors with strong risk appetites, this can be a lucrative line of business, as has been the case in recent years thanks to a combination of high interest rates and broadly favorable credit conditions. But the business also comes with a major health warning for would-be investors.

Leveraged finance basics

Leveraged finance encompasses three major product lines: high-yield bonds, leveraged loans, and collateralized loan obligations (CLOs), which can also be viewed as a subset of leveraged loans. High-yield (HY) or “junk” bonds made their name in the 1980s. The junk bond heyday ended in ignominy in 1990 when their principal advocate Michael Milken was jailed for fraud. Nonetheless, junk bonds today occupy an established position in the world of credit.

Leveraged loans are made by nonbank lenders usually to highly indebted companies to finance mergers and acquisitions, recapitalize their balance sheets, or refinance debt. As they are floating rate loans, the associated interest rate risk is lower (for investors) than junk bonds. This attribute, in a rising interest rate environment, has seen leveraged loans volumes in the US surpass those of HY bonds in recent years. Leveraged loans are typically syndicated, meaning they are structured, organized, and administered by at least one bank, making them easier to trade.

Collateralized loan obligations (CLOs) are a type of structured finance product that pools leveraged loans and repackages them into tranches with varying levels of risk and return. CLO funds purchase leveraged loans and bundle them into a diversified loan portfolio. Investors can then buy tranches of this portfolio through securitization, gaining exposure to leveraged loans while managing risk. Having experienced rapid growth, CLOs now account for about 70% of the US leveraged loans market.

Private credit thrives

Private credit – a segment of leveraged finance where funds are provided by nonbank financial institutions, such as private equity firms and specialized credit funds, rather than traditional banks – has thrived in this environment.

Private credit provides superior access and flexibility compared to syndicated leveraged loans, which involve multiple lenders and can be cumbersome.

With transactions typically involving fewer parties, private credit facilitates quicker dealmaking and often secures more favorable terms for borrowers. This flexibility has made private credit a preferred choice for companies seeking financing solutions tailored to their specific needs, such as mergers and acquisitions, balance sheet recapitalization, or debt refinancing. Essentially, private credit has filled the gap left by traditional banks' reduced lending capacity amid challenging economic conditions.

Direct lending & its attractions for investors

Direct lending, which accounts for about one-third of the private credit market, primarily involves first-lien loans provided to middle-market companies with annual revenues ranging from USD 10 million to USD 1 billion. These loans are typically offered by non-bank lenders directly to businesses, bypassing intermediaries. Coupon payments are often tied to short-term benchmarks such as the secured overnight financing rate (SOFR).

Direct loans offer several attractions for investors. Among these are floating rates and relatively short durations, which compensate investors for the high risks. As they are not issued in open markets, and therefore much less liquid than publicly traded debt, direct loans come with an illiquidity premium, reflected in higher relative returns. A further attraction is the downside protection offered by the seniority of senior direct debt over bonds in the capital structure, while subordinated direct debt also has claims. This structure enables direct lending funds to negotiate favorable covenants amid tighter credit conditions and higher yields.

Signs of complacency amid gathering clouds

While private lending has been in a sweet spot, rewarding investors with solid double-digit returns in segments such as first-lien loans, it's still a market that carries significant risks. Fears are growing in some circles that these risks are underappreciated, as subdued volatility and low default rates have bred complacency. Other signs of an excessively carefree market include the growing prevalence of riskier covenant-lite (cov-lite) loans, which provide less protection to creditors and have contributed to a declining recovery rate for US loans over time.

Meanwhile, some clouds have been gathering, including recent stress in the private equity market, with some high-profile deals being pulled at the last minute. This has contributed to a shift towards structured credit products like securitization of debt pools and credit card receivables.

Regulators increasingly concerned

This potentially toxic cocktail of high nonbank participation, complacency amid pockets of stress, and the sheer speed of private credit growth, has drawn increasing scrutiny from regulators. The market is large enough now that any ructions within it raise the specter of systemic risk, the ultimate fear for regulators. In the US, the Financial Stability Board (FSB) has flagged this rapid growth as a potential threat to financial stability, while the Federal Reserve has issued warnings about the deteriorating underwriting standards in leveraged lending.

In Europe, the ECB has expressed concerns about the high levels of leverage and the loosening of lending standards in the eurozone's leveraged finance market, while in the UK the Prudential Regulatory Authority (PRA) is said to be preparing for a comprehensive review of banks' exposure to private equity firms. The review is expected to focus on the risk management practices of banks involved in leveraged lending and their ability to withstand potential losses.

These developments speak to growing concerns and a growing consensus among regulators that more stringent regulations and oversight may be needed to mitigate the risks associated with leveraged lending and ensure the stability of the financial system. It's hard to know at this stage what concrete measures will be taken, but it's safe to assume leveraged finance is likely to stay on regulators' radar for the foreseeable future.

Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- Credit Analysis – An Introduction
- Credit Risk – An Introduction
- Credit Risk – Types & Asset Classes
- Credit Risk Appetite – An Introduction
- Corporate Banking Products – An Introduction
- Corporate Banking Products – Syndicated Lending
- Corporate Banking Products – Short-Term Finance
- Corporate Banking Products – Accounts Receivable Finance
- Regulation – An Introduction
- Banking Regulation – An Introduction
- Markets Regulation – An Introduction

Bonds back in favor: Will it last?

As we headed into 2024, the stage seemed set for a rousing rally in US bond markets. A combination of soft economic data releases and a dovish surprise from the Fed Chair Jerome Powell, following the FOMC's December 2023 press conference, appeared to signal an end to the sustained high-interest-rate regime, with a cutting cycle on the cards.

Instead, the macroeconomic picture proved remarkably resilient, as high-frequency inflation and growth prints continually beat expectations in the early months of 2024. US Treasuries duly sold off while equities continued their upward march, as equity investors chose to ignore inflation and prioritize growth, with the AI boom providing further fuel.

In recent weeks, however, data has started to soften again, giving bond markets a new lease of life and putting equities on the backfoot. At the index level, this weakness has been masked by continued strong performance from a handful of tech giants – mainly Nvidia and Apple – and is better captured in more economically sensitive benchmarks such as the S&P 500 equal-weighted stock index and global equity indexes.

Bond market distortions

The high-interest-rate regime has been accompanied by some persistent distortions in the bond market. One of these is an inverted yield curve (long-end rates progressively lower than short-end rates). Traditionally, an inverted yield curve has signaled a looming recession. But on this occasion the inverted yield curve wrongfooted any investors heeding this signal. The current inversion seems to be an artifact of the peculiar circumstances that triggered the hiking cycle in 2022 – namely COVID-related supply shocks combined with excessive fiscal stimulus. It reflects progressively lower inflation expectations as we move out along the curve, rather than weaker future growth.

Another distortion is credit spreads – the yield premium of "risky" corporate bonds over "risk-free" government bonds – at record lows. At present, US corporate debt is offering a premium of 1.5% over the equivalent US government debt benchmark – about 50 basis points below the historical norm. The message here is in stark contradiction to that of the inverted yield curve. Not only is the bond market showing no distress, with little to no fear of recession, but it's reflecting outright complacency about growth.

Yield curve inversion coupled with record-low credit spreads is an anomaly. One of them must be wrong. So far, the yield curve inversion has been misfiring as a recession signal, while credit spreads have been on the money, as macro data has by-and-large surprised to the upside. But could this change?

The case for bonds

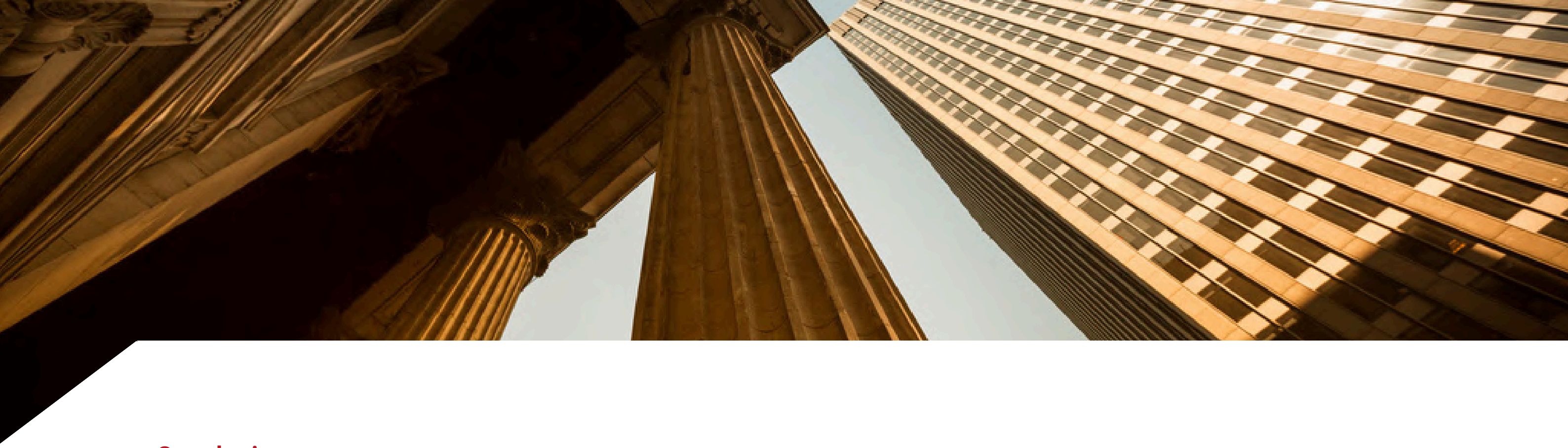
Some strategists, including Michael Hartnett of BofA, expect the outperformance of US treasuries versus stocks to continue, favoring bonds over equities for the rest of 2024. Hartnett has also stated a preference for more rate-sensitive long-dated bonds, or “duration.” This may seem odd given the inverted yield curve. With the Fed seemingly on course to cut rates this year, and 2-year US Treasuries still yielding around 4.6% as inflation trends lower again, “bull steepeners” (short rates down/prices up) look like the logical trade.

The case for duration rests on a gloomier macroeconomic outlook than is currently being priced. Hartnett, quoted in a Bloomberg article in May, noted “risk to corporate profits from some weaker signals on the economy” as well as positioning that is still heavily weighted toward equities over bonds. This positioning could provide additional fuel to any reversal in what Hartnett called the “anything but bonds” trade in the second half.

The case against bonds

The bond bears have a strong case too, which rests primarily on structurally elevated inflation in the US, driven by aggressive fiscal stimulus. The US fiscal deficit is projected to reach 7% of GDP this year (according to the Congressional Budget Office) and politicians on both sides of the aisle show no willingness to rein in spending. This means there will have to be massive supply of bonds in the years to come that could be difficult for the market to absorb.

Citing these risks as well as immigration pressures, one Fed governor and noted hawk, Michelle Bowman, even recently stated her willingness (in a speech cited by the FT) to raise borrowing costs if required. She believes structural inflationary pressures could keep US prices rising faster than in other advanced economies, where some central banks have begun cutting rates.



Conclusion

Long-dated bonds have undergone dramatic declines in recent years. TLT, the most widely followed and actively traded long-dated (20+years) US Treasury ETF, is down almost 40% from its all-time high reached in mid-2020. This illustrates the effect of duration (sensitivity of price to yield). It also implies significant room higher if the Hartnett camp is right, though it should be noted that those 2020 highs, or anything close, are well out of reach (an anomaly that may never be seen again).

By the same token, the downside potential to buying duration is significant if the bond bulls are wrong. It's a high risk/highish reward proposition. Buying short-dated bonds (2-year USTs, for example) looks like a more favorable risk/reward – in the worst-case scenario where bonds take another dive, investors still lock in nominal yields of around 4.6% for two years. But it's the consensus view and won't make anyone rich.

Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- Bond Markets – An Introduction
- Fixed Income Analysis – An Introduction
- Fixed Income Analysis – Credit Risk
- US Bond Markets
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- Yield Curves – Construction
- Duration Analysis
- Financial Authorities (US) – Federal Reserve
- Economic Indicators – An Introduction
- Inflation – An Introduction
- Monetary Policy
- Fiscal Policy Analysis