Box 5
Leveraged loans: a fast-growing high-yield market

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The market for leveraged loans is significant and recent developments may be generating financial stability risks.[25] In both Europe and the United States, the markets for leveraged loans issued by non-financial corporates are about five times larger than high-yield bond markets. In 2017 US leveraged loan issuance rose well above its pre-crisis levels, with gross issuance, depending on methodology and data source, estimated at between €500 billion and €1 trillion, while EU issuance, estimated at between €120 billion and €320 billion, is around the previous highs recorded in 2007 and 2014 (see **Chart A**).[26,27]

25 While there is a general understanding that a leveraged loan is a secured loan granted to a highly indebted (levered) company, there is no generally agreed definition. The industry defines leveraged loans as secured loans where the borrower is sub-investment-grade or the spread at issuance is higher than a certain threshold.

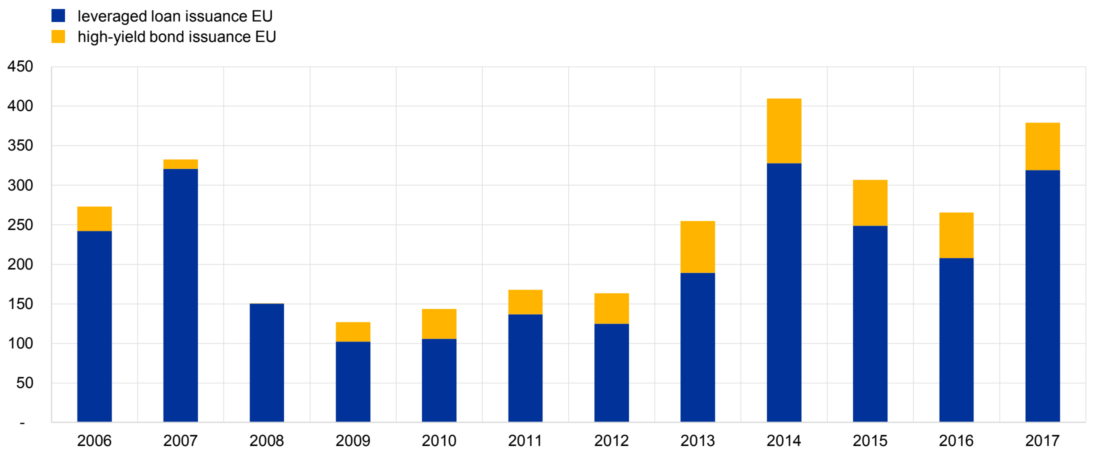
26 The actual size of the market is likely to be even greater, as an increasing share of the leveraged loan market is accounted for by direct lending, a private, bilateral type of leveraged loan transaction where financing is provided by non-banks. Such loans are likely to be only partially captured by existing data sources.

Chart A

Since the crisis leveraged loan issuance has matched previous highs in the EU

Primary market gross issuance of non-financial corporate high-yield bonds and leveraged loans in the EU

(2006-2017; € billions)



Sources: Thomson Reuters for leveraged loans, Dealogic for bond issuance, and ECB calculations.
Notes: Primary market issuance data do not include borrowing by financial and project finance companies or by governmental entities. Thomson Reuters data on gross primary market issuance of leveraged loans include refinancing of leveraged loans that are carried out via amendments to pricing of loan agreements with existing investors.

High investor demand has allowed increasingly leveraged corporates to obtain financing in the leveraged loan market. In the United States, corporate leverage for firms active in the leveraged loan market has already exceeded pre-crisis peaks and the same trend has been observed for first lien corporate leverage in the European market (see **Chart B**).[28] In many cases, actual leverage is likely to be significantly higher than reported leverage, given the increasingly common practice among borrowers of making optimistic adjustments to pro-forma EBITDA levels. At the same time, as in the high-yield bond market, valuations are tight (see **Chart 2.6**).

Non-price terms in the leveraged loan market also reveal a significant relaxation of underwriting standards. In both Europe and the United States, the level of investor protection envisaged in leveraged loan contracts is low: covenant lite (cov-lite) transactions are now reported to account for around 80% of the issuance in both markets, compared to less than a quarter during the pre-crisis period (**Chart B**).[29] Since investors have fewer means of timely intervention to restrict borrower behaviour, this increases the likelihood that defaults will be delayed and recovery rates will

27 The lower estimate of the gross issuance in the primary market is based on market data sources which capture refinancing via a repayment of the loan to existing investors followed by a re-syndication of the loan to new investors. The upper estimate also captures refinancing of leveraged loans carried out via amendments that change the pricing of the loans to existing investors. All else being equal, methodologies that include cashless amendments as part of refinancing activity result in higher gross issuance amounts. Some of the differences in the estimated primary market issuance among commercial data providers are probably also due to differences in the scope of data coverage.

28 First lien leverage is leverage that considers the debt secured by the first claim on the underlying assets.

29 Cov-lite leveraged loans have no maintenance covenants in the loan documentation to protect the borrower. Maintenance covenants require certain tests, such as maximum leverage, minimum interest coverage ratio and maximum capital expenditure limits, to be met by the borrower at all times. Cov-lite leveraged loans still maintain at least some incurrence covenants. Unlike maintenance covenants, incurrence covenants prevent the borrower from breaching certain thresholds only when undertaking certain actions, such as mergers, and thus offer weaker investor protection. Moreover, in recent years, investor protection has been further weakened by a marked decline in the number of incurrence covenants per loan.

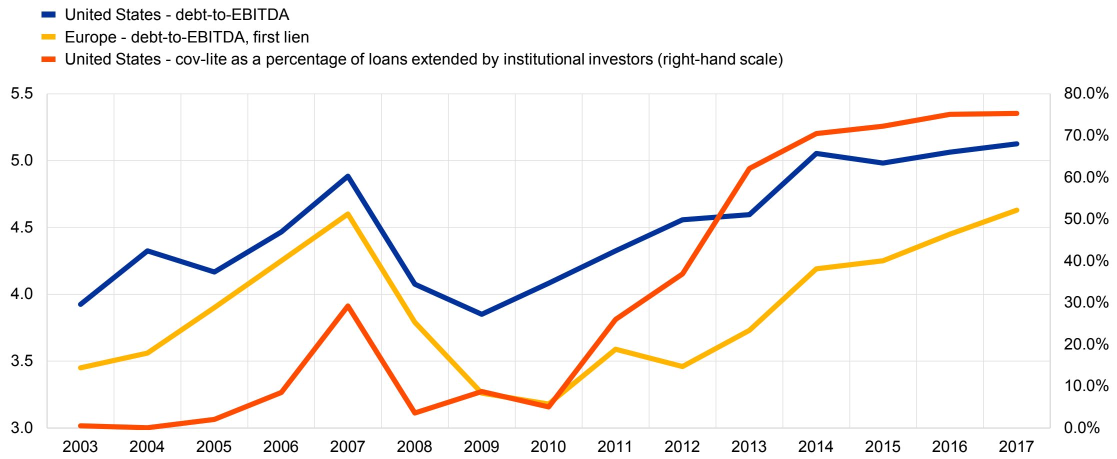
be lower. High borrower bargaining power has also led to other forms of weakened investor protection, such as restrictions on loan transferability in the secondary market and limits on the share of the issuance that can be held by any one investor.

Chart B

Corporate leverage in US and European leveraged loan markets is at a post-crisis high, while underwriting standards have deteriorated markedly

Corporate leverage levels in the European and US leveraged loan markets and the share of cov-lite loans in primary US leveraged loan market

(2000-2017; ratios and percentages)



Sources: S&P Ratings Direct and ECB calculations.
Note: Leverage is computed as gross debt divided by pro-forma EBITDA.

Credit standards in the European leveraged loan market closely mirror those in the United States, where the leveraged loan market is larger and at a more advanced stage of the credit cycle. Anecdotal evidence suggests that some of the more aggressive practices, in terms of both higher leverage and lower investor protection, are associated with transactions by cross-border US private equity sponsors, with transactions initiated by sponsors typically employing more leverage than the average. This probably reflects the high bargaining power of private equity sponsors, who account for 70-80% of the borrowing volumes.

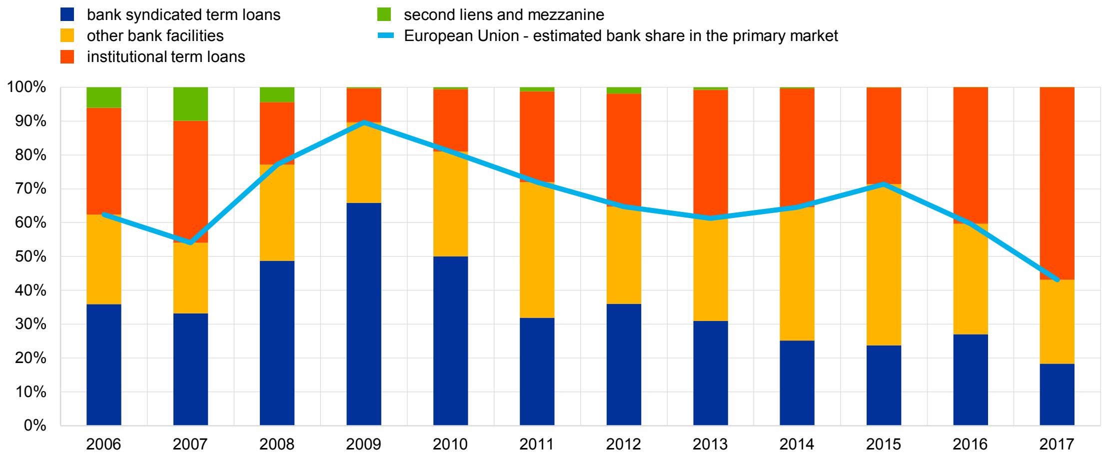
In the EU, non-bank investors have increasingly replaced banks in the financing of highly indebted companies. Chart C shows that, since the financial crisis, banks have reduced their share of financing in the primary market, with non-bank investors estimated to have provided more than half of the overall financing in 2017. This reflects both very high investor demand, as investors have increasingly purchased term loans and even bank facilities traditionally retained by banks, and higher capital charges and restrictions imposed on bank activities since the crisis.

Chart C

Non-banks in Europe have acquired increasingly large shares of leveraged loans in the primary market since the financial crisis

Breakdown of leveraged loan facilities in the EU market by type and estimated share of primary market loans extended by EU banks

(2006-2017; percentages)



Sources: Thomson Reuters and ECB calculations.
Notes: Institutional term loans cover term loans B, C, D and E, while bank syndicated term loans cover term loans A (TLAs). Other bank facilities cover bridge loans, revolving credit facilities, and capital expenditure (capex) and acquisition loans. Banks' share in the primary market is estimated as the share of term loans retained by the banks and of other bank facilities in the total volume of leveraged loans syndicated in the primary market.

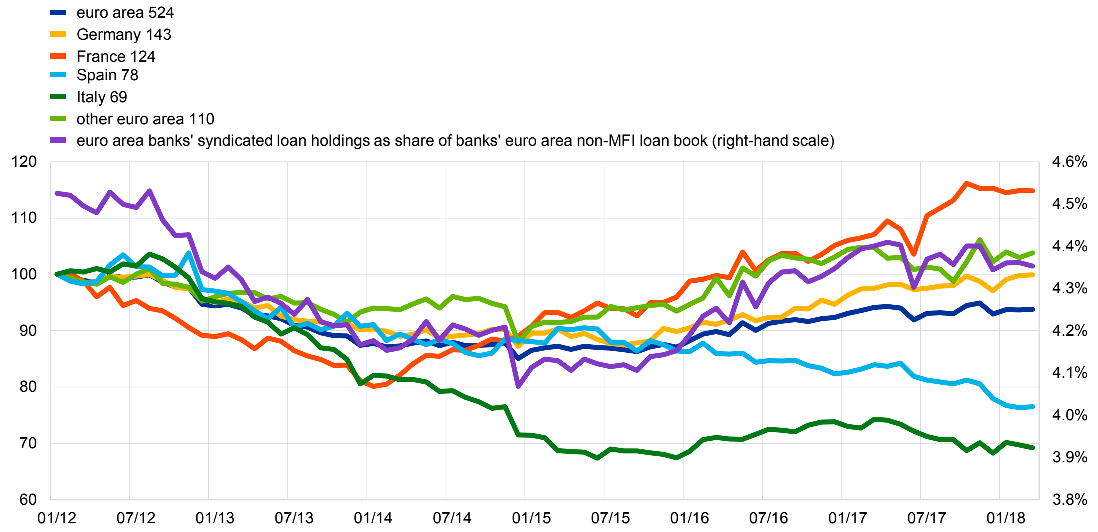
Despite accounting for a smaller overall market share, euro area banks may have increased their exposure to leveraged loan markets recently. As previously mentioned, banks have generally reduced their role as investors and arrangers in leveraged loan markets. Nevertheless, against the background of a resurgence in issuance, euro area banks' holdings of leveraged loans to euro area non-financial corporates may have picked up again. While statistics on the direct holdings of leveraged loans by euro area banks are not available, syndicated leveraged loans are estimated to account for about a third of the syndicated loans extended by euro area banks in major jurisdictions to euro area non-financial corporations. Syndicated loans accounted for 4.4% of the euro area banking sector's loan exposure to euro area non-MFIs in March 2018 (see **Chart D**). The absolute exposure amounted to €524 billion a 10% increase compared with levels at the end of 2014. German and, in particular, French banks are driving overall euro area bank exposure higher, while Spanish and Italian banks have decreased their holdings by around 20% and 30%, respectively, since the beginning of 2012.

Chart D

Some euro area banks' holdings of syndicated loans have been increasing recently

Euro area banks' holdings of syndicated loans extended to euro area corporates by country

(Jan. 2012-Mar. 2018; index: Jan. 2012 = 100 (left-hand scale); percentages per annum (right-hand scale))



Source: ECB MFI balance sheet items (BSI) statistics.
Notes: Numbers next to countries in the legend show country-level syndicated loan holdings in € billions in March 2018. Holdings of syndicated loans represent the stock of syndicated loans extended by euro area MFIs, excluding the Eurosystem, to euro area non-financial corporations at the end of each month. The syndicated loan data cover loans extended to both investment-grade and sub-investment-grade companies.

Developments in leveraged loan markets may create financial stability risks. In particular, the rollover of maturing loans into exposures with a significantly worse risk-return profile may create vulnerabilities. In addition, the distribution of risks beyond the banking sector is unknown, given the lack of statistical data. Finally, higher than expected potential losses in this sector may spill over to the wider economy. With these risks in mind, the ECB issued guidelines on leveraged transactions in May 2017 which set minimum supervisory expectations regarding loan origination, loan identification and the leveraged lending risk control framework for the banks under its remit.[30] In this context, all relevant credit institutions should be in a position to demonstrate how their loan origination and risk management practices reflect the ECB's expectations by November 2018.

[30] See *Guidance on leveraged transactions*, ECB, May 2017.