Box 13

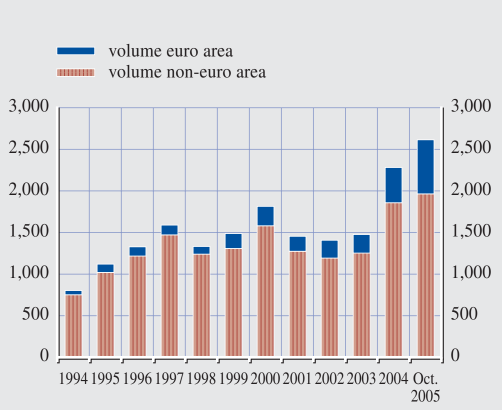
THE SYNDICATED LOAN MARKET IN THE EURO AREA MATURES INTO A DISTINCT ASSET CLASS

The global syndicated loan market has grown significantly over the last decade, with the total amount of gross issuance more than tripling between 1994 and 2004 (see Chart B13.1). The share of euro area borrowing rose from close to negligible levels just a few years earlier to reach 25% of global lending in 2005 (from January to October).

On the primary syndicated loan market – where loans are originated – loans can be broadly distinguished into investment-grade and leveraged according to the credit quality of the borrower. Spreads on investment-grade loans – which still account for the largest share of gross signings – are at record lows, reflecting high levels of liquidity and strong competition at this end of the rating scale (see Chart B13.2). Under these circumstances, conditions for borrowers have improved: maturities of extended loans have increased from 4.1 years in 1999 to over 6 years in 2004, and a less frequent use of covenants was reported. At the same time, the

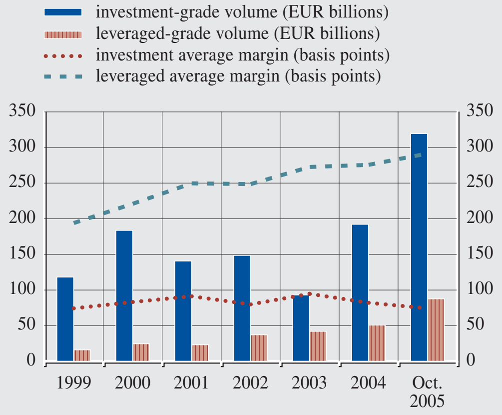
Chart B13.1 Annual volumes of syndicated loans

(USD billions)



Source: Dealogic (Loanware).

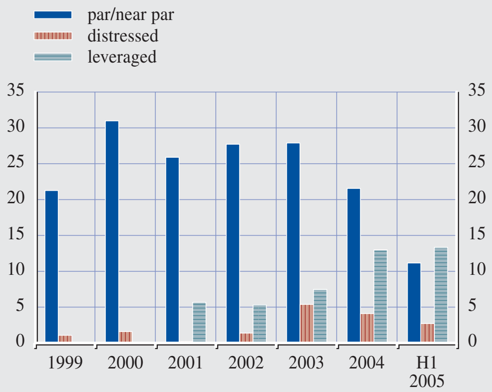
Chart B13.2 Euro area investment and leverage grade volumes



Source: Dealogic (Loanware).

Chart B13.3 Secondary trading volume in Europe

(EUR billions)



Source: Loan Market Association.

combination of an erosion in pricing and the potential weakening of lenders' positions in the loan documentation have given rise to concerns regarding possible mispricing of credit risk.

As a result of the hunt for yield, the supply of capital for the leveraged loan segment has grown significantly, contributing to stronger competition in the primary market. Unlike in the investment-grade segment, the margins in the leveraged loan market have slightly increased (see Chart B13.2), although according to recent market views, the growing competition is exerting downward pressure, and pricing in the euro area may not reflect credit risk differentials, at least when compared to similarly rated credit in the US. The broadening of the investor base in the leveraged loan market – which now includes insurance corporations, hedge funds and specialised CDO managers – has promoted product innovations which have in turn led to the emergence of new structured loan tranches with various levels of subordination, such as second lien loans[1] or payment-in-kind (PIK) instruments.[2]

The growth of the European secondary market, where syndicated loans are traded, reflects the broadening of the investor base, and was supported by more uniform market practices and standardised documentation produced by the Loan Market Association; however, at around 6% of the primary market, it remains still small. The secondary market is differentiated into par/near par, leveraged and distressed segments depending on the price to par at which the loan is traded. The secondary leveraged trading volume, non-existent at the launch of the euro, has since rapidly developed into the most important secondary market segment, accounting for about 50% of the trading in the first half of 2005 (see Chart B13.3).

Three recent developments in the leveraged loan market provide a further indication of the establishment of the syndicated loan market as a distinct asset class. Firstly, syndicated loans are increasingly assigned ratings by the rating agencies, and a new set of recovery ratings (estimating the likely recovery of the principal in the event of default) has been introduced. Secondly, the first index for leveraged loans that provides a benchmark against which investors can assess the performance of their investments was launched[3], and is likely to enhance transparency and liquidity in the market still further. Thirdly, the arrival of CDS referencing European leveraged loans may attract additional investors as it will enable them to manage actively their exposure.

These developments, coupled with considerable growth in both the primary and the secondary market as well as significant changes in the product structure, have contributed to turn

1 Second lien loans are usually secured by a second-ranking charge on assets backing senior secured debt, and are typically subordinated in their rights to receive principal and interest payments from the borrower to the rights of the holders of senior secured debt.
2 PIK instruments pay interest in the form of additional loans (or bonds) instead of cash, thereby increasing the principal, and are classified as first-loss tranche but with preference in liquidation to equity securities.
3 In November 2004 Standard & Poor's launched the European Leveraged Loan Index (ELLI), tracking back to December 2002.

leveraged loans into a debt product that allows financial market participants to tailor their credit risk exposures. However, although these developments are indeed contributing to ensuring a better allocation of risks in financial markets, they may also give rise to concerns on financial stability grounds since, according to some market participants, credit risk may not be adequately reflected in the pricing, which is evident in the small or non-existent differences in prices for different layers of credit quality. At present, pricing is mainly driven by strong competition in the primary market and reflects to a lesser extent credit risk differentials. Pricing conditions that may currently appear to be appropriate could prove inadequate in the case of a turn in the credit cycle. A rise in global interest rates and an increase in market volatility, coupled with a significant increase in corporate sector leverage, may well contribute to such a turn. An improvement in the pricing of syndicated credits is however on the horizon. The recent launch of an official index for leveraged loans is expected to lead to better credit differentiation in the pricing. Furthermore, the impact of Basel II may lessen the prevailing importance of the current supply-demand dynamics and could also promote more efficient loan pricing with differentiation according to the risk profile of the borrowers.