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Leveraged Loans and Systemic Risk (Second of a Series)

THE LEAD | March 7, 2019

According to a Harvard study, middle-aged men who did 40 pushups have a 96% lower risk of cardiovascular disease than those who did 10 or fewer.

Not since eighth grade gym class has anyone ordered us to "drop and give me twenty." But surely in all those formative years we comfortably amassed 40 pushups. To our chagrin, however, a closer reading revealed they meant 40 pushups now *in a row*.

But are pushups themselves fending off heart attacks, or is the ability to do pushups just one indicator of a healthy, fit human being?

Cause and effect was also top of mind as we assessed media reports of risky leveraged loans threatening both the economy and the US financial system. The latest was a Bloomberg opinion piece that questionably indicted the entire collateralized loan obligation class ("The Bomb That Blew Up in 2008? We're Planting Another One.")

Among other things, the author argues that risks incurred by investors in CLOs are not well understood. He also states that losses sustained by banks holding the triple-A tranches could lead to a "liquidity squeeze." Our friends at the LSTA rebutted the main points of the article in a letter to Bloomberg this week [link].

But there are other cases to be made against the anti-CLO thesis. In an address to bankers last week at the SFIG convention in Las Vegas, former Fed chair Janet Yellen acknowledged that the kind of pre-crisis leverage that existed with sub-prime mortgages isn't present today.

As reported by LPC, Ms. Yellen also confirmed that holders of CLO liabilities are "not by and large leveraged entities." Indeed, as we have noted in prior commentaries, the vast majority of broadly syndicated loans – the CLO assets – are also held today, not by banks, but by large, well-capitalized, institutional investors.

The benefits of CLOs have been well covered by us ("Why CLO's Matter?") and others. Suffice it to say that no investor in the highest rated debt tranches of securitized leveraged loans has ever lost money, even though the meltdown caused by sub-prime mortgages. That speaks to the resilience of the asset class.

It's also true that while the largest and most liquid loans endured significant secondary price deterioration at the depths of the credit crisis, most of that discount was emotional. Once the Fed injected liquidity and confidence back into the system, prices returned quickly to par. 2009 institutional default rates ended up below 10%, and fell to less than 3% the following year.

As the current economic cycle ages, sweeping generalizations are growing about the impact of future loan defaults and lower recoveries on the financial system. Worries about borrower leverage and weak covenants are one thing. But if issuer-specific problems didn't cause a systemic meltdown when regulated entities were under-capitalized and direct lending was in its infancy, why would that happen now?