FINANCIAL SERVICES FORUM

A Look at Leveraged Lending

Leveraged lending - or when a loan is made to a borrower with a credit rating below investment grade – and its impact on the American financial system has recently become a topic of discussion amongst banking regulators, members of Congress, and the financial industry as a whole.

While regulators should continue to monitor certain risks associated with leveraged lending, such risks do not pose a systemic threat to the U.S. economy.

By the Numbers:
The amount of leveraged lending is not outsized relative to other debt markets.

- ✓ One estimate, for example, puts the total outstanding amount of leveraged loans at **$1.5 trillion.**
- ✓ That same estimate shows:
  - non-financial business debt is at **$15.2 trillion**;
  - household mortgage debt at **$10.3 trillion**; and
  - household consumer debt at **$4 trillion**.

And, when compared against the broader fixed income markets, leveraged loans represent ***less than five percent*** of the total, according to the Loan Syndicated and Trading Association.

By the Books:
Banks hold ***less than eight percent*** of the leveraged loans outstanding. And, as Federal Reserve Chairman Jay Powell noted in a recent speech, collateralized loan obligations (CLOs), or actively managed securitization vehicles that primarily buy higher-risk assets, hold the most - roughly 62 percent.

Banks operating within the federal regulatory framework, like the members of the Financial Services Forum, engage in underwriting practices that assess underlying credit quality and monitor performance on an ongoing basis.

Leveraged loans are typically made in two parts:

1. a revolving credit facility that is held by one or more banks; and
2. a term loan that is often sold to institutional investors, like a pension fund or insurance company.

Recent research actually shows that the portion held by a bank – the revolving credit facility – almost always contains a variety of covenants, or financial conditions, used to assess the borrower's credit quality.

When both the revolving credit facility and the term loans are considered together, ***less than two percent*** of leveraged loans are "covenant-lite," a consistent trend since 2005.

By the Experts:
U.S. and international regulators have acknowledged that the American banking system's resiliency – including the significantly higher capital requirements and rigorous stress tests – will serve as a safeguard against threats, including risks involved with leveraged loans.

As Federal Reserve Chairman Jay Powell recently noted: *"Regarding…leverage in the financial system—today banks at the core of the financial system are fundamentally stronger and more resilient. Our post-crisis regulatory framework is based on robust capital requirements backed by strong stress tests, resulting in much higher levels of capital in the banking system (figure 6)."*

And as the Comptroller of the Currency, Joseph Otting, said last month, *"Recent supervisory assessments show that OCC regulated banks have satisfactory risk management around leveraged lending."*

As part of its international analysis, the International Monetary Fund (IMF) noted that certain risks have risen in the leveraged loan market, but concluded that *"potential spillovers from distress in the leveraged loan market to the rest of the financial system are mitigated by a number of factors,"* including that banks play a smaller role in this market. For example, leveraged loans originated and retained on banks' balance sheets account for only 2.5 percent of total tangible bank equity and warehouse lines to CLO managers are only at about $20 billion, versus more than $200 billion in 2008.

Perhaps the Washington Post editorial board put it best, *"…major U.S. banks are far better capitalized now than they were before 2008, rendering them less vulnerable to the contagion a leveraged lending collapse might set off."*

To learn more about leveraged lending in the U.S. economy click here.

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