NBP Narodowy Bank Polski

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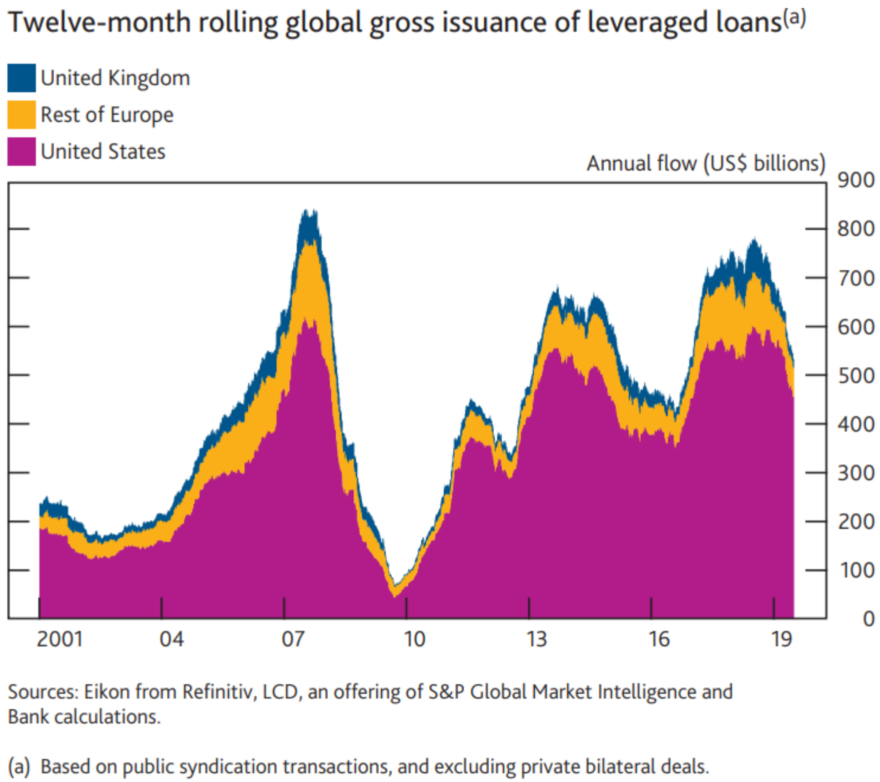
# Discussion on *US monetary policy, bank capital, and the origins of international leveraged loans* by *S. Avdjiev and Jose-Maria Serena*

16th NBP-SNB Annual Joint Seminar

*Standard disclaimers apply*

# An important contribution to an important issue





And an interesting method for mapping the loans with firms and lender reference data

Source: Bank of England, Financial Stability Report July 2019. BIS Quarterly review, September 2018

# FSB Plenary meets in Paris on November 7th, 2019

…vulnerabilities associated with leveraged loans and collateralised loan obligations (CLOs) have grown since the global financial crisis, although there have been some mitigating developments.

Source: https://www.fsb.org/2019/11/fsb-plenary-meets-in-paris/

# Key take-aways

1. **Low US interest rates** spur the origination of risky USD-denominated int'l leveraged loans.
    1. banks with higher levels of regulatory capital originate more leveraged loans and are more sensitive to interest rates.
    2. banks with low market valuations engage in more risk-taking, especially when interest rates are low.
2. **Banks with high regulatory capital <u>and</u> low valuations** are most likely to extend risky international leveraged loans

# Some questions

# How consistent are the results with previous research?

- „**Higher** U.S.short-term interest rates are associated with an increase in cross-border bank lending (Cerutti at al. 2017)
- Avdjiev et al. (2018) extend this finding to a large sample of lender countries, providing supporting evidence for the international portfolio rebalancing channel."
- Avdjiev and Hale (2019):
  - higher levels of the macro fundamentals component of the US MoPo are associated with higher growth rates in cross-border bank lending, **but**
  - higher levels of the pure MoPo stance component of the US MoPo are associated with lower growth rates in cross-border bank lending

Quote after: S. Albrizio, S. Choi, D. Furceri, Ch.Yoon (2019), *International Bank Lending Channel of Monetary Policy,* IMF Working Paper/19/234

# What is being explained?

Dependent variable (as classified by lenders themselves)

- highly leveraged loan
- leveraged loan
- near investment grade loan
- investment grade loans loan

<u>How is the „leveraged loan” defined across banks and across time?</u>

- See e.g. „*There is no commonly accepted definition of leveraged loans*” BoE Financial Stability report, July 2019.
- The data time span is very wide (1995-2017) and the definition of what is a leveraged loan might have changed

<u>What about covenant-lite loans?</u>

<u>Leveraged (floating rate) loans crowding out (fixed rate) high yield bonds?</u>

# What drives what?

- Banks with **high regulatory capital** (Tier1/RWA, controlled for the size of the bank) are **most likely** to extend risky international leveraged loans

Or – maybe?

- Only the banks which are:
  - **sufficiently large**
  - **have appropriate know-how**
  - **have good relations with the NFCs, internationally**

  have the capacity to be in the business of extending international loans, inculding leveraged ones
- Is high capital (ratio) a sine qua non condition for the banks to grant c-b loans?
- Are large banks better capitalized?

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…vulnerabilities associated with leveraged loans and collateralised loan obligations (CLOs) have grown since the global financial crisis, although there have been some mitigating developments.

… banks globally have the largest direct exposures to leveraged loans and CLOs, concentrated among a limited number of large global banks, with a significant cross-border dimension.

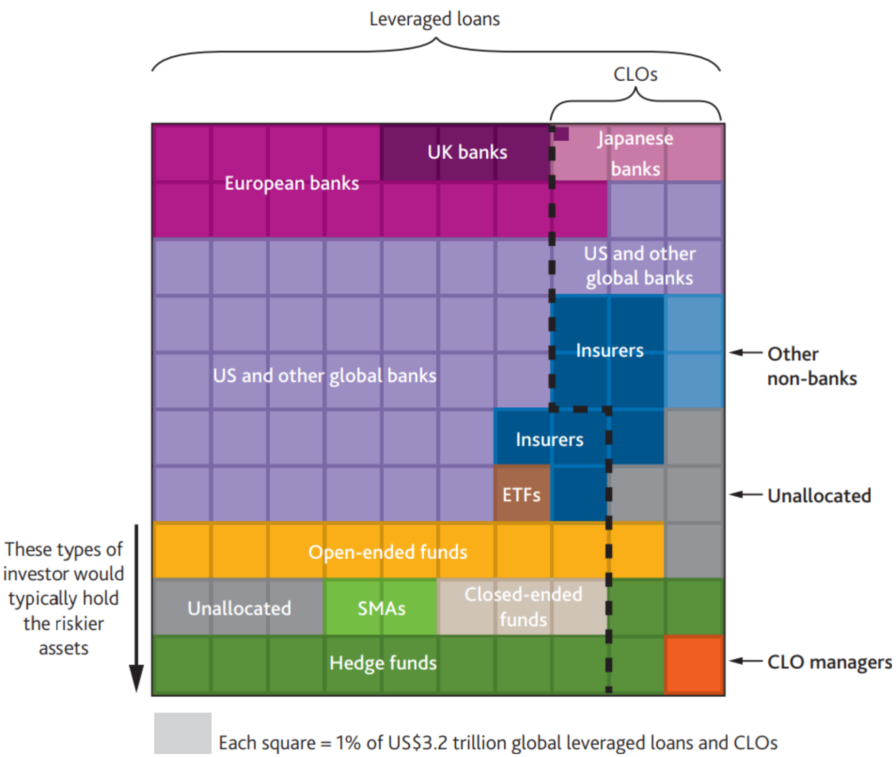
… a number of non-bank investors are also exposed to these markets.

Source: https://www.fsb.org/2019/11/fsb-plenary-meets-in-paris/

# What is the role of non-institutional holders of leveraged loans?

**Chart F.7** A material share of the overall leveraged loan market is held by global banks

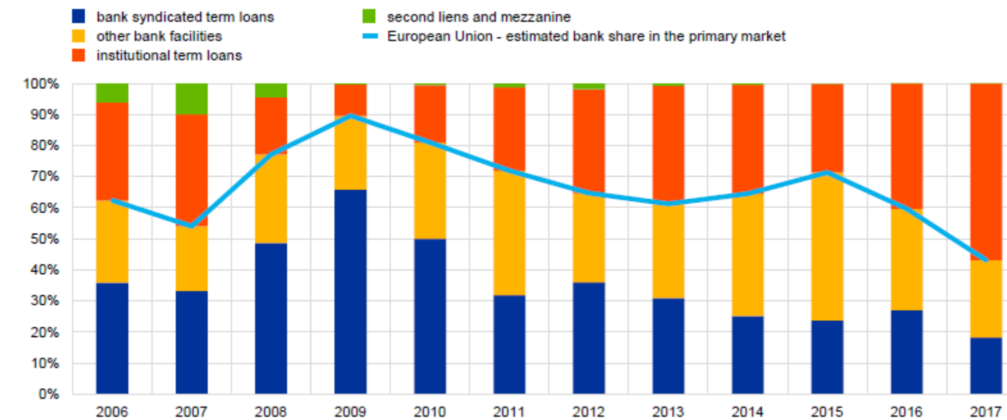
Indicative estimate of leveraged loans and CLOs outstanding globally by investor type(a)(b)(c)(d)(e)(f)(g)(h)




Non-banks in Europe have acquired increasingly large shares of leveraged loans in the primary market since the financial crisis

**Breakdown of leveraged loan facilities in the EU market by type and estimated share of primary market loans extended by EU banks**

(2006-2017; percentages)




Sources: Thomson Reuters and ECB calculations.
Notes: Institutional term loans cover term loans B, C, D and E, while bank syndicated term loans cover term loans A (TLAs). Other bank facilities cover brid
loans, revolving credit facilities, and capital expenditure (capex) and acquisition loans. Banks' share in the primary market is estimated as the share of term
loans retained by the banks and of other bank facilities in the total volume of leveraged loans syndicated in the primary market.

Source: Bank of England, Financial Stability Report July 2019, European Central Bank, Financial Stability Report May 2018

# What is the interpretation of other variables?

1. To answer the question on what is the key driver of the increase of international leveraged loans?

2. Good to know for the proper policy design

# Questions put together

1. Consistency with previous research
2. Is it the size/know-how/relationships which drive the size of LL issuance of particular banks?
3. Tole of non-institutional holders of leveraged loans
4. Interpretation of other variables

*We protect the value of money*