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TAKING THE TEMPERATURE OF RISK MANAGERS:

The Outlook on Leveraged Loans

Taking the Temperature of Risk Managers: The Outlook on Leveraged Loans

In late October 2020, GARP surveyed 87 risk managers about the current risks associated with leveraged loans and collateralized loan obligations (CLOs, which are securitization vehicles with asset portfolios almost entirely composed of leveraged loans. See more in our Guide to the Leveraged Loans Market). The survey revealed that the vast majority of risk managers believe that default risk has increased since the start of 2020, and two-thirds expect a further increase in risks associated with leveraged loans in 2021. A majority believe there is a substantial chance that recovery rates on defaulted loans will be much worse than historical averages going forward. However, most are not very concerned about the impact of such risk realizations on their own financial institution.

Respondent locations were approximately evenly divided between EMEA, the Americas, and Asia. The average respondent has more than ten years of risk management experience. The results reported below are for the subset of 56 respondents who described themselves as moderately or very familiar with leveraged loans and CLOs, but results are not very different if all respondents are included.

The leveraged loan and CLO markets were stressed in March and April 2020, with large declines in secondary market loan prices and many rating agency downgrades of loans and CLO tranches. By the time of the survey, conditions had improved due to strong policy actions and a partial economic recovery.

The volume of loan and CLO issuance was large in the third and fourth quarters of 2020. Many companies were able to obtain cash in debt markets to sustain operations and to support growth. However, a risk associated with such issuance is that some companies with large debt loads are now even more leveraged and thus even more vulnerable to a worsening of economic and financial conditions.

SURVEY RESULTS

Survey respondents believe that leveraged loans and CLOs are riskier than at the start of 2020 but not as risky as in the second quarter. 41% view the current risk of widespread leveraged loan defaults as moderately significant, while roughly equally-size groups view this risk as either very significant (27%) or mildly significant (29%) (Figure 1). Over 90% of respondents believe that default risk has increased since the start of 2020, approximately evenly split between a small increase (50%) or a large increase (46%); the remainder believe the risk has not changed (Figure 2).

Figure 1: Default Risk

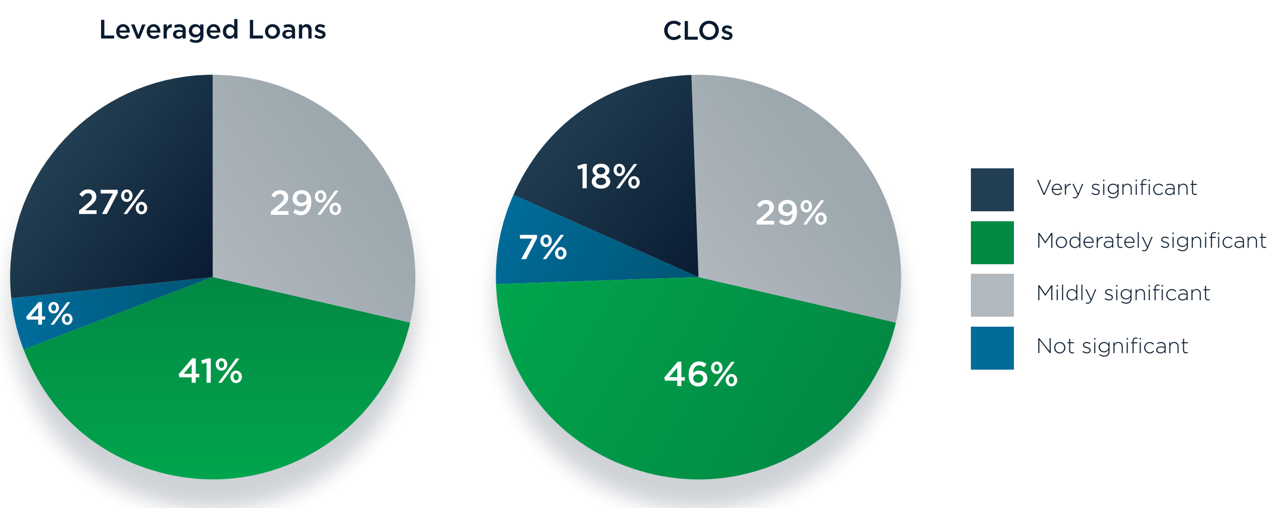
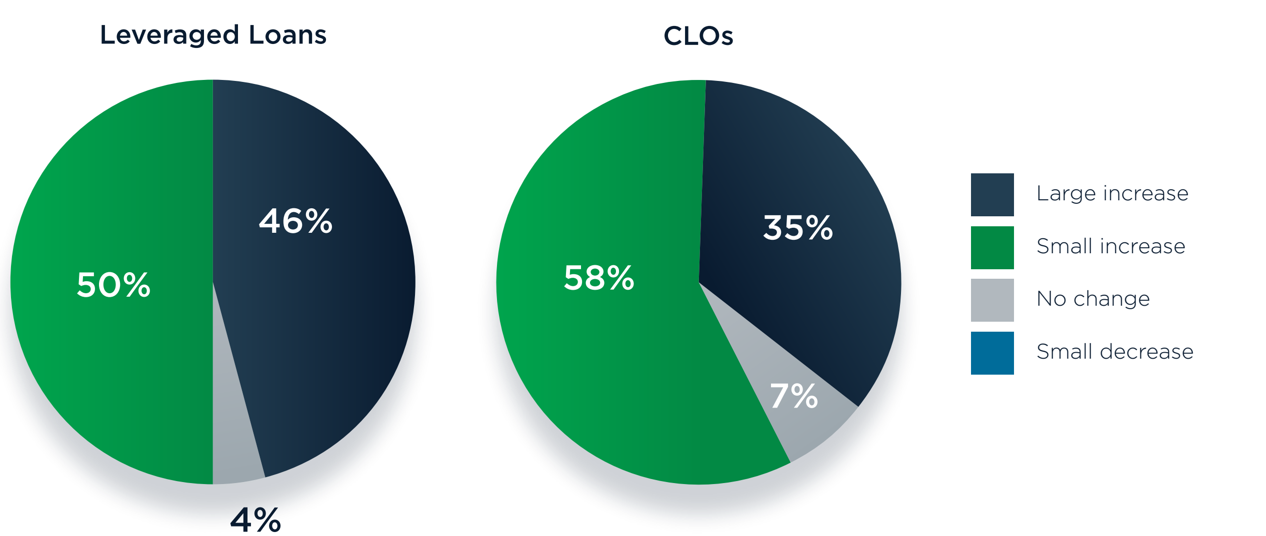
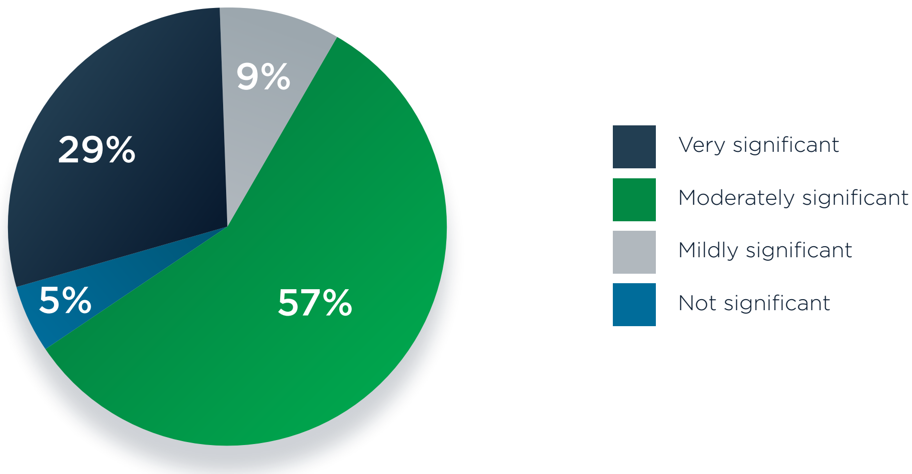


Figure 2: Change in Default Risk During 2020



Recovery rates on defaulted loans are also a concern: More than half of respondents believe there is a moderately significant risk that recovery rates going forward will be much worse than in past episodes of stress, and another third believe that risk is very significant (Figure 3). Unusually poor recovery rates could cause losses on riskier CLO tranches if default rates pop up to high levels.

Figure 3: Risk of unusually bad recovery rates on defaulted loans



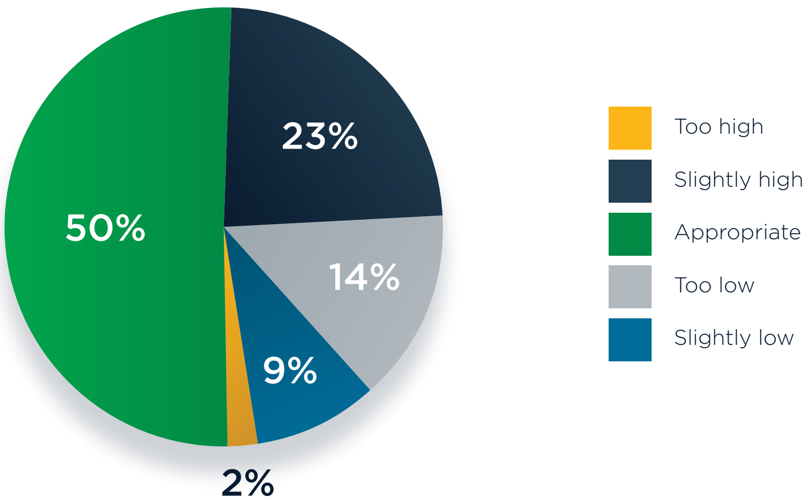
While half of respondents reported moderate concern at their company regarding leveraged loans and CLOs, only 7% reported this as a major concern. Most respondents are not very concerned about the impact of leveraged loan and CLO risks on their own company if defaults become widespread, with about two-thirds predicting no impact or a minor impact and only 11% predicting a major impact (Table 1).

Table 1. Risks to respondent's company

	What is the current level of concern at your company regarding leveraged loans and CLOs?	What impact would widespread defaults on leveraged loans or CLOs have on your company?
Major	7%	11%
Moderate	50%	27%
Minor	29%	45%
None	13%	18%

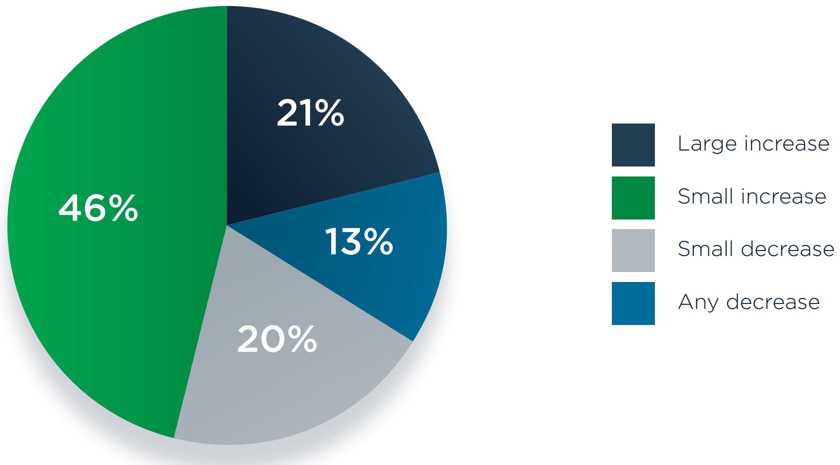
Most respondents believe their company is aware of the risks, with half believing their company's level of concern is appropriate and only about 10% believing it is too low (Figure 4). The average respondent also believes the level of concern in financial markets is about right.

Figure 4: Company's level of concern about leveraged loan and CLO losses



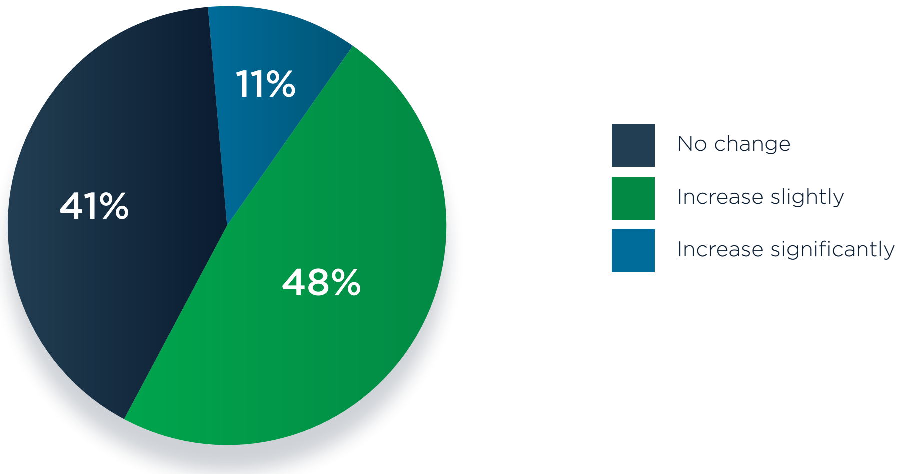
Looking forward, two-thirds of the respondents expect an increase in risks associated with leveraged loans in 2021, with 46% expecting a small increase and 21% expecting a large increase; 18% expect a small decrease and only 2% a large decrease (Figure 5). Almost all respondents expect little or no change in their company's risk exposure to leveraged loans and CLOs.

Figure 5: Expected change in risks in 2021



Turning to policy, somewhat surprisingly given the generally benign view of risks inherent in the survey results, almost half of all respondents believe policymakers should do more to address the risks associated with leveraged loans and only 16% believe policymakers should do no more. However, only 11% of respondents believe policymakers will take significantly stronger actions to address leveraged loan risks in 2021, with the remainder about evenly split between no change and a slight increase in strength of policy measures (Figure 6).

Figure 6: Expected change in strength of policy actions in 2021



More information can be found in our press room or the Risk Snapshots section on garp.org.

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