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MARKETS

Financial Watchdog Warns About Dangers of Leveraged Loans

A limited number of big banks have the most exposure to these markets, Financial Stability Board says



Randal K. Quarles, vice chairman of the Federal Reserve board of governors, chairs the Financial Stability Board.

PHOTO: ERIN SCOTT/REUTERS

By [Paul J. Davies](#)

Dec. 19, 2019 5:00 am ET

The boom in the market for leveraged loans, a favorite financing source of private-equity-backed companies, has created vulnerabilities in the global financial system, according to a report from international regulators.

A limited number of big banks are most exposed to these markets because they arrange the loans and hold some of them while also offering borrowers revolving credit facilities, according to the Financial Stability Board, a collection of global central-bank officials.

The same banks also arrange and underwrite the creation of structured investment funds known as collateralized loan obligations.

The market for leveraged loans has grown rapidly in recent years, supported by the creation of CLOs, and may range in size from \$1.4 trillion to \$3.2 trillion globally, depending on the types of lending included.

CLOs have boomed again as investors hungry for yield have returned to a kind of investment that was last popular in the run-up to the 2008 credit crisis.

Banks globally had almost \$1.4 trillion of loans and revolving credit facilities to these riskier borrowers at the end of 2018, much of which hadn't been drawn down, according to the FSB. On top of that, banks had almost \$340 billion of exposure to loans and CLOs at the end of 2018, some of which are meant to be held only temporarily.

The FSB identified the holders of 79% of leveraged loans and 86% of CLOs, but said little was known about the exposure of certain nonbank investors to these markets.

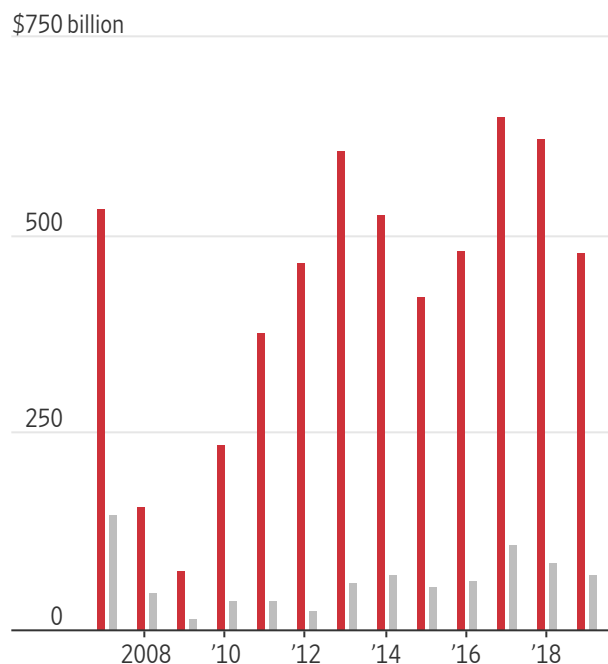
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Have you had a good or bad experience with leveraged loans? Join the conversation below.

Easy Credit

Issuance of leveraged loans

■ US ■ Europe



Note: 2019 is year to December 18. Europe converted to dollars at \$1.113.

Source: LCD, S&P Global Market Intelligence

“Given data gaps, a comprehensive assessment of the system-wide implications of the exposures of financial institutions to leveraged loans and CLOs is challenging,” the FSB said.

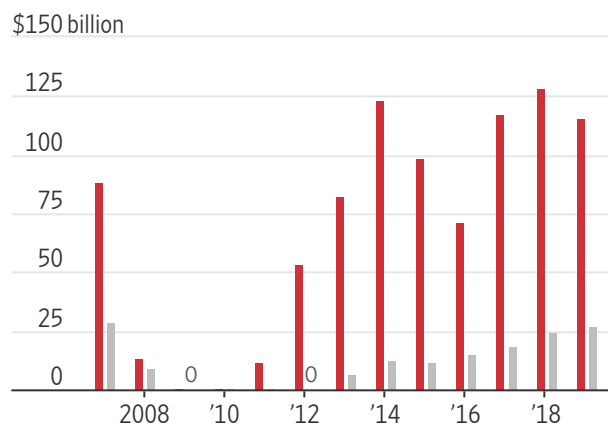
The U.S. dominates leveraged-loan markets, but the FSB, which is chaired by Federal Reserve Vice Chairman Randal K. Quarles, produced the special report to draw together different sources of information globally—both to identify risks and to find the gaps in knowledge about the market.

“This report provides a fact base that authorities and market participants can use to help assess the risks posed by leveraged loan and CLO markets and respond accordingly,” Mr. Quarles said.

Funding Frenzy

Issuance of collateralized loan obligations, CLOs

■ US ■ Europe



Note: 2019 is year to December 18. Europe converted to dollars at \$1.113.

Source: LCD, S&P Global Market Intelligence

The Federal Reserve warned last month that the leveraged loan market is growing quickly despite consistently weak credit standards, joining other regulators in flagging the risks.

The Bank of England also wrote about the risks associated with leveraged loans in its financial stability report this week, pointing to high leverage that was often understated by borrowers and weak documentation. In January, it published a study comparing the loan market to pre-2008 subprime mortgages in the U.S.

Vulnerabilities have grown in the markets because companies are borrowing more relative to their earnings, or using greater leverage, the FSB said. At the same time, the terms in loan documentation have weakened, according to the report, while the changing makeup of investors involved might have increased market complexity.

Higher leverage makes companies riskier because more of their earnings will have to be used to repay debt, which becomes even more difficult in a slowing economy.

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