Banks’ leveraged loan pipeline could pose a threat to financial stability

Submitted by: BlueSky Public Relations Ltd
Tuesday, 12 February 2019

Lowering bank lending standards have become a major cause for concern for financial regulators, especially in the leveraged loan market, which is growing fast. In the US, it has even outgrown the bond market according to some measures. But according to new research from the UCL School of Management, it is not just the declining lending standards that have the potential to cause disruptions in the financial sector.

According to Professor Frederic Malherbe; “Banks arrange loans, but then sell them on to institutional investors. This means that credit risk – the risk that a borrower fails to repay their debt – plays a much less important role for banks than in the past. Instead, banks are faced with ‘pipeline risk’, the risk that market conditions deteriorate while the loans are still in their pipeline and have not yet been sold on. Loans are in the pipeline typically for a few weeks only, but these weeks can become months when key investors in loans experience outflows and hence can’t buy”.

“This can turn into a problem when banks compete aggressively and make promises on the terms at which the loan will be issued. For instance, if necessary, the bank may be permitted to increase the interest margin from say 5% to maximum 6%, to entice the market to buy. As part of an aggressive bid, the bank might agree to limit the maximum margin to 5.5% instead. But if market conditions are such that 5.5% are not enough, the bank will have to provide further enticements out of its own pocket. For instance, by selling shares in the loan at a discount. Therefore, the more aggressively the banks compete, the more “pipeline risk” they are exposed to.”

The researchers recommend that to assess and monitor the degree of exposure of the financial system, bank supervisors construct an indicator of “pipeline risk” based, among other factors, on how much flexibility is permitted in the underwriting contracts. This means that banks must disclose all the terms of their contracts to regulators – something that they do not currently have to do.

In practice, such an indicator has the potential to become a key input to stress tests and bank capital regulation in general.

The paper is under revision for publication in The Review of Financial Studies.

/ENDS
For more information, a copy of the paper or to speak to professor Malherbe please contact Kate Mowbray at BlueSky PR on kate@bluesky-pr.com or call +44 (0)1582 7979 57

Distributed via Press Release Wire (https://pressreleases.responsesource.com/) on behalf of BlueSky Public Relations Ltd

Copyright © 1999-2024 ResponseSource, The Johnson Building, 79 Hatton Garden, London, EC1N 8AW, UK

e: info@responsesource.com t: 020 3426 4051 f: 0345 370 7776 w: https://www.responsesource.com

responsesource