Leveraged Loans. Asian Private Banks’ Latest Blockbuster Product. Late To The Party… With Leverage.

Fears of rising interest rates have motivated Asian investors to buy leveraged loans. The first real demand from Asia for leveraged loans came around the Taper Tantrum in 2013. The asset class did as it was intended and protected capital while delivering a rather unexciting return (as it was supposed to do.) Over-investment in the asset class, through ETFs and retail mutual funds led to a reversal as capital exited the asset class over 2014 and 2015 resulting in mark to market losses.

Some point to the distress in the high yield market due to the crash in the oil price but note that oil is very under-represented in the loan market. The sell off of 2015 was a technical sell off driven by over-investment in the asset class by less well informed investors. The sell off reached its apex in early 2016 when most retail money had left. Institutional capital, it should be noted, had been returning to the asset class well before this and was positioning for a recovery. 2016 saw the loan market rebound (performing loan prices which had traded into the low 90s, rebounded to par).

Today, 75% of performing loans trade above par. This is not ideal for an obligation which can be called, repaid or otherwise repriced basically on any given day. Indeed in a trillion USD market, 2016 witnessed some 100 billion USD of repricings, all occuring in the last months of the year. Repricing volume in 2017 matched all of 2016 in January alone.

In a repricing, the borrower basically renegotiates the loan

at a lower coupon, with the lender, who either agrees or faces early repayment of the loan, usually with no penalty fees.

And now we get to an interesting product in the Asian market. Private banks are selling leveraged loans packaged in the form of Fixed Maturity Products. With leverage. The typical product will lock the investor in to 3 to 4 years, be invested in a pool of leveraged loans, and be leveraged between 3 top 5 times.

1. The timing is not ideal. Buying loans above par is not ideal when they can be repriced or repaid at par. And a large proportion of loans are today trading above par.

2. The structure is not ideal. Loans are low yielding, low volatility, fairly predictable credit investments. They naturally lend themselves to leverage. But if that leverage removes some of those features such as the low volatility and predictability, then it defeats the purpose of investing in loans. The ideal structure for leveraging loans is a structure whereby the loans are financed by fixed maturity liabilities with limited recourse and no mark-to-market of the underlying collateral. Pricing is based on default, recovery and basically on the actual cash flows of the loan pool. This structure has a name: the CLO or Collateralized Loan Obligation. The CLO has a bad reputatation, all of it by association. CLOs not only survived 2008/9 but outperformed stocks and bonds. Leveraging a pool of loans with a bank credit line, with the usual loan to value covenants and margin requirements, is to create an unstable cousin of the CLO.

There are a few possibilities why wealth management firms would construct and offer a leveraged product packaging loans in this fashion.

1. They cannot sell CLOs to an unsophisticated audience because the audience is unsophisticated and would not understand the benefits, or because the regulator would not

allow it, or would take a dim view if the CLO later became impaired.

2. They cannot produce CLOs for whatever reason. For a bank, in-house production is ruled out by the conflict between risk retention rules and capital requirements although one cannot be sure if they got that far. Outsourcing CLO production would not have addressed the complexity issue since the bank would have had to conduct a comprehensive due diligence, and would have involved sharing of fees as well.

3. The product development progressed without realizing the CLO alternative, which would have been quite clever, but still leaves the collateral mark to market issue inresolved. Note that in the CLO space, market value structures no longer exist, a victim of mark to market and automatic deleveraging.

Caution is therefore recommended. The timing of buying leveraged loans is not ideal, and the structure of the leveraged vehicles is not ideal. Even a stable asset like leveraged loans has occasional volatility (2008, 2011, 2015) and while models can be built to estimate losses and deleveraging levels, too successful a product can create a feedback loop when prices fall.

If there is any doubt that market prices have outpaced fundamentals, consider this. Over a 12 month period ending 10 May 2017, the S&P LSTA Index of loans has returned 8.04% whereas the Blackrock Floating Rate Income ETF (FRA) and the Eaton Vance Senior Floating Rate ETF (EFR) have returned 16% and 21% respectively.