Financial Stability Challenges: High-Yield Market

Victoria Ivashina

March 23, 2022
1. The Lay of the Land: Commercial High-Yield Market
Segments of the Financial Market Catering to **High** Corporate Leverage:

- **Mid-small cap firms**
  - Private Debt

- **Large-mid cap firms**
  - Leveraged Loan Market
  - High Yield Bond Market

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**Recent development:** growth of private debt into large-cap space
Core Questions:

1. Are there any near-term default triggers or constraints for borrowers?
2. Are there significant constraints on restructuring?
3. Are there any (new) levered and/or runnable debt investors?

(cont.)
Three Core Non-Bank Structures:

1. **BDCs** (Business Development Companies)
2. **Credit Funds**
3. **CLOs**

Significant refinancing/restructuring activity; e.g., ARCC 1.26 22:Q4 to 1.09 23:Q1

Mutual funds are about 20% of the market, and although they are runnable the effect is typically offset by CLOs.
2. Let’s Dive Deeper: Leveraged Loan Market
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Financial Stability Challenges: High-Yield Market
Rise in Leverage, and Leveraged Lending in Particular Have Been a Source of Public Concern for Several Years Now

November 15, 2018
Warren Presses Regulators on Risks in Leveraged Lending Market
https://www.warren.senate.gov/oversight/letters/warren-presses-regulators-on-risks-in-leveraged-lending-market-

March 20, 2020
Warren Raises Concerns that Leveraged Lending Market Could Escalate Risks to Financial System as Coronavirus Outbreak Continues to Rattle Markets
JANUARY 2023
A GIANT IN THE SHADOWS
SUBPRIME CORPORATE DEBT

FIGURE 12: US COMPANIES USAGE OF BANK REVOLVERS AND NEW LOANS MARCH 2020

Cash Frenzy
U.S. companies tap billions of dollars in revolvers and new loans
- Revolver Draws
- New Loans

Source: Bloomberg, public filings
Rise in Leverage, and Leveraged Lending in Particular Have Been a Source of Public Concern for Several Years Now

The Worst Case

The U.S. banking system could be on the cusp of calamity. This time, we might not be able to save it.
Core Questions:

1. Are there any near-term default triggers or constraints for borrowers?
2. Are there significant constraints on restructuring?
3. Are there any (new) levered and/or runnable debt investors?
4. Are there hidden risks? If so, for whom: creditors or borrowers?
Average Debt Multiples of Large Corporate Loans: U.S.

Source: S&P Global Market Intelligence
"Cov-Lite" Loans, U.S., 2007-2021
Yet, Inclusion of Financial Covenants is Universal
Definitions: Cov-lite/Incurrence Covenants:

1. It is about financial covenants (think Debt/EBITDA)
2. Cov-lite loans do not have fewer or looser covenants; instead, they have financial covenants with different enforcement mechanisms
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Example: Two identical companies

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<thead>
<tr>
<th>Borrower A</th>
<th>Borrower B</th>
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<tr>
<td>Covenant: 5x Debt/EBITDA</td>
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<td>Maintenance (covenant):</td>
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<td>updated (typically, quarterly)</td>
<td>certain “restricted actions” (e.g., issuance of additional financing, sale of assets, or merger)</td>
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Now, take COVID, EBITDA falls putting both firms in excess of 5x Debt/EBITDA
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<td>Technical default</td>
<td>Continues to operate (but can’t incur certain contractual restrictions)</td>
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What Explains the Rise in Cov-Lite Issuance?

1. Erosion of credit standards/hidden risks: Sign of market overheating (policy focus, e.g., Stein, 2013)

2. Compensated erosion of credit standards: Rise in demand for cov-lite loans (post-crisis learning)
What Explains the Rise in Cov-Lite Issuance?

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3. Rising coordination costs of increasingly passive & arms-length investor pool

“Covenant-Light Contracts and Creditor Coordination” (with B. Becker)
Covenant-driven shifts in control from owners to creditors make less sense for firms that have a dispersed creditor base.

“Covenant-Light Contracts and Creditor Coordination” (with B. Becker)
That's great, but that still could mean that creditors’ protection of highly-levered loans is substantially weaker than it used to be.
Investment Response to Maintenance Covenant Violation:

"High-Yield Debt Covenants and Their Real Effects," (with Bräuning and Ozdagli)
Investment Response to Maintenance Covenant Violation:

Q: What would be an investments response for cov-lite/incurrence covenants?

“High-Yield Debt Covenants and Their Real Effects,” (with Bräuning and Ozdagli)
Investment Response to Maintenance Covenant Violation:

Panel A: Maintenance

A: It depends on (i) “Restricted Actions” (what you would contract, e.g., it is not obvious that you would want to cut investments); and (ii) the level of contractual incompleteness

“High-Yield Debt Covenants and Their Real Effects,” (with Bräuning and Ozdagli)
Investment Response to Covenant Trigger:

“High-Yield Debt Covenants and Their Real Effects,” (with Bräuning and Ozdagli)
Cov-lite Loans are Economically Consequential for the Borrowers:

- This is key for understanding the unravelling of a negative economic shock in an highly levered economy where debt is cov-lite
- Although the “bankruptcy wall” is far removed when economic shocks arrive, it is not business-as-usual: the drop in investments after incurrence covenants are triggered is sizable and quick
- E.g., it is relevant for understanding propagation of the 2020 shock

“High-Yield Debt Covenants and Their Real Effects,” (with Bräuning and Ozdagli)
What about Creditors?
Erosion of Credit Standards is Not Constrained to Financial Covenants
The Erosion of Covenant Structure on Senior Secured Debt is Prevalent:

Share of Leveraged Loans without **Deductibles**

“Weak Covenants,” (with B. Vallee)
In Sum:

1. Rise in cov-lite financial covenants or its pervasive use is not an (obvious) indication of credit standards erosion

2. Cov-lite loans do not trigger technical defaults (or make the news), but they do put significant constraints on firms and the economy when EBITDA falls

3. Erosion of credit standards is here, and it is not trivial, but it is not concentrated in financial covenant, and it takes place through “baskets” (deductions) and carve-outs
At a high level, this is right

This is largely exaggerated

The U.S. banking system could be on the cusp of calamity. This time, we might not be able to save it.
Thank you!