The US credit cycle: how much should it concern us? Part II

- **While household debt is in a relatively comfortable position, financial vulnerabilities have arisen in corporate debt.**
- **In particular, we show how investors now hold debt of companies with a higher risk profile and are somewhat less protected.**

The US' current expansionary phase is on course to become the longest in history and, so far, there have been no major shocks. However, over the past few years some financial imbalances have arisen, especially in the corporate sector, which could destabilise the wider economy in an adverse macroeconomic scenario.[1] We analyse these imbalances in more detail below.

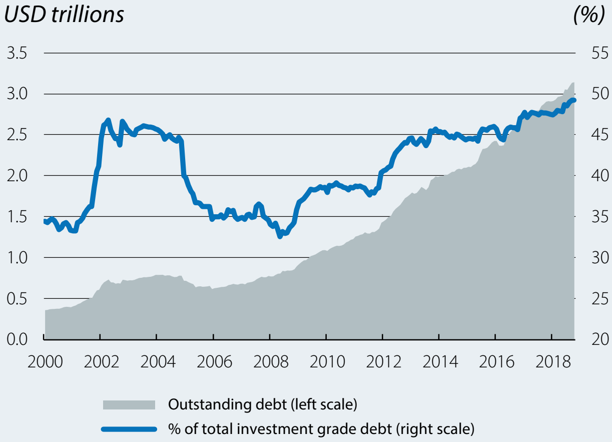
Corporate debt as the main source of risk

In recent years, the debt of non-financial corporations has increased significantly, reaching levels similar to those of 2007. This increase has partly been supported by growth in business profits, favoured by the tailwinds of global economic expansion, and by the environment of low interest rates, which makes the debt burden more bearable. In this regard, some institutions such as the IMF ensure that corporate balance sheets are generally in good health. However, this broadly positive view coexists with certain signs that indicate a deterioration in the quality of corporate debt and greater risk-taking in some market segments. These include: the indebtedness of companies with a poor credit profile, the decline in the use of clauses that protect the lender and the increase in debt issued by companies already highly leveraged.

There is widespread evidence of rising debt in companies with a poor credit profile. For instance, debt with a credit rating of BBB is currently at an all-time high (see first chart).[2] This is particularly relevant because usually, when the economy goes into recession, much of this debt sees its rating lowered and ends up classified as high yield. This forces many of its holders, such as investment funds or insurance companies, to sell it, since regulations impose limits on the volume of high yield assets they can hold in their portfolios.[3]

There are also indications that investors are less protected against risk than in the past. Normally, when a company issues bonds, the lenders are protected by various covenants (such as the issuer's obligation to maintain debt ratios below a certain threshold or to limit what the debt can be used for). However, as the OECD and the IMF point out, the use of these covenants has declined steadily since 2002, especially in higher-risk assets (such as high yield corporate debt).[4]

US: corporate debt rated BBB



Note: *The category BBB includes debt with a BBB+, BBB and BBB– rating.*
Source: *CaixaBank Research, based on data from the IMF.*

Finally, of particular concern is the growing accumulation of debt among companies that are already highly indebted (known as leveraged loans), since this increases the likelihood of default. According to data from the IMF, the outstanding debt of such companies has doubled between 2007 and 2018, from 0.6 trillion dollars to 1.2 trillion. In addition, leveraged loans are usually packaged up to create new assets (known as collateralised loan obligations, or CLOs), which are then sold on the secondary market. This process of leveraged loans being securitised evokes memories of the securitisation of mortgage loans that was at the heart of the 2008 financial crisis, and it reduces the incentive for the lender to perform an exhaustive analysis of the solvency of the debt's original issuer. However, various analyses, such as those performed by the Fed, indicate that the financial structure of CLOs is stronger and that

1. For an overview of the state of the US credit cycle, see «The US credit cycle: how much should it concern us?» in the MR04/2019.
2. BBB is the lowest rating considered investment grade, which consists of companies considered to be more solvent. Assets with a credit rating below BBB are classified as high yield.
3. See A. Ellul, C. Jotikasthira and C.T. Lundblad (2011). «Regulatory Pressure and Fire Sales in the Corporate Bond Market» Journal of Financial Economics, 101(3), 596-620.
4. According to the index developed by the OECD, which measures the use of covenants that protect the lender, the difference in their use between high yield and investment-grade companies has reduced by half over the past 15 years. See S. Çelik, G. Demirtas and M. Isaksson (2019). «Corporate Bond Markets in a Time of Unconventional Monetary Policy», OECD Capital Markets Series, Paris.

they are not a major source of systemic risk (in fact, the CLO market performed relatively well during 2008's financial crisis).[5]

Household debt is not a source of systemic risk

On the whole, household indebtedness is a less worrying source of risk than on previous occasions. Several factors contribute to this view: on the one hand, households have significantly reduced their indebtedness compared to the levels seen during the financial crisis. On the other hand, the quality of mortgage debt – the main component of household indebtedness – has improved, as new mortgages are being granted to households that a priori are more solvent (see third chart). Whereas between 2004 and 2007 the average percentage of new mortgages granted to households with a low or very low credit score[6] was 23%, in Q1 2019 they accounted for just 10%. Furthermore, mortgages granted to households with a higher credit score currently account for 56% of the total, compared to 25% in the years prior to the financial crisis.

The sources of risk in household debt lie within components that represent a relatively minor portion of the total, such as student loans. These have doubled in size since 2009, reaching 11% of all household debt, and they possess the highest delinquency rate of all types of household debt (10.9% in Q1 2019). However, given their relatively small size and the fact that they are guaranteed by the US Department of Education, they pose less of a risk to financial stability. Rather, they pose a potential restriction for economic growth: several voices are warning that the high levels of debt with which graduates are entering the labour market is acting as a hindrance for consumption and for young people[7] to access housing.

In short, the vulnerabilities of private debt are mainly to be found in the corporate sector and primarily reflect a deterioration in the quality of debt and greater risk-taking. With a reasonably positive economic outlook, the US is in a position to prevent these vulnerabilities from determining the future economic scenario. However, the fear is that, if the outlook deteriorates more than expected, these vulnerabilities could destabilise the wider economy. What would be the consequences in a more adverse scenario? We shall shortly see in a new instalment of the series «The US credit cycle: how much should it concern us?».

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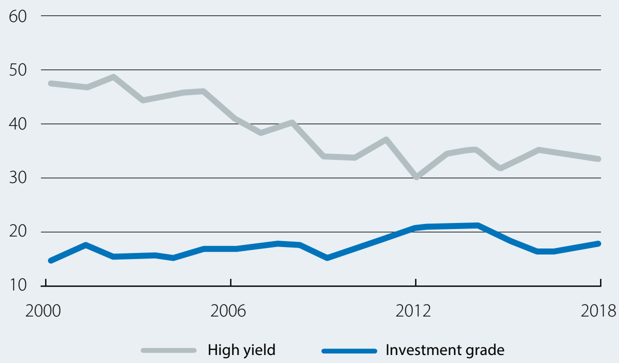
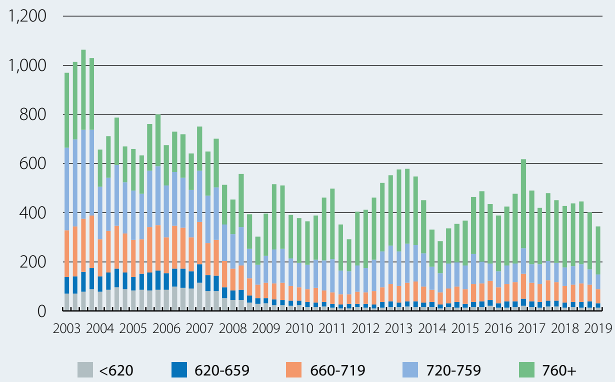
5. See R. Kaplan (2019). «Corporate Debt as a Potential Amplifier in a Slowdown». And the Fed (2019). «Vulnerabilities Associated with Elevated Business Debt», Financial Stability Report for April.
6. A credit score is an indicator used in the US to measure individuals' repayment capacity.
7. WC Dudley (2017), «Opening Remarks at the Economic Press Briefing on Household Borrowing, Student Debt Trends and Homeownership». Federal Reserve Bank of New York.

US: covenant protection index for bonds issued non-financial corporations
(%)



Source: *Çelik, S. et al. (2019). «Corporate Bond Markets in a Time of Unconventional Monetary Policy», OECD Capital Market Series, Paris.*

US: new mortgage lending by credit score
USD billions



Note: *Low credit score values indicate a lower debt repayment capacity.*
Source: *CaixaBank Research, based on data from the Federal Reserve Bank of New York.*