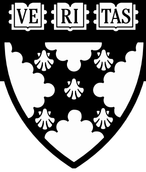

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State of the Corporate Loan Market

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ESRB Annual Conference

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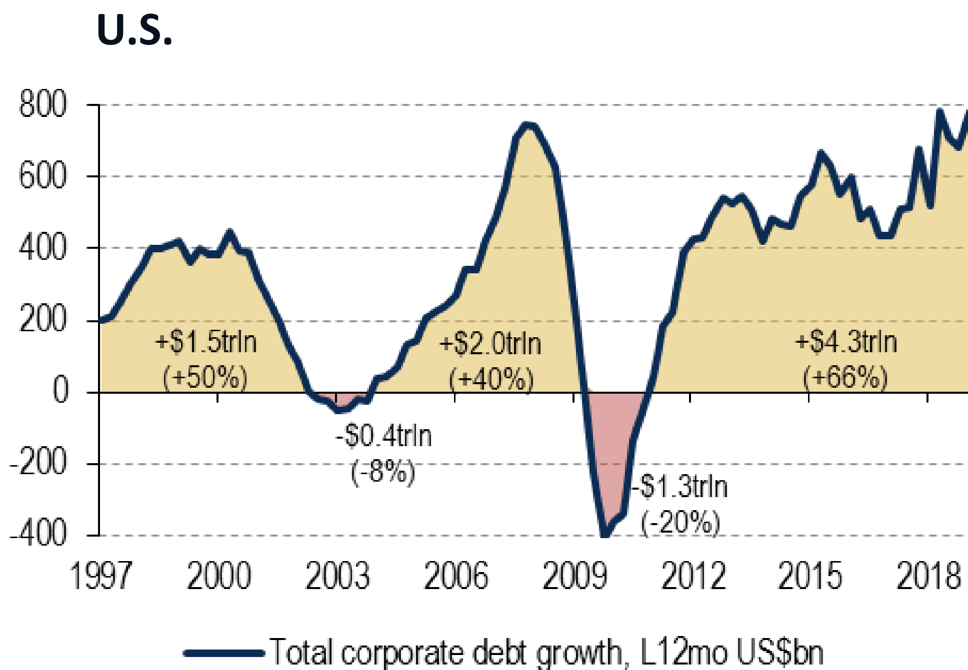
Facts:

Significant growth in non-financial corporate debt:

U.S.



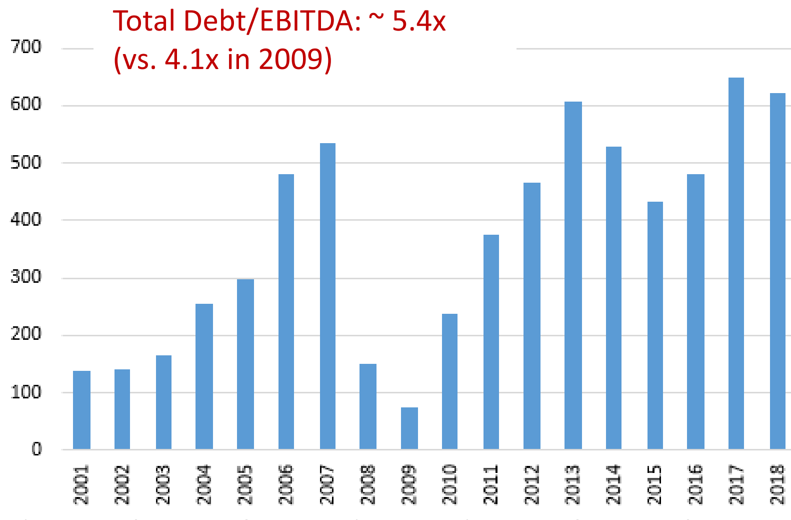
Source: BofA Merrill Lynch Global Research, Federal Reserve.

Facts (2):

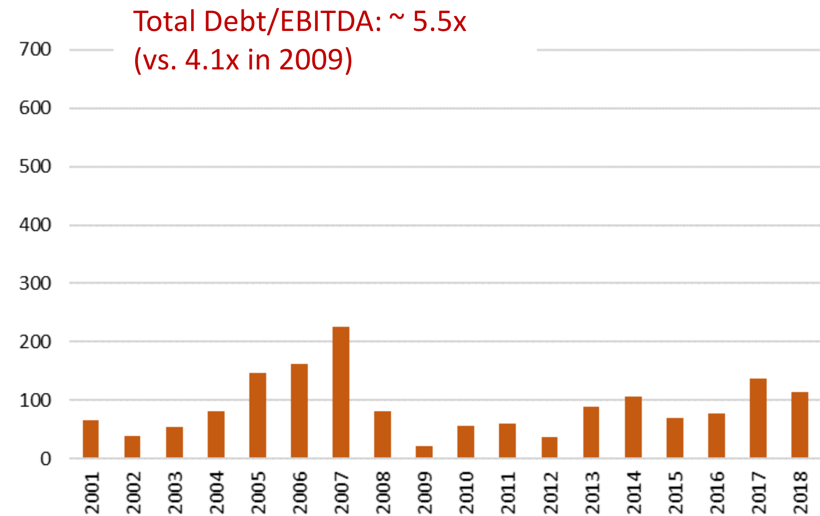
Growth has been concentrated in the “shadow banking”:

1. Leveraged loan market:

U.S.



Europe



Source: S&P Global Market Intelligence

2. Private debt

Framework for Thinking about Financial Fragility:

Questions to ask (and you ought to be asking yourself both):

1. **Is there risk?**

2. **Who is holding it?**
    - Are these institutions “runnable”?
    - Are these institutions levered?
    - Can these institutions withstand losses?

Framework:

1. Is there risk?

Note: In its current form, securitization is pivotal to the existence of the leveraged loan market

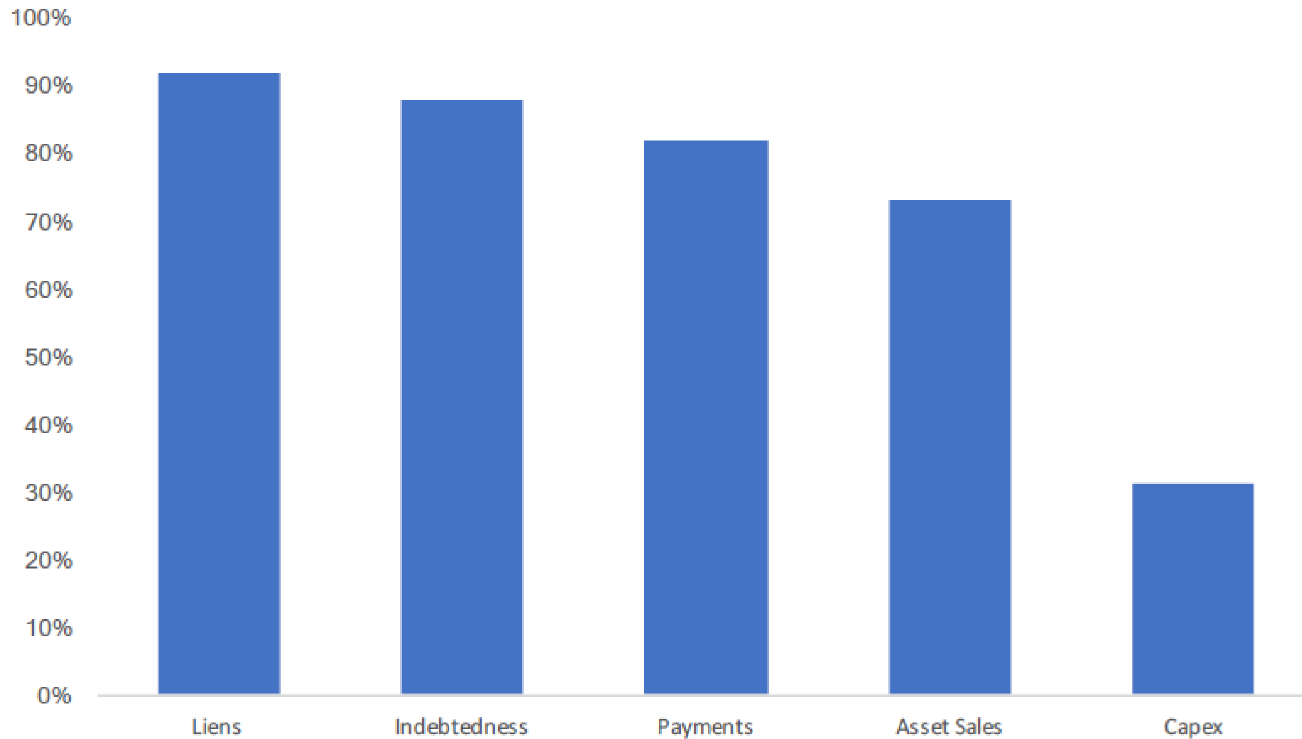
Common misconception:

Corporate leveraged loans are easier to diligence (than mortgages)

The borrower: yes. The claim: no! And the claim is what loan is.

Leveraged is not a claim on an asset (vs. the mortgage), this is primarily a claim on cash-flows and a timely renegotiation trigger. Loan contracts are very complex, and there is substantial heterogeneity.

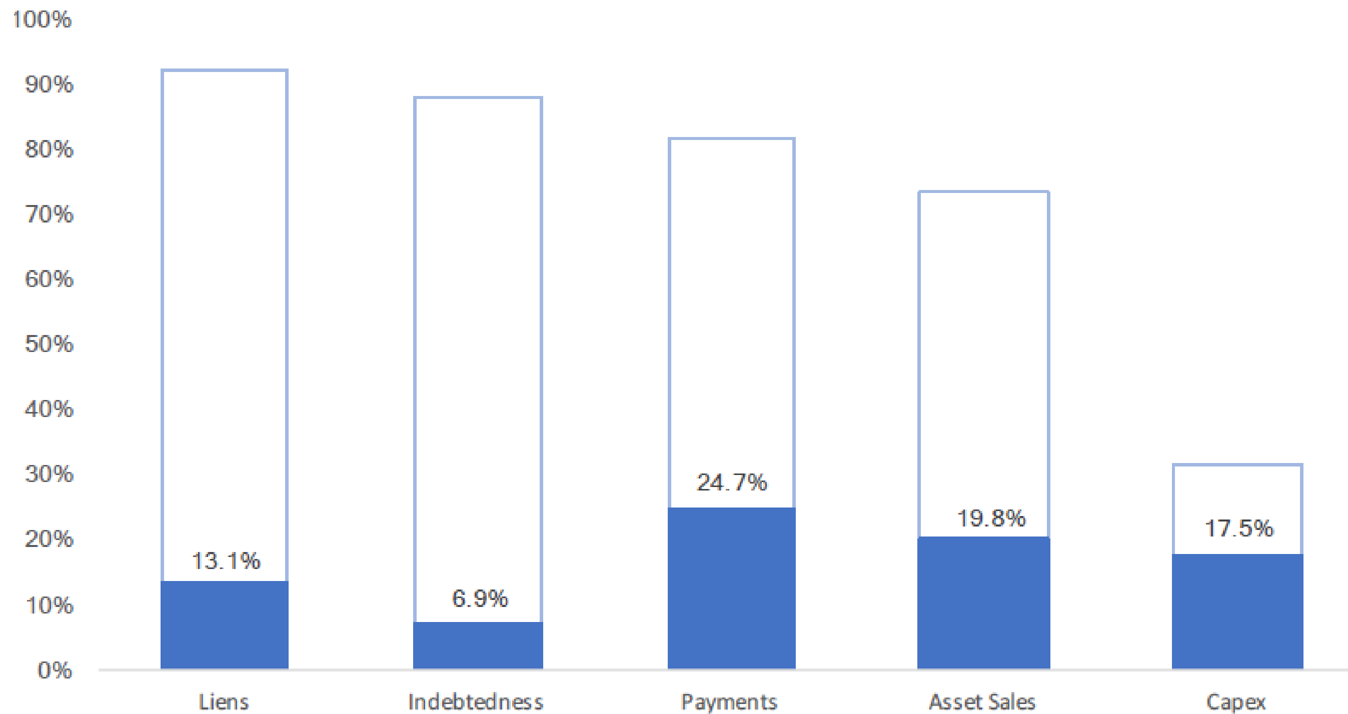
Use of Covenants in Leveraged Loans



Ivashina and Vallee (2018)

Fraction without "Small Font"

(contracts without baskets)



Ivashina and Vallee (2018)

Framework for Thinking about Financial Fragility:

Questions to ask :

2. Who is holding it?

- Are these institutions "runnable"?
- Are these institutions levered?
- Can these institutions withstand losses?

And again, for leveraged loan market, securitization is pivotal

So, the question is: who is holding tranches of CLOs?

- For banks operating in U.S., exposure through AAA tranches is ~$90B, but there is at least $500B of these out there. Who holds the rest?
- Ultimately, only a partial insight

Post 2008: A Unique Environment for Pensions

European Insurance and Occupational Pension Authority (EIOPA), *Financial Stability Report*:

Spring, 2009 – "The defined benefit (DB) occupational pension fund sector is coming under increased pressure, also because of low interest rates and prevailing longevity risk."

Spring, 2010 – "A sustained period of low interest rate environment is especially challenging for life insurers and pension funds. Persistently low risk-free rates will cause insurers and pension funds to suffer losses on products that guarantee higher interest rates than they can fund in such market conditions. It also increases risks as undertakings might be searching for higher yields as well as the present value of liabilities, leading to deterioration in the capital position."

Spring, 2011 – "While funding levels have improved, there still exists a great deal of uncertainty in the financial markets and the current low interest rate environment also creates differing problems in the Defined Benefit (DB) and Defined Contribution (DC) sector."

Spring, 2012 – "[R]ecent months have again seen the 10Y [Euro] benchmark rate decline to levels well below 2%. Clearly, long-term rates are of critical importance to life insurers and pension funds, as these institutions typically have long-run obligations to policyholders and pensioners that become more expensive in today's terms when rates are low."

…

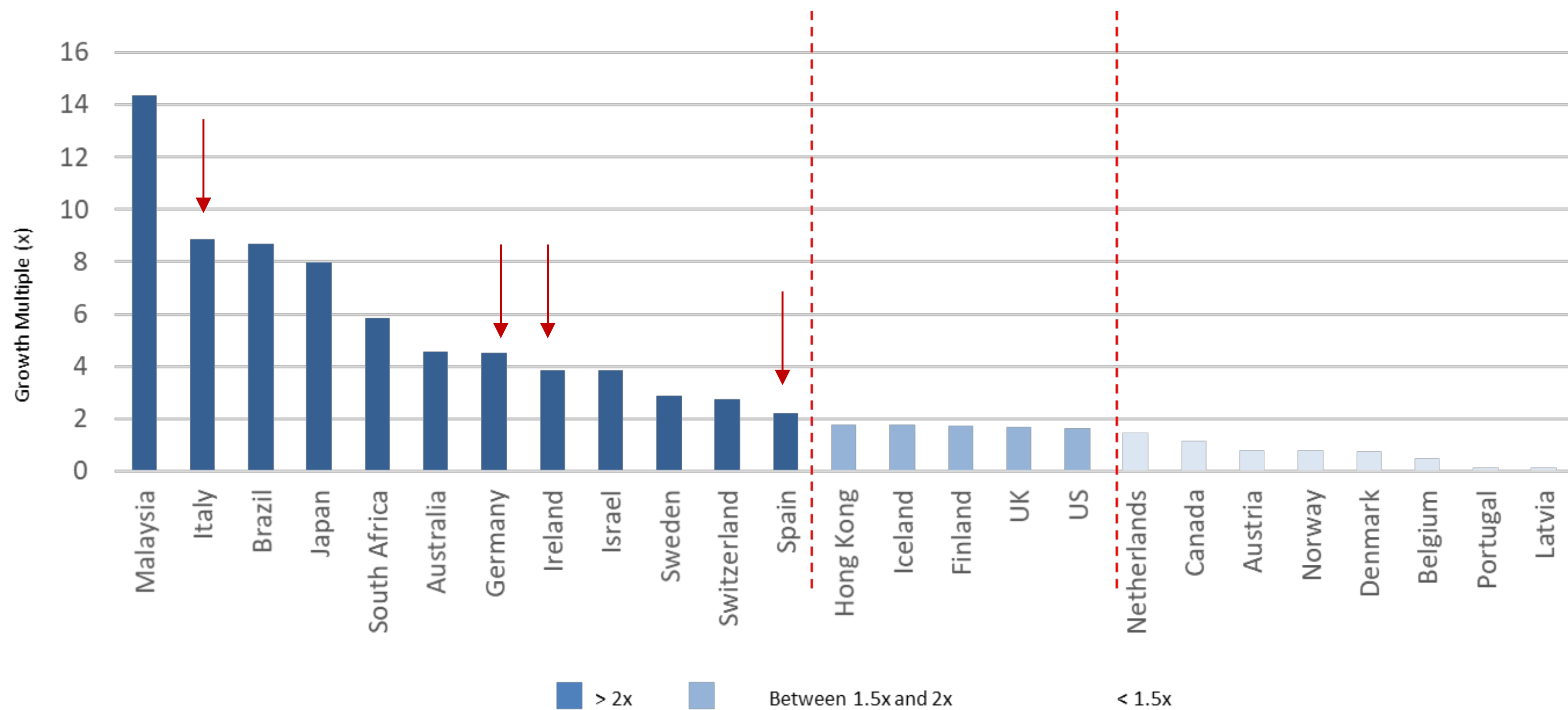
Spring, 2016 – "The ongoing low interest rate environment continues to generate challenges to the European occupational pension fund sector. […] In the course of 2015, lower interest rates had a further negative effect on cover ratios for most of the countries of the sample."

Broader Signs of Reaching for Yield within Pensions

Pension Allocations to Alternatives 2017 as a multiple of 2008 level

Value-weighted (within country) averages

(funds with 10 years of data)



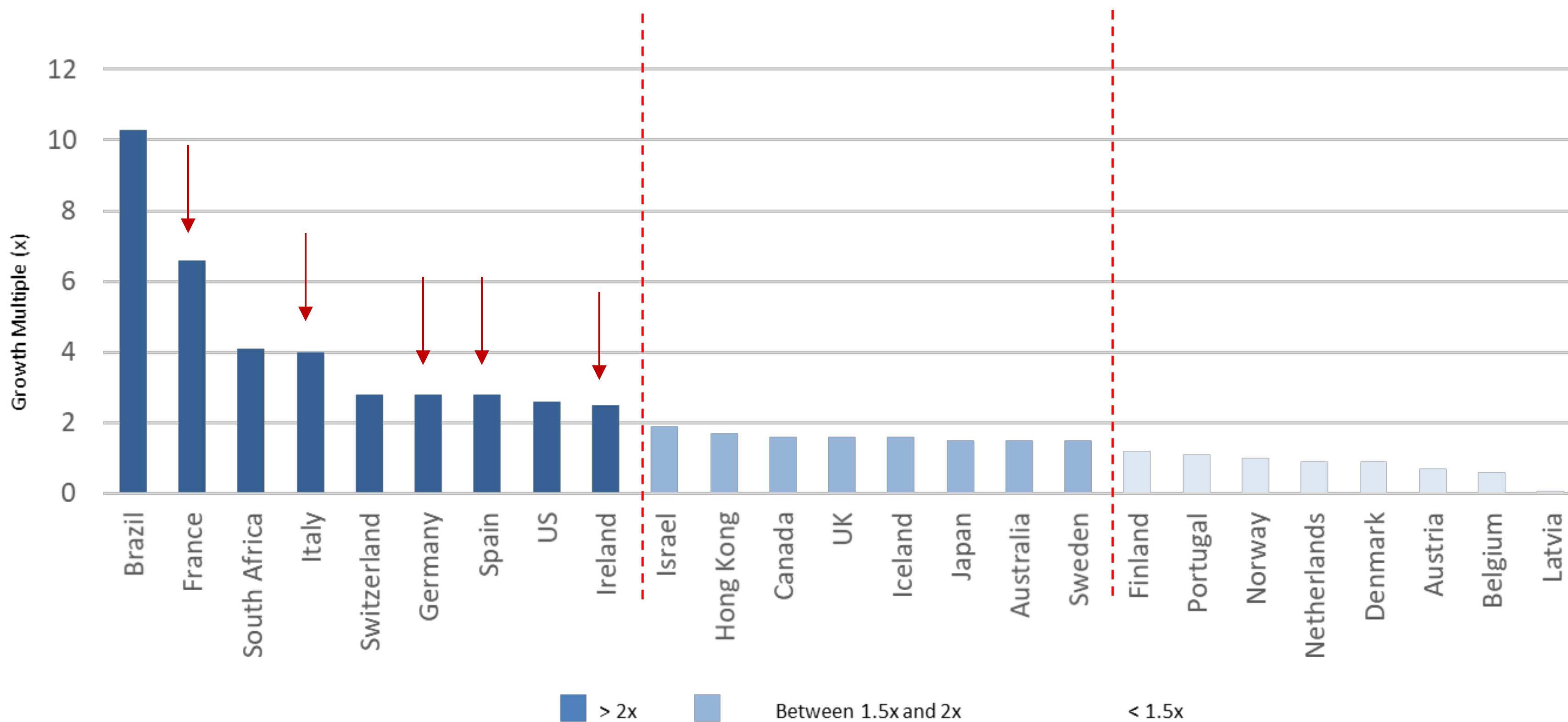
Ivashina and Lerner (2018)

Broader Signs of Reaching for Yield within Pensions

Pension Allocations to Alternatives 2017 as a multiple of 2008 level

Equally-weighted (within country) averages

(funds with 10 years of data)



Ivashina and Lerner (2018)