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INSIGHT

Leveraged Loans and Collateralized Loan Obligations (CLOs): Recent Developments and Policy Actions

June 11, 2020

Leveraged loans are a type of corporate debt extended to highly indebted companies. Borrowers often use leveraged loans to fund general operations or finance private equity firms' leveraged buyouts. Some leveraged loans are packaged into collateralized loan obligations (CLOs) through securitization. Leveraged loan and CLO markets' risk profile and rapid growth have drawn policy attention in recent years. Some are concerned that, when under stress, potential credit rating downgrades and escalating defaults in these markets could amplify financial system vulnerability.

During the COVID-19-induced economic downturn, the heightened market stress and reduced corporate earnings have led to performance deterioration in leveraged loans and CLOs. The related price decline is more evident for the lower-rated CLO tranches. The pricing reflects the investors' expectation that the relevant loss absorption structures may protect senior tranches while eroding certain equity and mezzanine tranches. The Federal Reserve (Fed) announced support for some highest-rated CLOs, benefiting certain newly issued CLOs. This Insight examines selected performance measures of leverage loans and CLOs and the related federal government interventions.

Leveraged Loan Market Growth

Since the 2007-2009 financial crisis, the leveraged loan market has increased, reaching $1.2 trillion (**Table 1**). As the market has grown, certain creditor protections called *covenants*—terms in the loan contract that allow the creditor to monitor the borrower and take certain corrective actions before a payment default occurs—have become less prevalent in many leveraged loan contracts.

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Table 1. Leveraged Loan Market Size and Covenant-Lite Share

	March 2020	Year-End 2008
Total par value outstanding	$1.191 trillion	$594 billion
Issuer count	1,173	825
Covenant-lite share	82%	15%

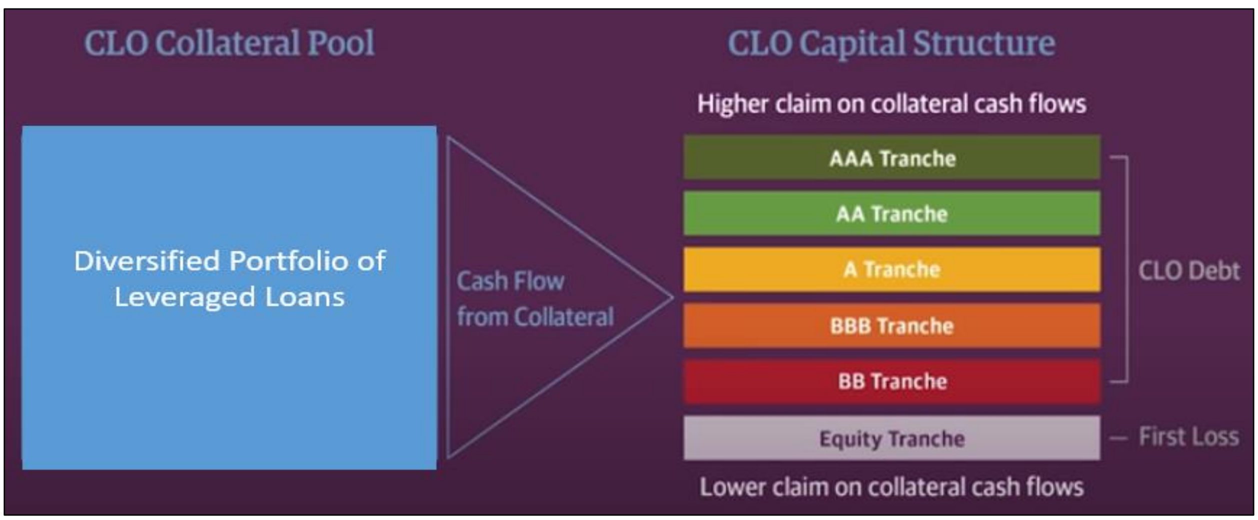
Source: S&P Global.

Notes: S&P/Loan Syndications and Trading Association leveraged loan Index. Not inflation adjusted. Covenant-lite means a loan agreement has fewer covenants.

CLO Loss Absorption Structure

CLOs are typically supported by a diverse collateral pool. A pool's cash flows are restructured and sold in separate *tranches* (**Figure 1**). The different tranches are assigned different payment priorities, so some tranches will incur losses before others. This tranche structure redistributes the loan portfolios' credit risk. The equity tranche would be the first in line to absorb losses from the collateral pool, followed by other lower credit rating CLO debt tranches (mezzanine). Lower CLO tranches receive higher yield to compensate for the risks taken.

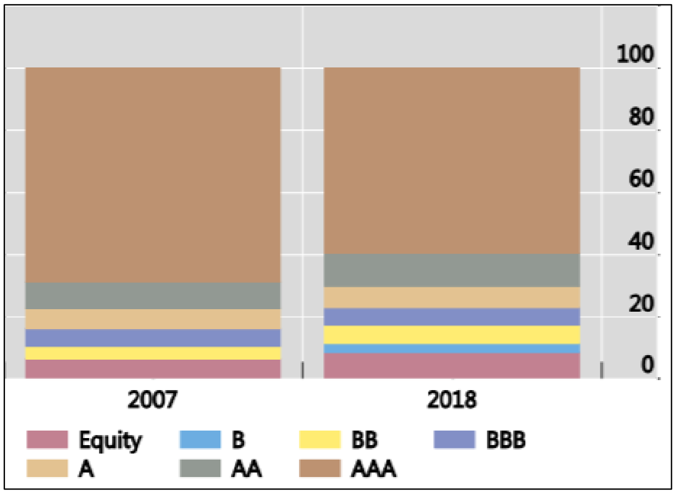
Figure 1. Typical Collateralized Loan Obligation (CLO) Structure



Source: Guggenheim Partners; Congressional Research Service.

Since the 2007-2009 financial crisis, the CLO subordination has increased somewhat to give additional protection to senior tranches. For example, a typical AAA-rated CLO tranche in 2018 would suffer losses only after the value of the underlying collateral fell by roughly 40%, as opposed to the roughly 30% declines that would have triggered losses in 2007 (**Figure 2**).

Figure 2. Changes in Collateralized Loan Obligation Subordinated Structure

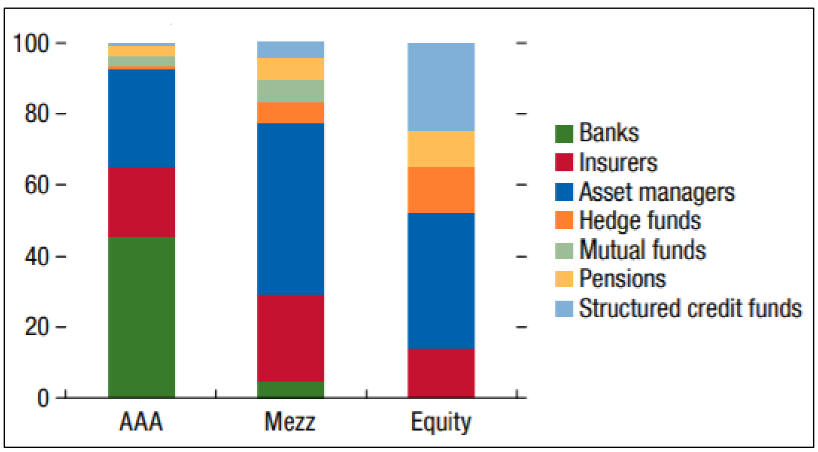


Source: Financial Stability Board.

The higher- and lower-rated CLO tranches have different investors. Although banks are major investors in AAA-rated CLO tranches, the asset management industry represents the largest investor base for higher-risk CLOs (**Figure 3**).

Figure 3. U.S. Collateralized Loan Obligation Investor Base

(percentage; as of 2019)



Source: International Monetary Fund.

Recent Market Performance

During the COVID-19 pandemic, many risk and pricing measures (e.g., loan defaults, downgrades, earnings leverage, covenant amendments, and price movements) for leveraged loans and CLOs have deteriorated.

Increased Defaults and Credit Rating Downgrades

Loan default rates are associated with borrowers missing payments or filing for bankruptcy. As of May 2020, leveraged loan default rates have reached the highest in recent years to more than 3% (**Figure 4**).

The ratio of credit rating downgrades to upgrades for U.S. leveraged loans has also reached a record high (**Figure 5**), suggesting credit quality deterioration.

Figure 4. U.S. Leveraged Loan Default Rate

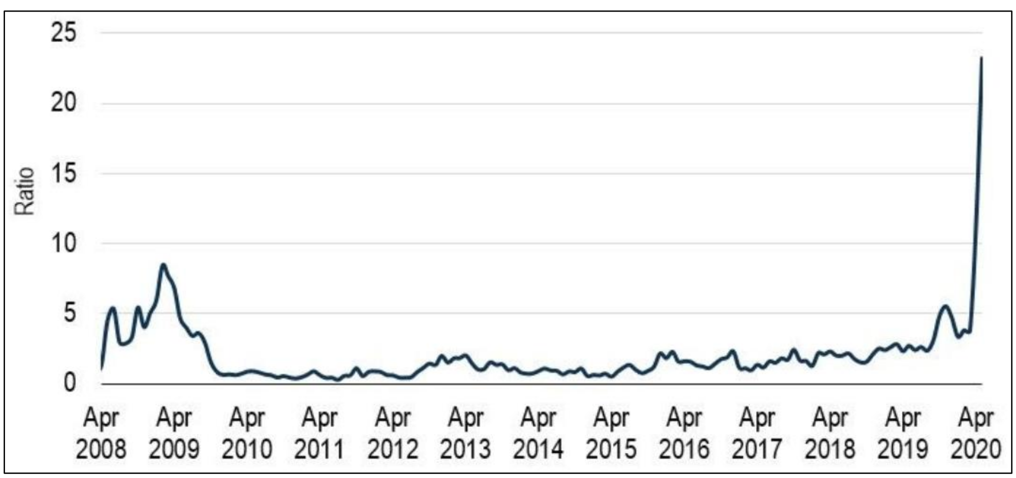
(as of May 21, 2020)

Source: S&P Global.

Notes: LTM = last 12 months. The large spike in early periods was caused by a $20 billion single-borrower default of Energy Future Holdings (TXU).

Figure 5. U.S. Leveraged Loan Downgrades to Upgrades Ratio

(as of April 30, 2020)



Source: S&P Global.

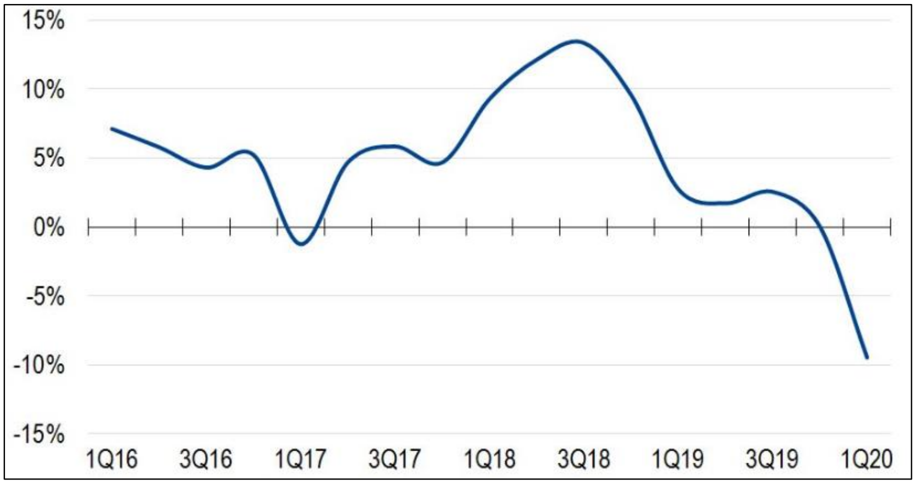
Increased Debt-to-Earnings Leverage

Leveraged loans received their name from borrowers having high debt-to-earnings "leverage," typically measured by the debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratio. The higher the leverage, the lower the companies' payment capabilities, and the more risk to investors.

Leveraged loans' debt-to-EBITDA ratio has risen substantially since 2019, even before the pandemic, (**Figure 7**) largely because of a significant decline in firms' earnings (**Figure 6**).

Figure 6. U.S. Leverage Loan Issuer Quarterly EBITDA Growth Rate

(as of March 31, 2020)

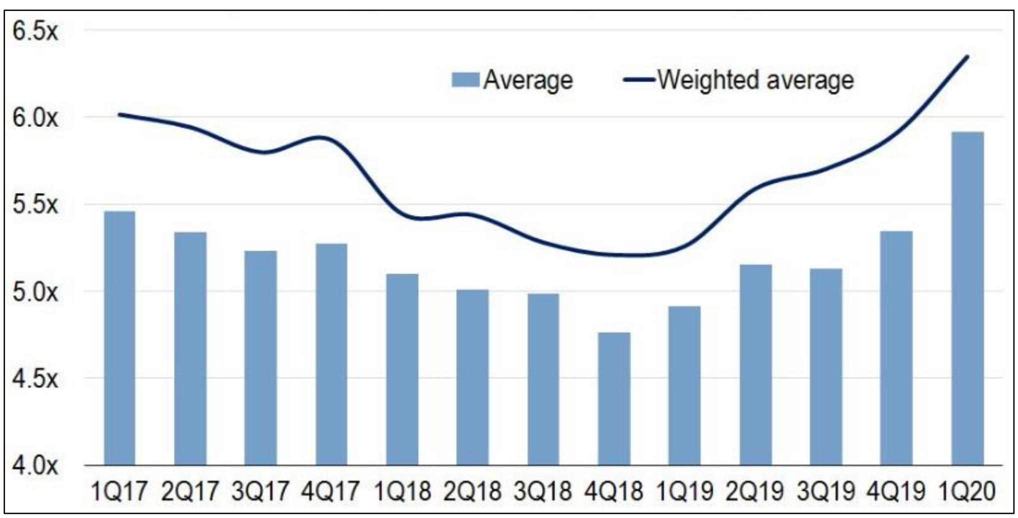


Source: S&P Global.

Note: EBITDA = earnings before interest, taxes, depreciation and amortization.

Figure 7. Average Leverage of Outstanding U.S. Leveraged Loans

(as of March 31, 2020)



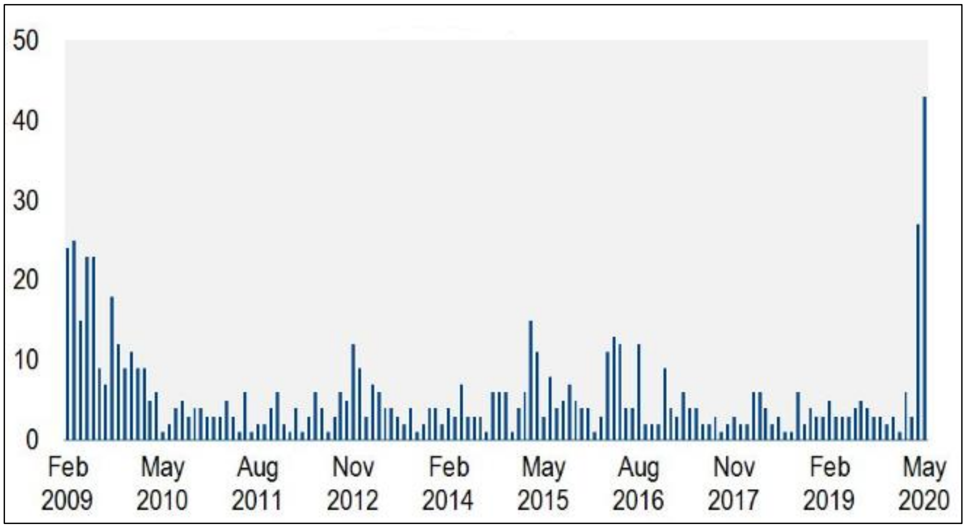
Source: S&P Global.

Record Covenant Relief Amendments

When borrowers are in trouble, they tend to negotiate with lenders for relief from covenants restricting their ability to exceed certain limitations. As of April 2020, borrowers and lenders are modifying loan covenants in record numbers (**Figure 8**).

Figure 8. Number of U.S. Leveraged Loan Covenant-Relief Amendments

(as of May 31, 2020)



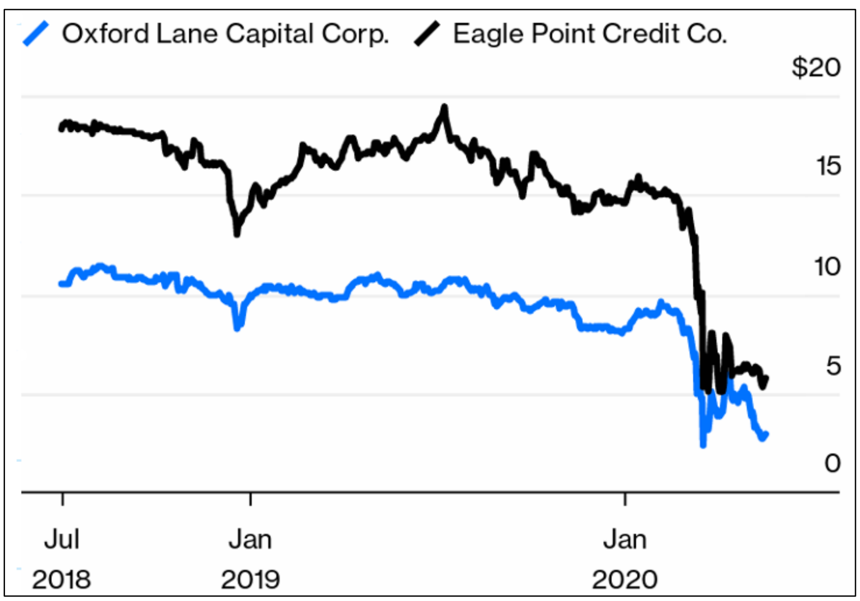
Source: S&P Global.

Price Movements

CLOs experienced sharp selloffs in March 2020. Although higher-rated CLOs rebounded to a large extent, lower-tranche CLOs, which are designed to absorb losses for collateral pools, did not recover at the same level (**Figure 9** and **Figure 10**).

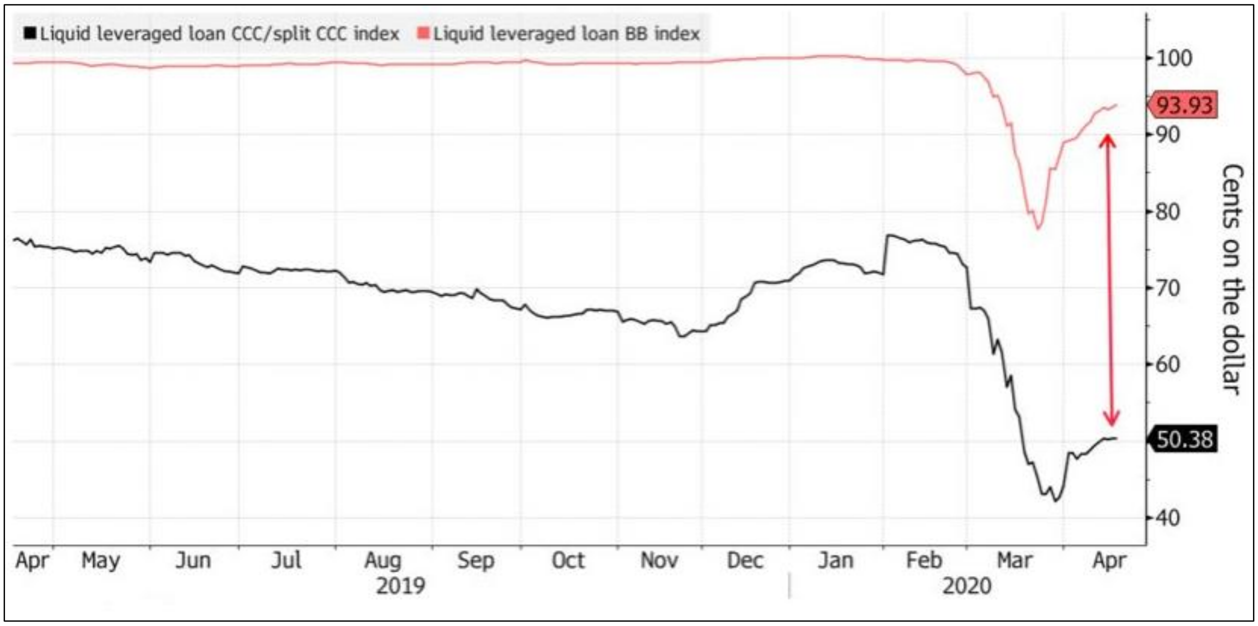
Figure 9. Price Performance Examples: Funds Invested in Lower-Tranche Collateralized Loan Obligations

(as of mid-May 2020)



Source: Bloomberg.

Figure 10. Leveraged Loan Collateralized Loan Obligation Rebound: Lower-Rated Versus Higher-Rated



Source: Credit Suisse, Bloomberg.

Federal Government Liquidity Intervention

The Fed—sometimes with support from the Treasury Department—has established several emergency lending facilities to provide liquidity to key capital markets segments. On April 9, 2020, the Fed expanded the Term Asset-Backed Securities Loan Facility (TALF) to provide support for leveraged loan and CLO markets in addition to other asset-backed security markets. Certain senior tranche AAA-rated *static* CLOs could qualify under TALF. Static CLOs are CLOs that do not include a period of reinvestment of collateral proceeds. The eligible CLOs must be newly issued, on or after March 23, 2020. The Fed expanded TALF again on May 12, 2020, to include CLOs that contain leveraged loans from earlier periods, including those leveraged loans originated on or after January 1, 2019.

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