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Leveraged Bank Loans: Increased Demand, Deteriorating Underwriting and Revised Regulatory Guidance (4/2/2013)

New issuance of leveraged bank loans has been increasing post-financial crisis, including among nontraditional lenders. Consequently, bank regulators are concerned over the quality of these loans due to signs of weakening standards. To the extent insurers consider investing in leveraged bank loans either directly or through collateralized loan obligations (CLOs) — particularly in this current low interest rate environment — thorough analysis, including a review of appropriate documents and models associated with the investment, will identify the risks involved and whether the proposed investment is prudent based on the insurer's strategy and investment guidelines. Having the appropriate infrastructure within an insurer's portfolio management division can help identify and monitor these risks. This includes having experienced analytical professionals within the portfolio management and credit analysis team, in addition to appropriate systems and monitoring processes in place with respect to operations and administration (as well as for business continuity plans). In addition, how the bank loans are sourced and the insurers' relationships with traders or agent banks, along with whether the bank loans are first or second lien, and how they are priced (i.e., marked-to-market, and by which vendor(s)) are also factors to be considered by insurers when investing directly in bank loans. Note that with respect to syndicated bank loans, the lead agent bank usually has (limited) authority to act on behalf of the syndicate regarding any amendments to the bank loan terms. This, therefore, emphasizes the need for insurers, and all investors for that matter, to understand the nature of their investments.

Leveraged bank loans are attractive in the current low interest rate environment because they are high-yielding with floating interest rates that increase as rates rise. Though they are typically rated below investment grade by the rating agencies, they are also senior debt within a company's capital structure, meaning that they take priority with respect to interest and principal over other classes of company debt. According to Standard &Poor's, the average yield on a leveraged loan was 5.44% in January 2013 compared to 2.75% on an investment grade corporate bond (according to Barclays U.S. Corporate Index). Leveraged loan issuance for all of 2012 was $42 billion, compared to a high of $160 billion in 2007, according to S&P Capital IQ Leveraged Commentary and Data.

In addition to a primary market for new issuance, there is an increasingly liquid secondary market for investing in leveraged bank loans, which has attracted additional institutional investors. Insurance companies invest in bank loans; however, historically, direct exposure has been minimal. Insurers are exposed to bank loans indirectly through investments in CLOs, which were approximately $22 billion as of year-end 2011. A resurgence of new issuance in CLOs post-financial crisis has played a role in the increased demand for leveraged loans. Leveraged lending decreased during the financial crisis but has been on a rebound since 2009. Non-bank lenders, as well as non-regulated investors, entered the market and were willing to accept looser bank loan terms. Consequently, underwriting standards have deteriorated; for example, meaningful maintenance covenants were being excluded. These "covenant-lite" loans do not have the safeguards — such as limits on how much debt a company can add to its balance sheet — that traditional leveraged bank loans carry. According to S&P, for the first two months of 2013, $25 billion of covenant-lite loans were issued, which is almost the same amount that had been issued at their peak in February 2007.

On March 21, banking regulators (that is, a joint effort between the Federal Reserve Board, The Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency) released updated supervisory guidance for banks regarding leveraged lending due to concerns over looser underwriting standards and banks increasing risk. The revised guidance primarily focuses on having banks establish sound risk-management practices; underwriting standards with clearly defined expectations; valuation standards that include established policies and procedures; pipeline management such that exposure can be measured timely; and reporting and analytics that include appropriate management information systems for monitoring loan characteristics and to perform stress testing.

Consequently, the Capital Markets Bureau believes it is important for state insurance regulators to be aware of the potential risks that bank loans as investments might carry, particularly if they reach high concentrations, and to be alert for significant investments by any one insurer.