



# **SIFMA Research**

## **Leveraged Loans Fact Sheet**

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## Description and Purpose of Markets

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### What are Leveraged Loans?

Leveraged loans are a type of syndicated loan for below investment grade companies (credit rating below BBB- or Baa3). Around 69% of companies in America hold below investment grade ratings<sup>1</sup>. 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. Term loans are similar to traditional loans where funding is disbursed at origination and repaid over time, typically held by non-bank institutional lenders such as insurance companies, asset managers, etc. Revolvers are types of loans that can be repeatedly drawn upon and repaid like a credit card, typically originated and held by banks. The principal amount of term loans outstanding is estimated to be roughly double the size of revolving facilities.

### 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. While the residential mortgage market has around \$10.6 trillion in loans outstanding and the broader fixed income markets have \$50.9 trillion in securities outstanding, there are only \$1.6 trillion in leveraged loans outstanding.

Leveraged loans are primarily held by banks, non-bank companies (insurance companies, finance companies), asset managers (in a loan mutual fund) or collateralized loan obligations (CLOs). CLO purchases continue to be a significant buyer of below investment grade corporate debt. According to the Federal Reserve, CLOs hold over 50% of outstanding institutional leveraged loans. In recent years, investors (typically funds) have increased the amount of lending they do directly with corporations, in direct lending arrangements. Direct lenders, which are not regulated by bank regulators and therefore not bound by regulatory constraints of banks, tend to focus on smaller loan sizes in broadly syndicated lending arrangements, albeit they are becoming more active in size.

Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency indicated that banks hold 63% of SNC bank-identified leveraged loans, most of which consist of higher rated and investment grade equivalent revolvers. Yet, banks hold only 24.4% of special mention and classified loans, i.e. those which present the most risk.

### How Do CLOs Manage Risk?

CLOs have stable funding with terms that can be renegotiated. According to Moody's, of the 5,176 CLO tranches outstanding between 1996 and 2014, only 1.1% became impaired and no senior tranches (Aa or Aaa ratings) suffered losses. CLO loss rates fair better than those for CDOs, with principal losses on high-rated CLO tranches negligible versus 43% of AAA CDO tranches ended up taking losses (Moody's, as of 2019).

In contrast to 2007, the current market is built on a more stable foundation. While market value CLOs – those which could be forced to sell into a deteriorating market – were prevalent pre crisis, they are no longer issued. Most securitized loans today are held in traditional CLOs, which are more long term and stable in nature and therefore less likely to be forced to sell 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.

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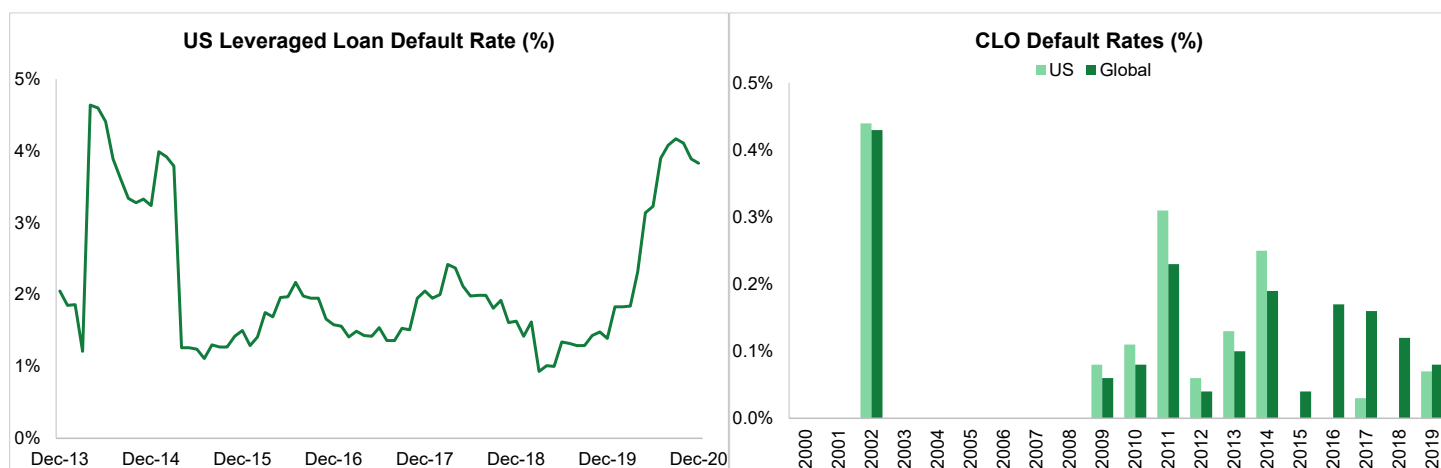
<sup>1</sup> Source: Statista. Includes bonds, loans, and revolving credit facilities rated by S&P Global Ratings that were outstanding on January 1, 2019

Further reducing risk, pipeline management practices have significantly improved. The pipelines of loans in progress (in the process of origination, not yet closed/sold) are far lower than 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, the volume for leveraged loan pipelines stands at \$44.8 billion in 1Q21, +308% from a year ago.

### What Are Default Rates for Leveraged Loans and CLOs?

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. Historically, leveraged loans and CLOs have low default rates. Leverage loan default rates peaked in 2014 at over 4.5%, but then remained in roughly a 1%-2% band from 2015 through 2019. In light of the global pandemic, rates began to climb in the latter half of 2020 to six-year highs. Rates have returned to a level below 2% as of May 2021.

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. As of 2019, the rate is below 0.1%.



Source: S&P Global Market Intelligence, S&P Global Fixed Income Research

## Chart Book: Fixed Income & Leverage Loans

### Current Landscape



Source: SIFMA, Dealogic (YTD = 1Q21)



Source: SIFMA, Dealogic (YTD = 1Q21)

### Today versus Historical

While leveraged loan (LL) origination and CLO issuance continue to grow, securities outstanding in both markets remain much smaller in comparison to other fixed income markets.

Where we are today (total outstanding as of 1Q21):

- MBS 22.0%, corporates 20.7% of total fixed income securities
- LL 3.2% of total fixed income securities; 0.14x MBS, 0.15x corporates
- CLO 1.3% of total fixed income securities; 0.06x MBS, 0.06x corporates
- Structured finance CDOs (SF CDOs) 0.2% of total fixed income securities; 0.01x MBS, 0.01x corporates

Where we were in 2008 (total outstanding):

- MBS 26.4%, corporates 19.9% of total fixed income securities
- CLO 0.8% of total fixed income securities; 0.03x MBS, 0.06x corporates
- SF CDOs 1.0% of total fixed income securities; 0.06x MBS, 0.10x corporates

1Q21	Outstanding			Issuance/Origination		
	\$ Trillion	% of Total	% Change	\$ Trillion	% of Total	% Change
MBS	11.5	22.0%	21.0%	1.3	34.7%	-9.4%
Corporates	10.7	20.7%	93.1%	1.0	18.7%	26.5%
Leveraged Loans	1.6	3.2%	n/a	0.9	7.2%	46.8%
CLO	0.6	1.3%	104.8%	0.1	0.8%	163.5%
SF CDO	0.1	0.2%	-78.6%	0.00	0.01%	-100.0%

2008	Outstanding		Issuance/Origination	
	\$ Trillion	% of Total	\$ Trillion	% of Total
MBS	9.5	26.4%	1.4	27.2%
Corporates	5.5	19.9%	0.8	16.5%
Leveraged Loans	n/a	n/a	0.6	13.4%
CLO	0.3	0.8%	0.03	0.3%
SF CDO	0.5	1.0%	0.0	0.0%

Source: SIFMA, Dealogic, LSTA (leveraged loan data as of FY20)

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