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Liquidity is credit's handmaiden

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In mid-2009 I was visiting with KeyCorp's then-CEO, Henry Meyer. We were discussing the Moody's downgrade of KeyCorp's senior and subordinated debt ratings during April. The downgrade followed a horrific first quarter at KeyCorp and most regional banks. Meyer, who seemed to be struggling to control his tongue, offered that the rating agencies would be good cowboys because they knew how to close the barn door after the horses had left.

The annual Shared National Credit exam has an element of Meyer's non-compliment regarding the statement of the obvious. I do not remember the release of the SNC exam results ever dropping a bomb on investors' laps or conveying something that was not known, but it nonetheless has useful information. Plus, the time series provides a good look of where the market has been and clues as to how it may evolve if one believes in cycles.

Leveraged lending guidance

During March 2013, regulators issued updated leveraged lending guidance about what constitutes a leveraged loan. Generally, leveraged loans entail a borrower with senior debt that is 3x EBITDA or 4x total debt. Loans in which the borrower is levered 6x or more are discouraged even if the intent is to distribute rather than hold.

The guidance also stipulates expectations regarding the pace of debt amortization and adequacy of capital structures. If you have not read the guidance, it is worth your time, as is an update that was issued in November 2014, because regulators thought too many banks were ignoring the 2013 guidance.

This year's SNC results, which were based upon a review of data supplied by banks as of year-end 2014 and March 31, 2015, contained no bombshells. The exam did offer a few data points about the credit cycle. SNC commitments rose 15.3% to $3.9 trillion from $3.4 trillion the prior year, which follows increases of 12.6% in 2014 and 7.8% in 2013. Leveraged lending commitments grew an astounding 31.8% to $1.04 trillion from $767.4 billion in the prior year and accounted for 26.6% of SNC commitments compared to 22.6% in 2014. The first year the exam began to single out leveraged lending was 2007. As bank and credit investors know, the seeds of the next downturn are usually sown during periods of rapid growth when participants are making a lot of money.

The rapid growth in leveraged lending does not mean a spike in credit losses is looming; nor does it mean that liquidity suddenly will be withdrawn as occurred during 2007 and 2008. But change is afoot, and liquidity is credit's handmaiden. On Nov. 8 *The Wall Street Journal* ran a story about banks being stuck with buyout loans as investor appetites cooled. Missed in the article, I think, is the beauty of the originate-and-distribute model. Aside from the importance that price discovery plays in the risk management process, unsold loans can be retained. The presumption is that they are underwritten well rather than iffy credits to be hoisted onto sophisticated institutional investors. This year's SNC exam raises some questions about underwriting, noting that more than 36% of leveraged loan originations were "weak." If true, maybe investors are shying away for reasons involving more than just the coupon (or price).

Another interesting data point in the exam is classified credits, which increased slightly to 5.8% of commitments from 5.6% last year. That is not a trend. The 2007 exam, which was based upon year-end 2006 and first-quarter 2007 credit data, reflected a 3.1% classification rate. Two years later classifieds rose to 15.5%. My memory is that the consensus view in late 2009 was that credit issues were peaking. The question was about how much improvement would occur. A tsunami of income seeking liquidity provided an unexpected answer: dramatic.

There are plenty of data points that suggest the market is now transitioning away from virtuous liquidity. Thomson Reuters reports that leveraged loans declined to $581 billion YTD through October compared to $828 billion YTD last year. The drop is more pronounced among institutional investors than pro rata leveraged lending retained by banks. That is not surprising given net outflows for leveraged loans and high-yield funds this year.

The nonbank participants are important players to watch. As active market participants, they are more likely to be in and out of the market given the call investors have on their funds. In effect, they are the swing liquidity provider. The SNC exam notes that nonbank entities accounted for 23.0% of SNC commitments (and around 41% for YTD leveraged loan originations, per Thomson Reuters), up from 8.4% in 2001. Most of the market share gain came at the expense of foreign banks rather than U.S. banks, whose share declined to 33.7% from 45.4%.

So far, credit deterioration has largely been confined to the energy sector. Fitch published a report on Nov. 13 that indicated the trailing 12-month default rate for energy credits was 5.3%, the highest since a 9.7% peak in 1999 following the late-1990s collapse in oil prices. Metals/mining's default rate was 9.5% due to the implosion of the coal industry. Excluding these two sectors and Caesars Entertainment, the default rate was only 0.7%.

In the case of the energy sector, I think KeyCorp's Meyer would say the horse has left the barn and the regulators run the risk of making the situation worse if they second guess too much and take unreasonable positions, such as the one suggested by *The Wall Street Journal* in September. The article indicated that regulators were vetting energy credits based on total debt rather than the banks' exposure, which usually is only the senior debt. Liquidate the collateral and the banks are paid first. Along the same lines, the 2013 leveraged lending guidance notes that cash should not be netted against debt when calculating the leverage multiple. The industry convention for lenders and investors is, of course, to measure net debt.

Are these items nitpicky? Sure, but liquidity has a propensity to evaporate when it is needed the most. Lehman Brothers was unable to roll over its sizable short-term debt when it had to do so, which caused credit losses to mushroom in markets as liquidity evaporated. Nearly 20 years earlier, Drexel Burnham Lambert collapsed and contributed to convulsions in the high-yield market because it was a key market maker. Are regulators going to quash the leveraged loan market in their effort to dial it back a bit? Let's hope not.

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