SBH Fixed Income Research

Floating-Rate Bank Loans: Understanding Embedded Risks in the "Other" High Yield Market

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KEY POINTS

- An increasing number of fixed income investors have sought to insulate themselves against rising interest rates by allocating to investments such as floating-rate bank loans.
- Though floating-rate bank loans can offer some protection against rising rates, we view these investments as essentially a shadow "junk bond" market with significant credit risk.
- Floating-rate bank notes have lower credit quality than in the past, with less protection for investors and a different investor base, potentially resulting in significant volatility.
- It is reasonable for investors to proactively address the effects of rising rates, but we believe substituting credit risk for interest rate risk in this environment is not the best solution.

As high yield bond managers, we often receive questions from clients about our perspective on the floating-rate bank loan market. This investment category has experienced explosive growth since the end of 2010, representing more than $1 trillion assets as of September 30, 2018.[1] Floating-rate bank loans—also known as bank loans, levered loans or more generally the leveraged loan market—have increased in popularity because investors see them as natural hedges against rising interest rates. What should investors know about floating-rate bank loans? And what are some of the potentially overlooked pitfalls to be avoided—especially rising credit risk—in these investments?

THE TWO "JUNK BOND" MARKETS

To start, it is important to understand that we believe that there are two high yield or "junk bond" markets available to investors today: 1) the traditional high yield bond market, which consists of bonds issued primarily by companies with below investment grade credit ratings; and 2) the floating-rate bank loan market, which consists of loans originated primarily by banks. Traditionally, the floating-rate bank loan market has been considered a high-quality income source that can be used as a hedge against rising rates. The interest rate received by the floating-rate bank loan investor floats or "adjusts," typically on a quarterly basis, following changes to the underlying reference rate (typically LIBOR). Allowing the interest rate on the investment to change every three months limits the price volatility of the investment due to changes in interest rates, thereby acting as a hedge.

Today, after a decade of low interest rates and increased investor appetite for yield, we believe that floating-rate bank loans have morphed into a "shadow" junk bond market. Exhibit 1 on the following page shows a side-by-side comparison of these two high yield markets as of the end of the third quarter of 2018. The biggest common denominator? More than 87% of the issuers in both markets are rated below investment grade, as they typically carry more debt on their balance sheet and investors demand more compensation to take on the increased credit risk.[2]

[1] Source: S&P LTSA Leveraged Loan Index
[2] Source: S&P LTSA Leveraged Loan Index, Bloomberg Barclays US High Yield Corporate Index

Exhibit 1: Comparing the Two "Junk Bond" Markets

Side-by-Side Comparison*

	Traditional High Yield	Floating-Rate Bank Loans
Market Size ($ billions)	$1,274	$1,074
Market growth since 12/31/10	37%	131%
Coupon	Fixed Rate	Floating Rate (typically dependent on LIBOR changes)
Collateral	Unsecured	Secured
Typical Call Protection?	Yes, >3yrs	Limited, many approx. 6 months
Average Trade Settlement	T+2 days	T+13 days
Credit Rating Mix		
Investment Grade	5%	11%
Non-Investment Grade	95%	87%
Not Rated	0%	2%

*As of 9/30/18
Sources: Segall Bryant & Hamill, Bloomberg Barclays US High Yield Corporate Index, CMS BondEdge, S&P LTSA Leveraged Loan Index

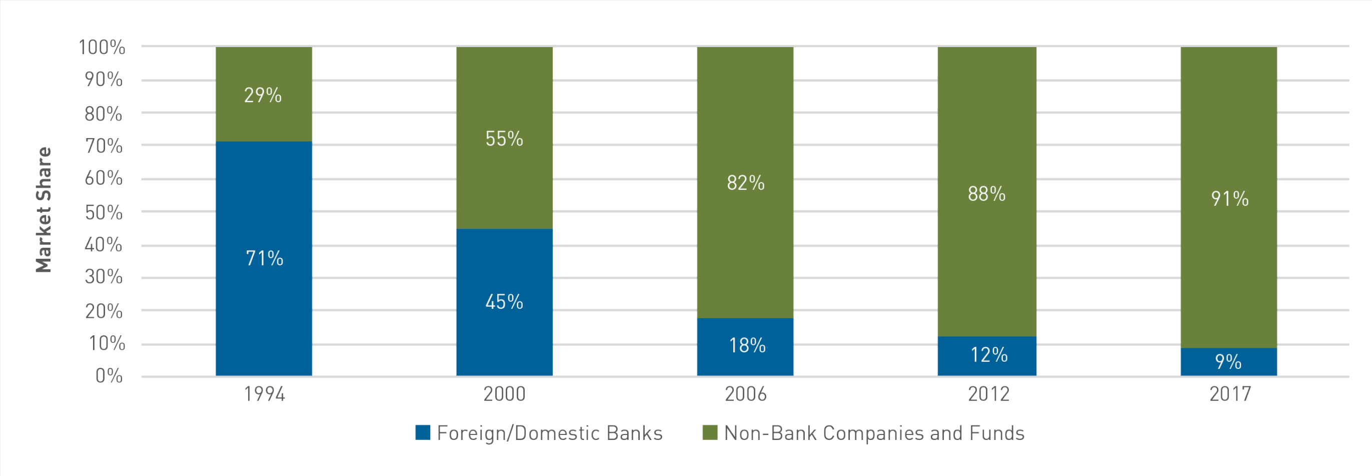
Now let's dig into how the floating-rate bank loan market has developed over the last decade. The following trends reflect the changing dynamics of the floating-rate bank loan market and document the increasing risks in these investments.

TREND #1 – A RELATIVELY NEW INVESTOR BASE

Prior to 2000, the majority of floating-rate bank loans were kept on banks' balance sheets. Exhibit 2 on the following page shows that non-banks have become the dominant owners of floating-rate bank loans over the past 25 years. Today, these securities are primarily held by institutional investors. The shift away from patient, buy-and-hold investors (traditional banks) to a new investor base introduces new risks and considerations. For instance, in the past banks tended to hold these loans until maturity. In contrast, institutional investors can buy and sell these loans much more frequently if they so desire. Institutional investors are also likely to have shorter investment time horizons and higher liquidity needs than banks that previously held these loans to maturity. In addition to institutional investors, a large number of floating-rate bank loans are held in collateralized loan obligations (CLOs), which are complex levered structured finance vehicles collateralized predominantly by a pool of loans.[3] The absence or a reduction of demand from the CLO buyer, who currently accounts for over 60% of new issue floating-rate bank loan demand, would increase the refinancing risk for all the underlying borrowers in the market.[4]

[3] Further details on collateralized loan obligations (CLOs) are outside the scope of this paper. For additional information on CLOs, please see the NAIC's Capital Markets Bureau's "Collateralized Loan Obligations (CLOs) Primer," which is accessible at https://www.naic.org/capital_markets_archive/primer_180821.pdf
[4] Source: S&P LCD

Exhibit 2: A Dramatic Shift to Non-Bank Owners of Floating-Rate Bank Loans

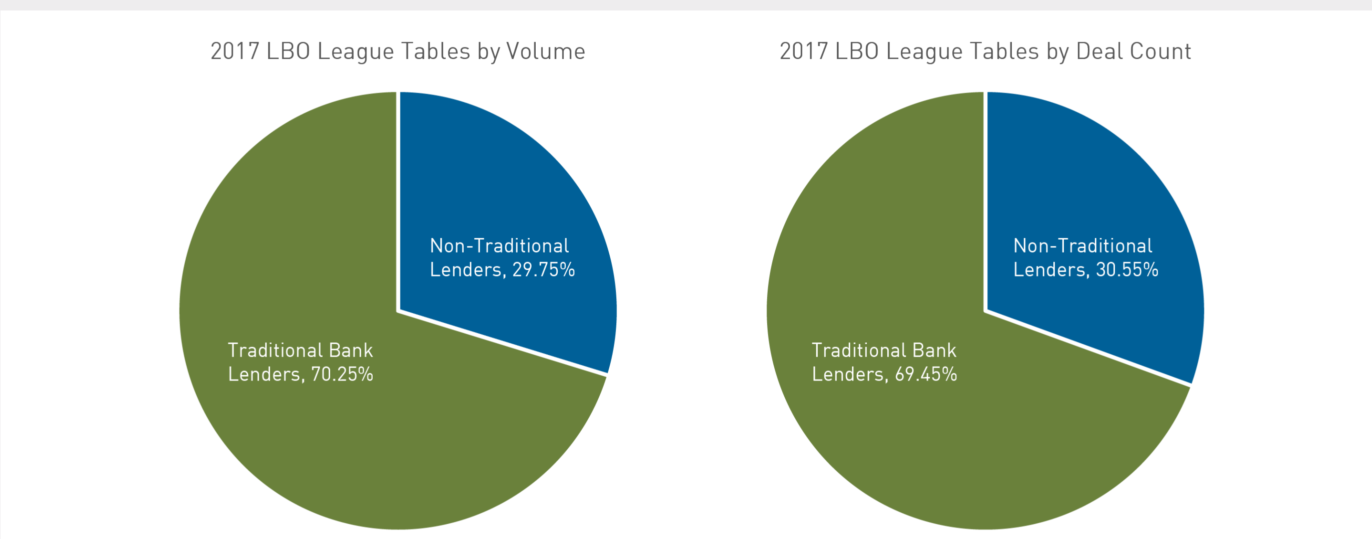


Source: S&P LCD Leveraged Lending Review Q4-17

TREND #2 – THE EMERGENCE OF NON-TRADITIONAL ORIGINATORS IN THE MARKET

Historically, floating-rate bank loans were originated by traditional bank lenders and subsequently sold to institutional investors. This has changed. As shown in Exhibit 3, in 2017 non-traditional lenders—including business development companies, private equity firms, asset management firms or foreign investment banks—originated 30% of floating-rate bank loan volume and 31% of deals for leveraged buyouts (LBOs), which represent the riskiest segment of the floating-rate bank loan market. We believe these non-traditional lenders have been drawn to this market and have different motivations for originating these loans than the traditional bank lenders, which are subject to regulatory oversight and have more stringent restrictions on their ability to originate loans. As a result, many of the non-traditional lenders have become significant players in the origination for riskier loans that banks cannot or do not wish to originate.

Exhibit 3: Non-Traditional Lenders Have Grown in Both Volume and Deal Count



Source: Thomson Reuters LPC

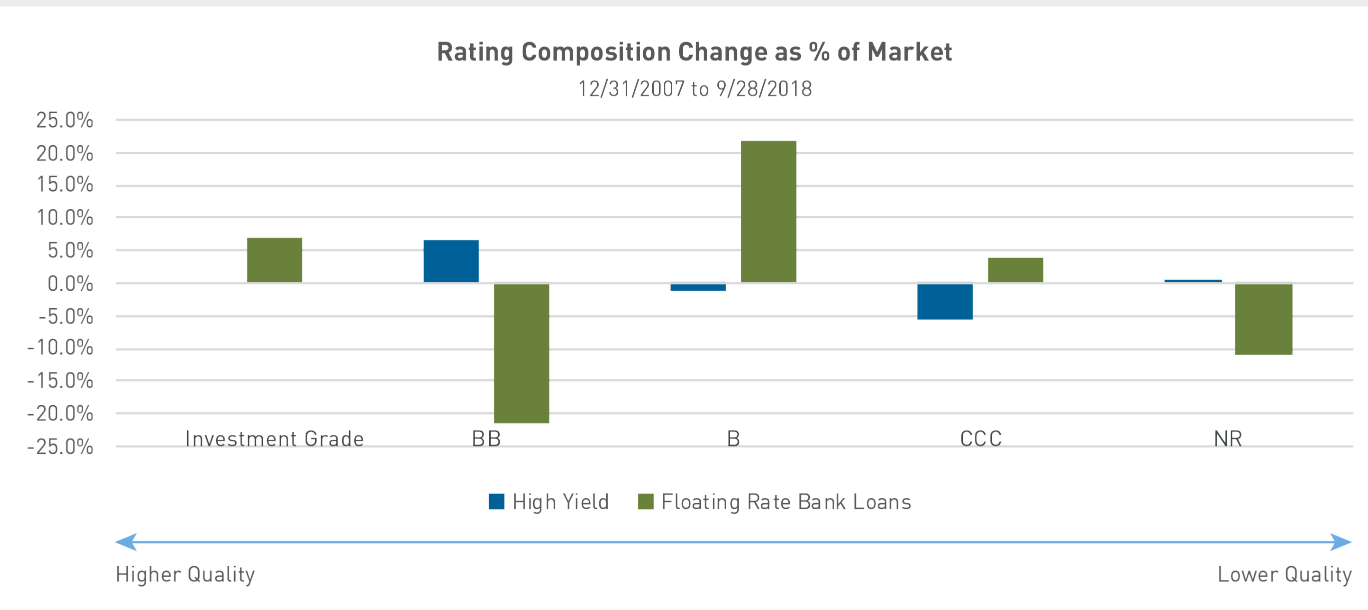
TREND #3 – DECREASING COVENANT PROTECTIONS

Historically, floating-rate bank loans carried protections through "maintenance covenants," which require periodic "check-ins" in which lenders can identify if a borrower is maintaining proper debt coverage and other metrics to ensure the health of the loan. On the other hand, "covenant-lite" loans generally do not include maintenance covenants, meaning that a borrower can violate debt coverage or other metrics without the lender being able to do anything. In 2017, 72% of the floating-rate bank loans were "covenant-lite", while before 2012, this total represented less than 20%.[5] With maintenance covenants in place, a lender can take action sooner and potentially start preserving asset value if a borrower runs into cash flow troubles or experiences other problems. In the absence of these protections, a borrower can potentially destroy more value prior to bankruptcy, likely leading to lower debt recovery for lenders.

TREND #4 – DIVERGENT CREDIT RATING TRENDS

We have seen these two junk bond markets—traditional high yield bonds and floating-rate bank loans—move in opposite directions. The traditional high yield market has seen higher quality BB-rated issuers become a bigger proportion of the overall high yield market since 2007, while the reverse is true with the floating-rate loan market. Over the same time frame, lower-quality single-B and CCC issuers have become a bigger proportion of the floating-rate bank loan market. The floating-rate bank loan market has been much more accommodative to lower quality issuers since 2007.

Exhibit 4: The Diverging Credit Quality of the Two "Junk Bond" Markets



Source: Segall Bryant & Hamill, Bloomberg Barclays US High Yield Corporate Index, S&P LTSA Leveraged Loan Index

[5] Source: Fitch Ratings

BE CAREFUL NOT TO SUBSTITUTE ONE TYPE OF RISK FOR ANOTHER

While investors have rightfully been focused on the potentially disruptive effects of rising interest rates on bond prices, we believe that some investors may be overlooking heightened credit risk embedded in investments like floating-rate bank loans that aim to protect against rising rates. As shown in Exhibit 4, floating-rate bank notes now have lower credit quality than in the past, with less protection for investors and a different investor base. All of these factors can lead to volatility and heightened credit risk. While it is an appropriate tactic for fixed income investors to proactively address rising rates, we do not think that substituting credit risk for interest rate risk is an effective solution. For instance, consider a driver crossing an icy bridge at night. The driver is correctly focused on avoiding black ice and losing control of the car, which is the most immediate fear. Unbeknownst to the driver, however, there is a truck hurtling towards the bridge from the other direction at a high speed as it reaches a curve just before the bridge—representing an unseen potential hazard for the driver. To apply this analogy to the floating-rate bank loan market, while we don't think an accident is necessarily imminent, we want investors to be aware that there are risks that may be lurking where they may not be looking.

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