HedgeFund Intelligence

Absolute Return 2015

ANTICIPATING A POTENTIAL CRISIS FOR LEVERAGED LOANS

By Nancy Davis | February 9, 2015

Nancy Davis of Quadratic Capital Management says to expect more volatility in this crucial market.

The most senior part of the corporate capital structure is threatened with turmoil due to several destabilizing factors. Leveraged loans have become popular floating rate credit instruments for investors concerned about a rising yield environment. A combination of bubble-style lending practices and the implementation of little-understood regulatory changes could combine to disrupt this $1 trillion asset class.

Purchasers of levered loans include collateralized loan obligations (CLOs), exchange traded funds, mutual funds and closed end funds. In a zero interest rate environment, loans, which delivered losses in excess of 40% in 2008, have permeated income-starved portfolios.

Five specific factors threaten the leveraged loan market:

- Demand shock due to risk retention rules under Dodd-Frank
- A liquidity mismatch resulting from the Volcker Rule and the rise of daily liquid products in the credit space
- Falling lending standards and the growing popularity of covenant-light deals
- A potential supply increase from greater M&A activity, especially given the sell-off in energy prices
- A lack of understanding of the floating rate attributes of leveraged loans.

These disruptions will likely bring serious price pressures and volatility to the leveraged loan market that could impact other areas of the corporate credit markets.

Risk Retention Rules under Dodd-Frank

Demand for leveraged loans is dominated by collateralized loan obligations, or CLOs, which are closed-end pools of leveraged loans. Leveraged loans face a massive demand shock as a result of new CLO regulations. In late 2014, a final rule was announced regarding credit risk retention mandated under Dodd-Frank. The final rule stipulates a 5% risk retention requirement by CLO managers (subject to certain exceptions) supposedly in order to align the interests of investors with the sponsors of securitization products.

This “skin in the game” requirement (which becomes effective in 2016) is incredibly disruptive to the CLO market. In essence, this rule is akin to saying that the manager of a fund must own no less than 5% of the fund’s assets. Many CLO managers simply do not have access to the capital to meet this requirement, calling into question their ability to create new CLOs after the rule becomes effective and, in turn, their ability to continue to purchase leveraged loans.

Loans are packaged into CLOs, which make up about 75% of the leveraged loan market. Mutual funds, cross over buyers (e.g., high-yield and distressed funds), and ETFs make up the balance of demand.

Risk retention will likely cause CLO issuance to slow, as few CLO managers have access to the long-term, locked-up capital necessary to satisfy this rule. The sponsor is allowed to satisfy this risk retention requirement by retaining an eligible vertical interest, an eligible horizontal interest, or any combination thereof provided the combined amount is no less than 5%. Ultimately, a push by CLO managers to achieve the capital they need will likely force consolidation of the industry. With CLOs being a significant source of demand for leveraged loans, a drop off in CLO issuance will be a demand shock, which may cause a sharp drop in the value of leveraged loans themselves.

Since the aforementioned rules were announced, the pipeline of issuance has dramatically slowed, reinforcing existing concerns about the future of the leveraged loan market.

Prior to the announcement of the new CLO risk retention rule, the leveraged loan market enjoyed ninety-six straight weeks of investment inflows. Since then, however, outflows have occurred in sufficiently large volume to create net outflows for 2014.

CLO issuance was robust with $115 billion in 2014, according to fixed income investment house DoubleLine. Now, with the risk retention rule announcement, dealers expect the new issue pipeline to be cut roughly in half to only $50 to $80 billion in 2015, according to Morgan Stanley. Assuming the same number of leveraged loans are originated, there will need to be a massive new source of demand to make up for the decline in CLO issuance, or else prices may fall significantly. Even though the risk retention rules only become effective in two years, the prospect of risk retention requirements becoming applicable to refinancing and re-pricing of CLO debt currently in the market could well result in the new issue market stalling now and the demand for loans sharply slowing.

Worries about the primary market are already causing the secondary market to re-price. Furthermore, new loans are being issued with a higher interest rate premium to investment grade credit and with increasingly onerous covenants attached.

A Potential Liquidity Mismatch

Other owners of loans include ETFs and open-end mutual funds that provide daily liquidity to their investors. But the loan market, which is traded over the counter, cannot reliably provide daily liquidity to loan holders. Mutual fund and ETF investors are known performance chasers. If their funds experience mark-to-market losses, these investors are likely to redeem. As the funds try to sell, prices may fall even further.

An unintended consequence of Dodd-Frank is there is the elimination of the liquidity safety net. The large banks are effectively out of the loan business. They will arrange syndicates of smaller banks to actually lend the money but they will issue far less of these loans themselves and hold much smaller positions on their books given the OCC and Fed's scrutiny on lending practices and leverage at the regulated banks.

Historically, when there were large sales of loans, dealer desks could warehouse the supply, gradually and carefully selling their inventory into the market in a manner that would minimize disruption. Today, with risk limits vastly curtailed and the definition of "proprietary trading" so nebulous, dealer desks function far more as simple middlemen than as bona fide market makers.

In place of the big banks that are being driven out of the loan market by regulation we have a shadow banking system made up of middle market banks, hedge funds, mutual funds and insurance companies. All have capital to finance loans, but none of them have the robust dealer desks and trading desks that the large banks once had.

The high-yield market, which one can sell short, has experienced a good deal of volatility over the past six months. The leveraged loan market, in contrast, is a one-way market, meaning there is no way to sell loans short. Because CLOs are closed-end securities, they are generally not very sensitive to the mark-to-market of their holdings. In essence, leveraged loan prices have benefited from the mark-to-market insulation derived from the closed-end structure of CLOs. The divergence in prices and in volatility between high-yield and leveraged loans does not make sense fundamentally, and the market is positioned for an eventual "catch-up" in both price and volatility in the leveraged loan market.

Falling Standards and Rising Industry Concentration

Loan issuers, mostly mid-sized and regional banks cobbled into syndicates by larger banks that act as arrangers, have made substantial concessions to borrowers in order to get deals done. More than 60% of the outstanding loans are considered "covenant light," generally meaning that the borrower needs to offer less financial transparency to the lender and is not obligated to meet specific solvency requirements during the loan term. Loan issuers generally assume a 70-80% recovery rate in the case of default. But that recovery rate relies on the enforcement of strong covenants. Covenant light lenders can have little faith in their recovery forecasts because there is not data to support the recovery rate assumptions given the weaker covenants.

In the event of rising defaults and falling loan prices, lenders will have to start restricting credit and borrowing costs will have to rise. But even absent this, the loan market could be in for trouble as Dodd-Frank rules are implemented in the market place.

A Supply Shock

The CLO risk retention rules and potential outflows from the retail space each point to a potential demand shock. But we might also find ourselves dealing with an over-supply of loans at roughly the same time.

Speculative grade companies typically use leveraged loans to finance mergers and acquisitions or to expand capital-intensive projects. While trying to take advantage of the shale oil boom, U.S. oil and gas borrowers have dipped into the loan well, borrowing a collective $43 billion, according to S&P Capital IQ. That's on top of the $204 billion the industry owes in junk bonds, estimates Barclays. With the price of oil falling by half in a short period of time, many of these borrowers might be in distress.

Mergers and acquisitions will likely increase in 2015, especially given the dislocations in the energy and commodity sectors. The conditions that led to strong M&A activity in 2014, including large amounts of cash on corporate balance sheets and pointed shareholder activism have not abated. Companies will want to access the loan markets to fund consolidations.

Loan Prices Will Fall if the Fed Raises Rates

The majority of leveraged loans have LIBOR floors around 90-100 bps. Many retail investors are not familiar with the floors and do not realize that the floating rate protection only kicks in after substantial increases in interest rates. As rates rise underneath the LIBOR floor, loan prices may adjust downward, causing retail investors to endure mark to market losses and potentially sparking outflows from leveraged loan mutual funds and ETFs, bringing the liquidity mismatch into focus.

This is not just a retail problem. CLOs are essentially arbitrage vehicles. They borrow money cheaply and lend it at higher rates. There is no ceiling to a CLO's borrowing costs, while approximately 60% of loans have LIBOR floors around 90 bps. When the Fed hikes, higher yields will initially negatively impact CLO returns and make their return hurdles harder to reach. If CLOs performance suffers, we could see less demand for the product and, in turn, fewer buyers of leveraged loans in the market.

We believe loans will experience more price volatility in 2015 and 2016 due to these five specific factors.

In the worst case, turbulence in the leveraged loan industry could lead to a full blown corporate credit crisis with vast economic ramifications. Whether or not that happens it does seem reasonable that the leveraged loan markets will experience significant price volatility in 2015 and 2016, if not beyond.

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ISSN: 2151-1845 / CDC10004H / 3021815