



# Risk Reward riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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## New Standards for Risk Management

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# ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS?

*In this article by banker Simon Ling-Locke, MBA, FCIB, DIPFS Director of Credit Risk Services at Risk Reward Ltd, the author explores the prospects of how we might be rushing towards yet another 'credit crash' in spite of efforts to avert this scenario.*

## What is Happening?

Over the last year or so many of you may have heard the phrase "extend and pretend" countless times. This is a situation where lender(s) agree to extend maturities and /or amend covenants on a debt instrument to a borrower to avoid an event of default occurring in the (vain?) hope that:

- the operating performance of the company will return to health, or
- the market will once again be prepared to refinance deals on high leverage multiples.

There is also a question of whether some banks are acting out of political expedience (and there is certainly anecdotal evidence of governmental willpower having an influence over hitherto commercial credit decisions).

The two issues we need to look at are firstly the potential size of distress in the European loan markets and secondly to consider whether "extending and pretending" will help companies and banks swim through the economic turmoil we are facing, or whether the delay is storing up

potentially larger and more insurmountable problems for the future.

## How Big is the Problem?

For the period up until the first half of 2007 there had been a very significant cyclical upturn in US and European syndicated lending, with overall primary loan volume growth of over 2.5 times between 2003 and 2007. This growth was particular focused on M&A (merger and acquisition) and leverage financing, as can be seen in the two charts at the bottom of the page.

Under current conditions of limited supply or indeed the total exclusion from the credit market for some companies, then the ability for these more highly leveraged borrowers from the boom era to repay, refinance or re-profile their debt obligations must be strongly questioned. This is only part of the problem since more companies will also face deteriorating operating performances and real liquidity crunches.

## The Refinancing Cliff

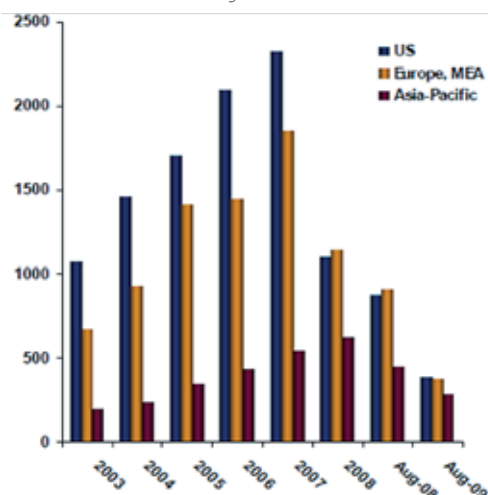
As an illustration of the refinancing cliff the market is facing over the coming

years the following chart is particularly interesting in terms of the sheer size of the refinancing requirement and the question of who will provide that funding. During the boom period up to the first half of 2007 over half of all European leveraged lending was funded by institutional investors, particularly through CLOs and much of this market has gone away due to forced liquidations for Market Value CLOs, liquidations or redemptions for Macro/Credit Hedge Funds, redemptions for TRS/Repo Financed Funds as well as for Unlevered Loan Funds which leaves Cashflow CLOs.<sup>1</sup>

<sup>1</sup> **Collateralised Loan Obligation (CLO)** is a debt security collateralised by commercial loans. Usually a CLO refers to the entire structured transaction in which multiple classes of debt or equity securities are issued by a special purpose vehicle (SPV) whose assets consist principally of commercial loans. **Market-value CLOs** have triggers written into them which force an unwind if the value of the loan portfolio (or the portfolio of swaps on those

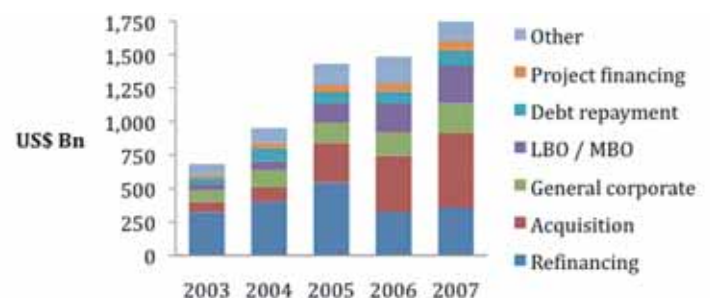
Primary Loan Volume (US\$Bn)

Source: Dealogic and Thomson Reuters



EMEA Loan Volume by Purpose

Source: Dealogic



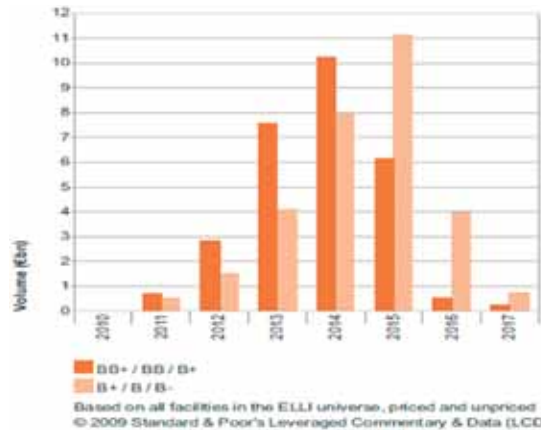
loans in the case of synthetic CLOs) falls below a certain level thus causing their liquidation.

**Macro Funds** use macroeconomic principles in leveraged CLOs to identify dislocations in asset prices, working on either directional or relative value plays.

**Total Return Swap (TRS)** is a bilateral financial transaction where the counterparties swap the total return of a single asset or basket of assets (for TRS Funds it is on a basket of CLOs) in exchange for periodic cash flows, typically a floating rate such as LIBOR +/- a basis point spread and payment against any capital losses. A TRS is similar to a plain vanilla swap except the deal is structured such that the total return (cash flows plus capital appreciation/depreciation) is exchanged, rather than just the cash flows.

**Unlevered Loan Funds** avoid leveraging up the CLO with debt and tend to be made up of long-only investors.

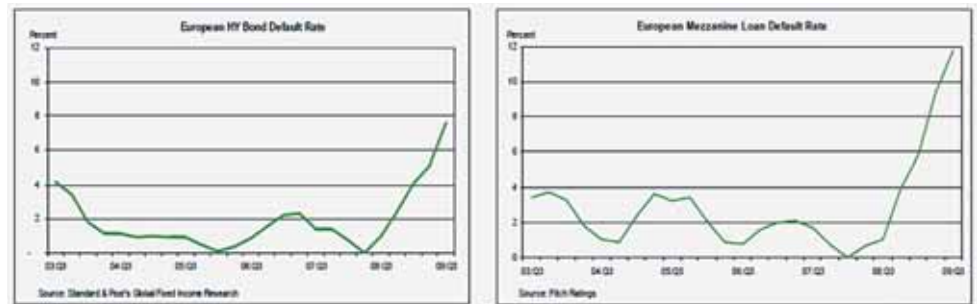
**Cashflow CLOs** are transactions in which the repayment of the CLO debt securities depend on the cash flow from the underlying loans.



**Maturity Schedule of European Institutional Loans by Par Outstanding**

**European HY Bond and Mezzanine Loan Default Rates**

Source: S&P and Fitch Ratings respectively



Clearly, without a significant turnaround in market appetite for lending or of the emergence of trade buyers of leveraged companies over the next couple of years, a wall of distressed debt will quickly build up. This will impact market sentiment both in the primary and secondary markets across Europe and America and lead to further pain on the already stretched capital of banks as they mark down the values of these loan assets.

**The Default Rate**

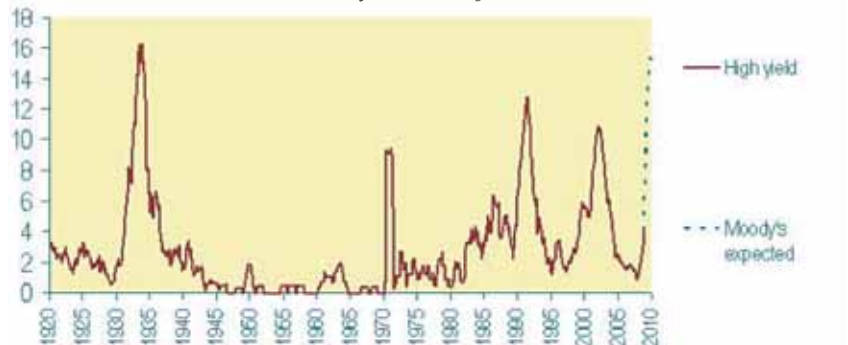
If we now also look at potential default rates in the sub-investment grade market then the picture of potential distress becomes even more apparent, this during a time when many lenders have been willing to reset covenants to avoid defaults.

**The Conclusion – Another Crash?**

So, a picture of increasing levels of distressed debt in the market can be expected over the coming years. This conclusion is hardly rocket science, but then again nor was the prediction made by us that there would be a market

**Moody's Global 12 month trailing speculative grade default rate since 1920 (%)**

Source: Moody's and Bloomberg



crash by 2007. Clearly few wanted to hear such an irksome message when profit targets were to be made (to paraphrase, hear no warnings, see no warnings, speak no warnings!). This is once again a time when players in the market need to sit up and prepare themselves for significant levels of restructuring and credit provisioning. You may ask why that is the case and in the next paper I will address this question by considering:

- impact from delaying a restructuring
- disconnect and lack of trust between management, owners and lenders (and indeed between different categories of lenders)
- the sheer volume of work and due diligence to be undertaken
- complexity and cross-border nature of many transactions.

**Look out for the following article in this series in the Q2 Risk Update.**

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