



Leverage Lending FAQ & Fact Sheet

February 2019

Key Takeaways

- Leveraged Loans are a type of syndicated loan made to below investment grade companies, i.e. companies with a credit rating below BBB-/Baa3
- While Leveraged Lending origination and CLO issuance has grown, both markets remain much smaller than common fixed income securities segments
- Leveraged Lending is small in comparison to the total amount outstanding in U.S. fixed income securities, 4.1% of the total or 0.18x MBS/0.19x corporate bonds
- Leveraged Lending & CLOs have low default rates; leveraged loan default rates peaked in 2014 at >4.5%, but are down to 1.6% as of November 2018

Contents

| | |
|--|---|
| Leveraged Lending: Frequently Asked Question | 3 |
| What is Leveraged Lending? | 3 |
| How Big is the Market and Who Holds Leveraged Loans? | 3 |
| Are CLOs Risky? | 3 |
| Leverage Lending: Fact Sheet | 5 |
| Change in Fixed Income Landscape Since 2008 | 5 |
| Leveraged Lending and CLOs Have Historically Low Default Rates | 7 |
| Authors | 8 |

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Leveraged Lending: Frequently Asked Question

What is Leveraged Lending?

Leveraged Loans are a type of syndicated loan made to below investment grade companies, i.e., companies with a credit rating below BBB-/Baa3. Many well-known companies fall into this category, including: Burger King, Chrysler, Dell, American Airlines and Avis. According to the Loan Syndications and Trading Association, over 70% of companies in America hold below investment grade ratings. A leveraged loan may be originated for a variety of reasons – general corporate purposes, refinance an existing loan, part of a recapitalization, finance a leveraged buyout, etc.

The two most common kinds of financing facilities are term loans and revolving facilities. A term loan is similar to a traditional loan where funding is disbursed at origination and repaid over time. These loans are typically held by non-bank, institutional lenders, such as insurance companies, asset managers, or other entities. A revolving facility is a type of loan that can repeatedly be drawn upon and repaid like a credit card. Revolving loans are typically originated and held by banks. The principal amount of term loans outstanding is estimated to be roughly double the size of revolving facilities outstanding.

How Big is the Market and Who Holds Leveraged Loans?

The leveraged loan market is a small but important piece of the U.S. financial system. In terms of size, the mortgage market has roughly \$10 trillion in mortgage loans outstanding, and the broader fixed-income markets have a total outstanding of over \$42 trillion.¹ There are \$1.7 trillion in leveraged loans outstanding.²

Leveraged loans are primarily held by banks, non-bank companies (insurance companies, finance companies), asset managers (in a loan mutual fund) or securitizations called collateralized loan obligations (CLOs). CLOs hold \$615 billion in leveraged loans (roughly 1/3 of the leveraged loans outstanding).³ In recent years, investors (typically funds) have increased the amount of lending they do directly with corporations, in so-called “direct lending” arrangements. Direct lenders, which are not regulated by the bank regulators and thus aren’t bound by various regulatory constraints that banks have, tend to focus on smaller loan sizes than typical in broadly-syndicated lending arrangements but are becoming more active in size.

The most recent Shared National Credit Report issued by the Fed, OCC, and FDIC showed that banks hold approximately 45% of the total loans reviewed by the regulators, but only 20% of the “special mention” and “classified” loans, those which present the most risk.

Are CLOs Risky?

CLOs are often cast as harbingers of systemic risk, but their historical performance through one of the most challenging economic cycles in modern history shows this is not the case. (Please see the Fact Sheet section for further details.) CLOs have stable funding, terms of loans can be renegotiated and, accordingly, have weathered the

¹ Federal Reserve, SIFMA

² LSTA

³ SIFMA

credit crisis with remarkable strength. According to Moody's, of the 5,176 CLO tranches outstanding between 1996 and 2014, only 1.1% became "impaired". No senior tranches – those rated Aa or Aaa – suffered losses. CLO loss rates are far below those for residential mortgage backed securities (>25%), CDOs (35%) or even comparably rated corporate bonds (16% for BB rated corporate bonds).

In contrast to 2007, the current market is built on a more stable foundation. While market value CLOs were prevalent pre-crisis, they are no longer issued. Those types of transactions could be forced to sell into a deteriorating market. However, most securitized loans today are held in traditional CLOs – more long term and stable in nature – which are less likely to be forced sellers in a downturn. Traditional CLOs are formed to purchase loans and are not able to hold significant cash balances. Accordingly, even if a CLO needs to sell a loan, it must replace it with another loan. CLOs cannot simply flee from loan markets at the first sign of a downturn.

Further reducing risk, pipeline management practices have significantly improved. The pipelines⁴ of loans-in-progress are far lower than they were in the mid-2000s due to lessons learned during this time period. This means banks are less exposed to the risk of owning assets that they are unable to sell at an economic price. According to Refinitiv LPC, over the past decade, pipelines have generally been 1/3 or less of peak levels.

Additionally, companies typically default because they cannot pay or service their debt. Current interest coverage ratios are very high – near record levels for loans in the S&P/LSTA index. At year-end 2018, the default rate for leveraged loans was 1.6%, with some rating agencies projecting that this rate will drop in 2019.

Federal Reserve Chairman Powell aptly summarized the current state of the leveraged loan market in a November 2018 speech: "The question for financial stability is whether elevated business bankruptcies and outsized losses would risk undermining the ability of the financial system to perform its critical functions on behalf of households and businesses. For now, my view is that such losses are unlikely to pose a threat to the safety and soundness of the institutions at the core of the system and, instead, are likely to fall on investors in vehicles like collateralized loan obligations with stable funding that present little threat of damaging fire sales."⁵

⁴ Loans that are in the process of origination which are not yet closed and/or sold.

⁵ Speech to the Economic Club of New York, November 28, 2018: <https://www.federalreserve.gov/newsevents/speech/powell20181128a.htm>

Leverage Lending: Fact Sheet

Change in Leveraged Loan and Fixed Income Landscape Since 2008

- In 2018, MBS still represent a significant portion of U.S. fixed income securities markets at 22.7% of total outstanding, down from 30.5% in 2008
- This is followed closely by Corporates at 21.9% of total outstanding, up from 17.7% in 2008
- Leveraged Lending is small in comparison, with loans outstanding equal to 4.1% of the amount of fixed income securities outstanding, or 0.18x MBS and 0.19x Corporate bonds outstanding
- CLOs, which purchase leveraged loans, are also very small in comparison – CLOs outstanding represent 1.3% of total fixed income securities outstanding (1.0% in 2008), or 0.06x MBS/0.07x Corporate bonds outstanding
- Structured finance CDOs⁶ (SF CDOs) represent 0.3% of total fixed income securities outstanding (1.7% in 2008), or 0.01x MBS and 0.01x corporate bonds outstanding
- While Leveraged Lending origination and CLO issuance continues to grow, both markets remain much smaller in comparison to various fixed income securities markets

| 2017 | Outstanding | | | Issuance/Origination | | |
|-------------------|-------------|------------|----------|----------------------|------------|----------|
| | \$ Trillion | % of Total | % Change | \$ Trillion | % of Total | % Change |
| MBS | 9.3 | 22.7% | -0.5% | 1.9 | 25.8% | -12.4% |
| Corporates | 9.0 | 21.9% | 47.5% | 1.6 | 22.1% | 69.3% |
| Leveraged Lending | 1.7 | 4.1% | n/a | 1.6 | 21.2% | 165.0% |
| CLO | 0.6 | 1.3% | 106.9% | 0.1 | 1.7% | 1198.7% |
| SF CDO | 0.1 | 0.3% | -81.5% | 0.01 | 0.03% | -94.4% |

| 2008 | Outstanding | | Issuance/Origination | |
|-------------------|-------------|------------|----------------------|------------|
| | \$ Trillion | % of Total | \$ Trillion | % of Total |
| MBS | 9.4 | 30.5% | 2.2 | 29.8% |
| Corporates | 6.1 | 17.7% | 0.9 | 15.3% |
| Leveraged Lending | n/a | n/a | 0.6 | 12.9% |
| CLO | 0.3 | 1.0% | 0.01 | 0.5% |
| SF CDO | 0.6 | 1.7% | 0.2 | 0.1% |

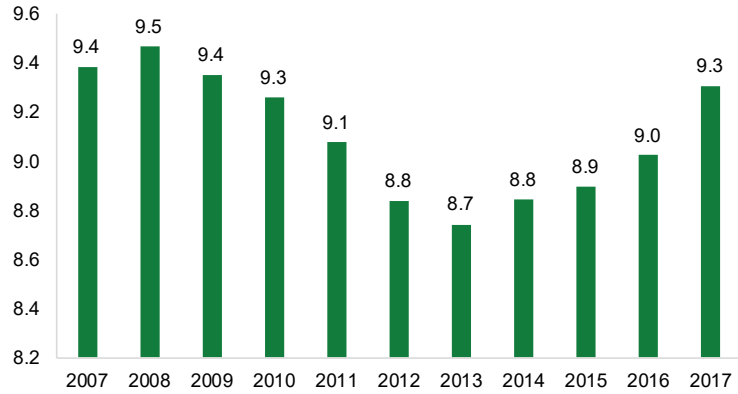
Source: SIFMA, Dealogic, LSTA (2017)

Note: MBS = mortgage-backed securities; CLO = collateralized loan obligation; SF CDO = structured finance collateralized debt obligation.

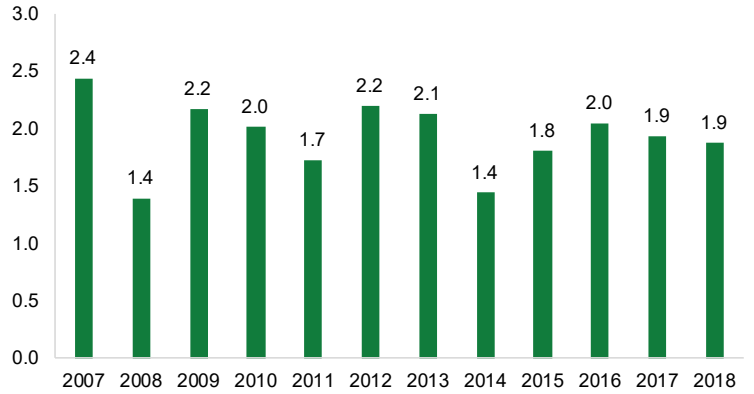
Other notable fixed income markets as % of total outstanding (2017) = Munis 9.4%, Agency 4.7%, ABS 3.7%

⁶ Structured finance CDOs are securitizations that are collateralized by other securitizations such as mortgage- or asset-backed securities.

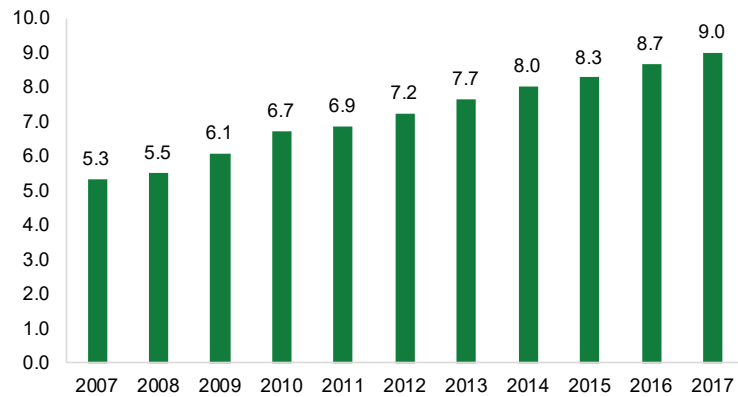
Outstanding (\$T) - MBS



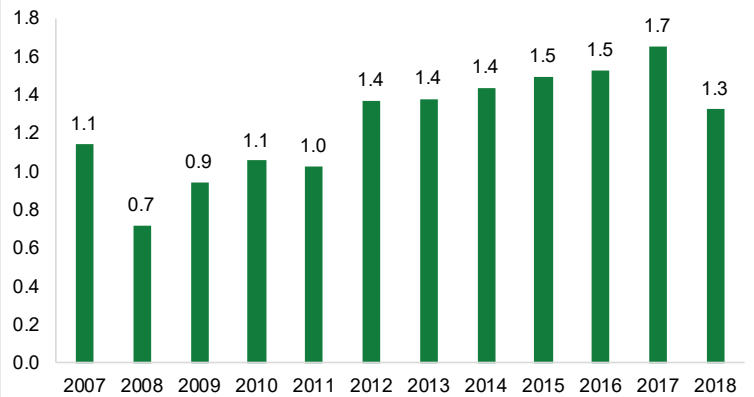
Issuance (\$T) - MBS



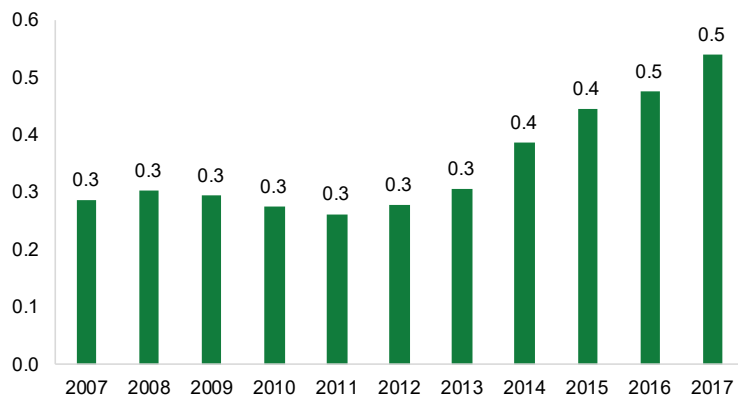
Outstanding (\$T) - Corporates



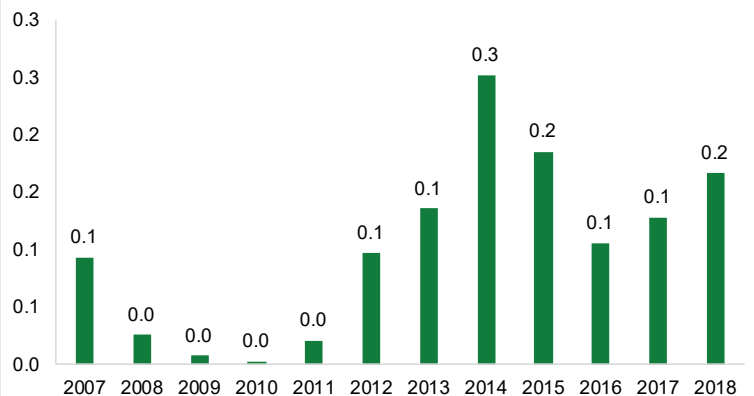
Issuance (\$T) - Corporates



Outstanding (\$T) - CLO

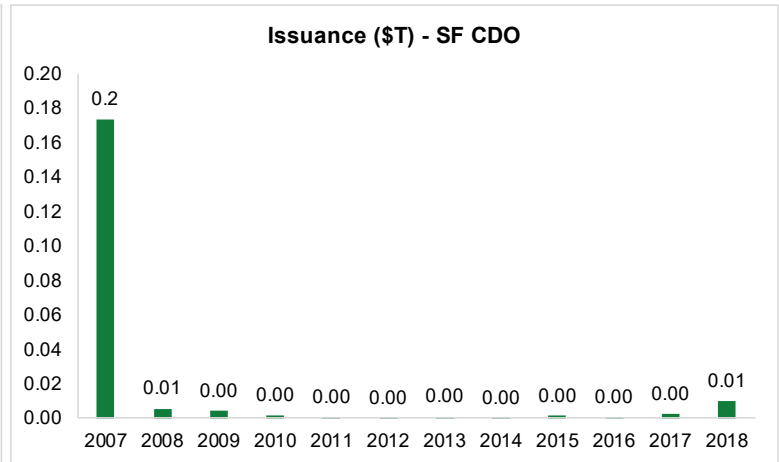
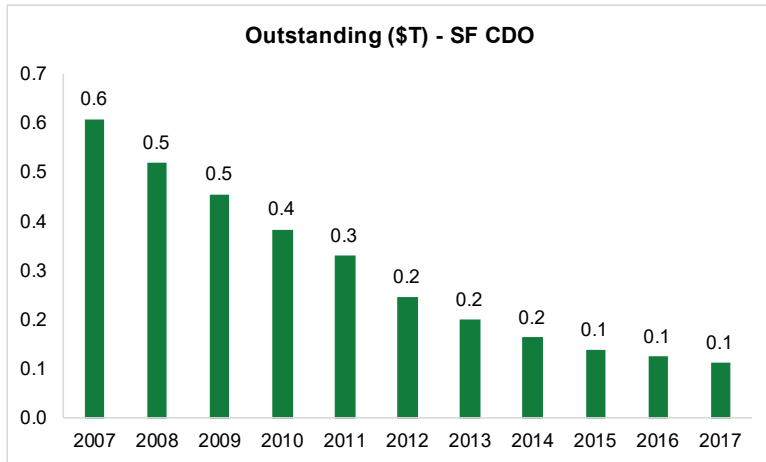


Issuance (\$T) - CLO



Source: SIFMA, Dealogic, LSTA (2017)

Note: MBS = mortgage-backed securities; CLO = collateralized loan obligation.

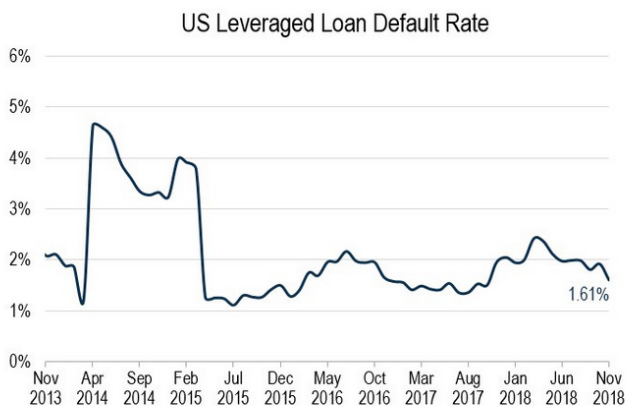


Source: SIFMA, Dealogic, LSTA (2017)

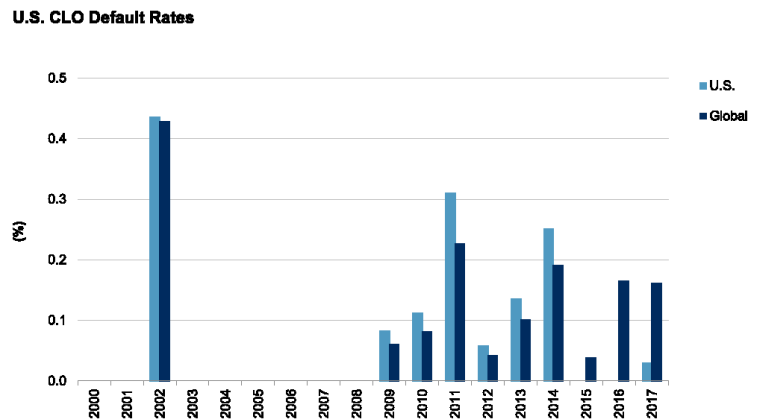
Note: SF CDO = structured finance collateralized debt obligation.

Leveraged Lending and CLOs Have Historically Low Default Rates

- Historically, Leveraged Lending and CLOs have low default rates
- Leverage Lending default rates peaked in 2014 at over 4.5%, but are down to 1.6% as of November 2018 (and have remained in roughly a 1%-2% band since early 2015)
- CLO default rates in the U.S. peaked at over 0.4% in 2002, but since then have been zero or negligible
- The lifetime default rate from 1996 to 2Q18 for U.S. CLOs is 0.4%, with de-minimis defaults from the 2009 vintage onward



Source: LCD, an offering of S&P Global Market Intelligence



Source: S&P Global Fixed Income Research.

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