Don’t get burnt by the demise of the debt machine

The practise of leveraging debt to make short-term speculative profit is what triggered the 2008 global financial crisis. It has not gone away—all the same mechanisms still exist, and many new ones have been added. With the real economy collapsing, the caution which followed the GFC has been replaced by the desperate drive to crank up earnings in some other way.

The US leveraged loan market has more than doubled over the last decade, becoming a major source of funding for US businesses, according to an 8 June *Financial Times* article, “Investors fret as leveraged loan market gets junkier”. These loans—made to already heavily indebted firms—are bundled up by private-equity firms and hedge funds, in the same way mortgages were pre-2008, and sold to investors as collateralised loan obligations (CLOs). So-called “debt securities” such as these have become the main source of income for many investors, both private and public, forming a new speculative bubble.

With the impact of the coronavirus and lockdown in the USA, the profits of many corporations have taken a hit and ratings on leveraged loans have been slashed. Major companies such as Hertz and JC Penney have collapsed. According to a 29 May Bloomberg article, there were more corporate bankruptcies in May that in any month since the 2008 crash. *FT* reported that “Downgrades have outnumbered upgrades by a ratio of 43 to 1 over the past three months”, according to a unit of S&P Global. CLOs containing these bonds have been put on review for potential downgrade.

Despite all this, issuance of new corporate debt is soaring. Since the US Federal Reserve announced in late March it would spend US$750 billion buying corporate debt as part of its coronavirus response package, major US companies have had a field day with new bond issues. Bloomberg reported that by 28 May US$1 trillion of new corporate debt had been written for the year. In 2019 it took until November to reach the same amount of debt. The article reported that “deals were being rushed out at a clip never before seen in the history of US bond markets”. The proceeds are not exactly being ploughed back into the real economy; they are boosting cash reserves or funding share buybacks.

Furthermore, defaults on leveraged loans are skyrocketing. They exceeded US$10 billion for the month, reported S&P Global on 27 May. Over the last year defaults have increased by 270 per cent to US$37.4 billion, the highest level since early 2010. One of the only factors preventing a complete blowout is the increasing relaxation of regulatory standards, allowing greater flexibility to debt issuers including with “covenant-lite” loan structures. Over 80 per cent of leveraged loans are now cov-lite, says S&P, which means they have little to no protective covenants governing collateral or income checks—they are as dodgy as subprime mortgages.

Japan takes a hit; how safe is Australia?

Japanese bank Norinchukin was another factor keeping the CLO market afloat, as one of the few buyers of European securities over the last year. In its international search for profit it has soaked up 10 per cent of collateralised loan obligations, but at the end of the Japanese fiscal year in March it had lost US$3.7 billion on its investments and will now cease further purchases. This will have ripple effects worldwide. As a whole, Japanese banks hold almost 20 per cent of the world’s CLOs.

Norinchukin, which was named as a potential source of “repo” (short term loan) market instability in September 2019, pools funds of farmers and fishermen. Rather than lending within the sector, noted a 27 May *Wall Street Journal* article, it has found it more lucrative to speculate. During the 2008 crisis, Norinchukin took heavy losses from Collateralised Debt Obligations (CDOs), the credit derivatives based on US subprime mortgages. Proponents of CLOs, however, claim that triple A-rated tranches have never defaulted. “CLOs were the one thing that didn’t blow-up in [Nochu’s] portfolio last time around”, said a London-based loan fund executive cited in a February 2019 *FT* piece.

The same was said of triple A-rated CDOs before the 2008 crisis. Today, with “a global economy that is in deep recession”, *WSJ* quoted former head of US asset-backed securities research at Credit Suisse Rod Dubitsky, “The entire concept of triple-A CLOs goes out the window”.

In 2007 Australian councils, churches, charities and hospitals lost over AU$200 million invested in AAA-rated CDOs sold to them by Lehman Brothers subsidiary Grange Securities. The Reserve Bank of Australia reported in 2005 that “CDOs comprise[d] around 10 to 15 per cent of total local government financial assets, with some councils’ holdings substantially higher”. This raises the question, what are they investing equivalent funds in now?

A look at the statements of a handful of councils which previously made CDO losses revealed only general descriptions of investments, such as equity securities (shares) or unlisted (over the counter) equity securities; debt securities including bonds and notes, including floating rate notes (bonds with a variable interest rate linked to benchmark rates); and fixed income investments such as certificates of deposit. Some councils note maximum allowable investments within various ratings categories from AAA to BBB+; others specify that risks are managed with a diversified portfolio, purchases with high credit ratings only, and by seeking independent financial advice—not very reassuring, as all of those measures were also taken prior to 2007. All such investments carry risk and are exposed to unpredictable market movements dictated by the sinking global financial swamp. Some will carry more risk than others: Wingecarribee Shire in NSW reported that investment income for the year ended 30 June 2019 “exceeded budget expectations by AU$1.265 million”. That doesn’t happen without high risk.

Why do Australian councils continue to dabble in this domain as if they were fund managers? Following the 2007 scandal, a NSW councillor told the Citizens Party that while councils used to borrow to fund infrastructure and works projects, “Now there’s no government mechanism for them to do these kinds of major developments. So they’ve all basically been told to sit on their hands, that ‘No, you can’t have any additional funds’, so they have to build up a big nest egg before they can pay for anything. So they were more or less forced to invest this money, and now they’re losing it.” It is high time we rectified this with a national investment bank from which councils can borrow.

By Elisa Barwick, Australian Alert Service, 10 June 2020
