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Market Excesses 'Approaching a Threatening Level': IMF Issues Stark Warning On Leveraged Loans

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An unusually blunt warning about the massive market in leveraged loans from a normally-circumspect International Monetary Fund should give investors pause at a time of rising concern about global financial stability.

Fund economists Tobias Adrian, Fabio Natalucci and Thomas Piontek have published a new blogpost highlighting some fairly alarming trends.

"We warned in the most recent Global Financial Stability Report that speculative excesses in some financial markets may be approaching a threatening level. For evidence, look no further than the $1.3 trillion global market for so-called leverage loans, which has some analysts and academics sounding the alarm on a dangerous deterioration in lending standards. They have a point.

"This growing segment of the financial world involves loans, usually arranged by a syndicate of banks, to companies that are heavily indebted or have weak credit ratings. These loans are called 'leveraged' because the ratio of the borrower's debt to assets or earnings significantly exceeds industry norms."

Adrian, a former New York Fed economist and now Director of the Monetary and Capital Markets Department, alluded to some of these risks during a presentation at the CATO Institute's 36th Annual Monetary Conference held on Thursday in Washington.

"With interest rates extremely low for years and with ample money flowing though the financial system, yield-hungry investors are tolerating ever-higher levels of risk and betting on financial instruments that, in less speculative times, they might sensibly shun," Adrian and his colleagues write.

"Speculative-grade companies have been eager to load up on cheap debt. Globally, new issuance of leveraged loans hit a record $788 billion in 2017, surpassing the pre-crisis high of $762 billion in 2007. The United States was by far the largest market last year, accounting for $564 billion of new loans."

It's not just the market's size and scope but also its increasingly loose underwriting standards, reminiscent of the mortgage market before the 2008 crash. "It is not only the sheer volume of debt that is causing concern. Underwriting standards and credit quality have deteriorated," the report said.

Another 2008-ish trend—the kind of "risk-spreading" and asset resale that ended in tears last time around.

"A significant shift in the investor base is another reason for worry. Institutions now hold about $1.1 trillion of leveraged loans in the United States, almost double the pre-crisis level. That compares with $1.2 trillion in high yield, or junk bonds, outstanding. Such institutions include loan mutual funds, insurance companies, pension funds, and collateralized loan obligations (CLOs), which package loans and then resell them to still other investors. CLOs buy more than half of overall leveraged loan issuance in the United States."

The sobering conclusion: “Having learned a painful lesson a decade ago about unforeseen threats to the financial system, policymakers should not overlook another potential threat.”

It sounds nice in theory. However, Federal Reserve officials have few tools—and have sought any new ones—does grapple with potential risks in the so-called shadow-banking system, which operates outside the part of the financial system it regulates. This gap may yet prove the gateway to the next financial crisis.