

The leveraged loan market: credit and systemic risk identification

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Introduction

Leveraged loans are syndicated loans granted to highly indebted borrowers (Bruche et al., 2020) and are, therefore, subject to great scrutiny. Concerns in this market arise due to the presence of the covenant-lite agreement and the possible systemic risk (e.g. Federal Reserve, 2013; European Central Bank, 2020, 2022). In this research, we evaluate the riskiness of the covenant-lite agreement and the effect on the probability of default. Following the accurate identification of credit risk, we proceed to assess each bank within the syndicate by capturing their exposure to riskier loans, evaluating systemic risk, and analyzing their interconnectedness with all other lenders.

Methods

Our dataset includes global leveraged loans, with instruments' structural information, borrowers' financial indicators and composition of the syndicates. Using logistic models and mediation analysis (VanderWeele, 2015), we evaluate the effect of the covenant-lite on the probability of default, investigating whether this is granted based on the riskiness of the borrower and whether this acts as a mediator variable. Starting from the compositions of the syndicates, through M-Quantile regression (Breckling and Chambers, 1988), we subsequently identify the exposure to the riskiest loans for each lender. Finally, we propose indicators to evaluate systemic risk and interconnectedness.

Results

The results allow us to state that the covenant-lite agreement does not cause greater credit risk and that this is carefully evaluated by the lenders. Through the exposure indicator, we are able to evaluate which banks have a greater concentration of riskier leveraged loans, and how these can impact systemic risk. Finally, through the similarity indicator, we identify the banks that are most interconnected. All these analyzes allow to better

identify the risk in this specific market and to contribute to its understanding, proposing indicators that can be used by the Supervisory Authorities.

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