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Bonds and syndicated loans during the Covid-19 crisis: decoupled again?

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Bonds and syndicated loans during the Covid-19 crisis: decoupled again?

Key takeaways

- *Borrowing by non-financial firms in global debt markets surged following the Covid-19 shock. Bond issuance boomed, while syndicated loan originations trailed.*
- *Led by easier access to bond markets, large firms significantly increased their borrowing. The rest of the firms faced bottlenecks due to their reliance on a strained syndicated loan market and hurdles in switching to bond markets.*
- *Large firms, which had lower cash buffers pre-crisis than smaller firms, used part of the fresh credit to raise their buffers in addition to meeting liquidity shortfalls.*

Introduction

As economic activity slowed and uncertainty rocketed during the Covid-19 outbreak, non-financial firms dashed to debt markets – namely bond and syndicated loan markets – to secure funds for covering operational expenses, and possibly buttress their cash buffers. Policy initiatives accommodated this surge by boldly supporting bank-intermediated as well as market-based credit. The subsequent boom in borrowing was, however, uneven. Using data on global debt markets up to early June 2020, we document that bond issuance surged but syndicated loan originations trailed.

The decoupling of bond and syndicated loan markets is reminiscent of a broadly similar trend observed during the Great Financial Crisis (GFC). Although the current crisis did not originate in the banking sector, banks seem to be pulling in their horns as their lending capacities have been hit, and a dim economic outlook has made them more cautious. At the same time, collateralised loan obligation (CLO) issuance has declined and end investors have become more risk-averse – which has created additional blockages in the complex plumbing of the syndicated loan market.

At the firm level, the bulk of new borrowing has been raised by *large firms* – with revenues above $1 billion – reflecting their better access to the booming bond market.[1] Large firms typically had lower cash-buffers pre-crisis than other firms, and used part of the fresh credit to raise their buffers in addition to meeting liquidity shortfalls.

[1] We classify firms borrowing in debt markets as either large or mid-sized using a revenue threshold in line with usual industry practice (eg Dun & Bradstreet (2017)). Our findings are robust to alternative thresholds such as $2 billion. We further assume that firms in the debt market that do not disclose financial information are mid-sized; indeed, large firms typically need to disclose such information. Small firms (ie with revenues below $10 million) rarely borrow in debt markets.

Our findings draw on the worldwide bond issuance and loan originations by non-financial firms in debt markets, which is a major source of funding for large and mid-sized firms. As of end-2019, firms from 121 jurisdictions had outstanding bonds and syndicated loans.

Borrowing by firms in global debt markets: pandemic vis-à-vis the GFC[1]

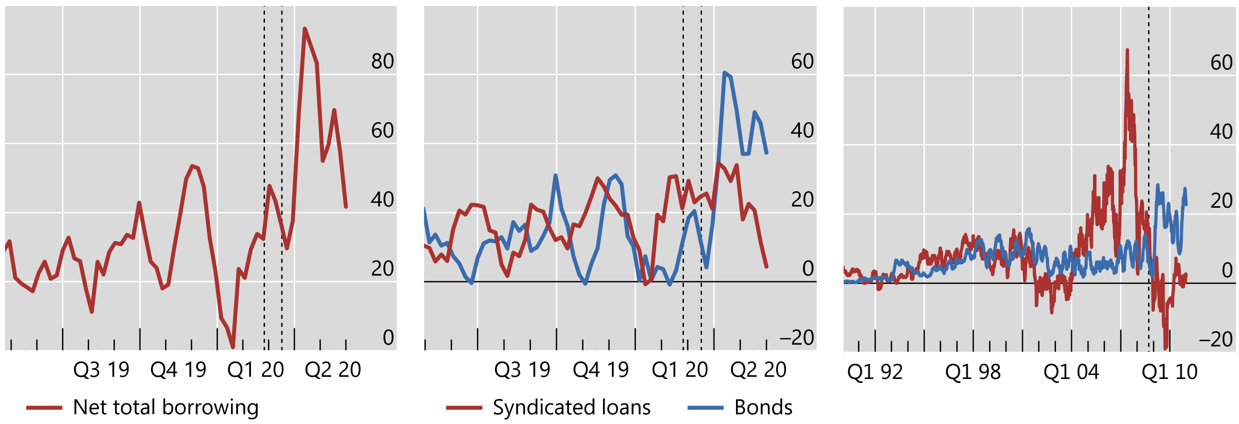
In billions of US dollars

Graph 1

Borrowing in debt markets boomed[2, 3]

Bond issuance and syndicated loan originations decoupled…[2, 4]

…in a repeat of a similar occurrence during the GFC[4, 5]



[1] All panels are based on global bond issuance and syndicated loan originations. Syndicated loans include term loans and credit lines. Net flows are computed as gross borrowing (issuances and originations) minus redemptions. [2] The dashed vertical lines indicate the last week of February (24 February–1 March) and third week of March (16–22 March), marking the spread of the turmoil to debt markets and the beginning of credit policies by the major central banks, respectively. [3] Total borrowing includes bond issuance and loan originations. [4] Net flows of bonds and syndicated loans. [5] The dashed vertical line indicates the second week of September 2008.

Sources: Dealogic; authors' calculations.

Global borrowing in debt markets boomed, driven by bond issuance

Borrowing by non-financial firms in global bond and syndicated loan markets surged at the height of the Covid-19 crisis, before moderating as financial conditions began to normalise (Graph 1, left-hand panel). Central banks played a pivotal role in accommodating the surge. From mid-March, many advanced economy central banks expanded existing corporate bond purchase facilities or set up new ones (Cavallino and Fiore (2020)). Some have purchased debt in both secondary and primary markets, and a few have included syndicated loans in their asset purchase programmes (eg the Federal Reserve). At the same time, credit guarantees and funding for lending programmes have been instigated to support bank-intermediated credit, such as via syndicated loans. By late March, these facilities accommodated a surge in overall borrowing in global debt markets.

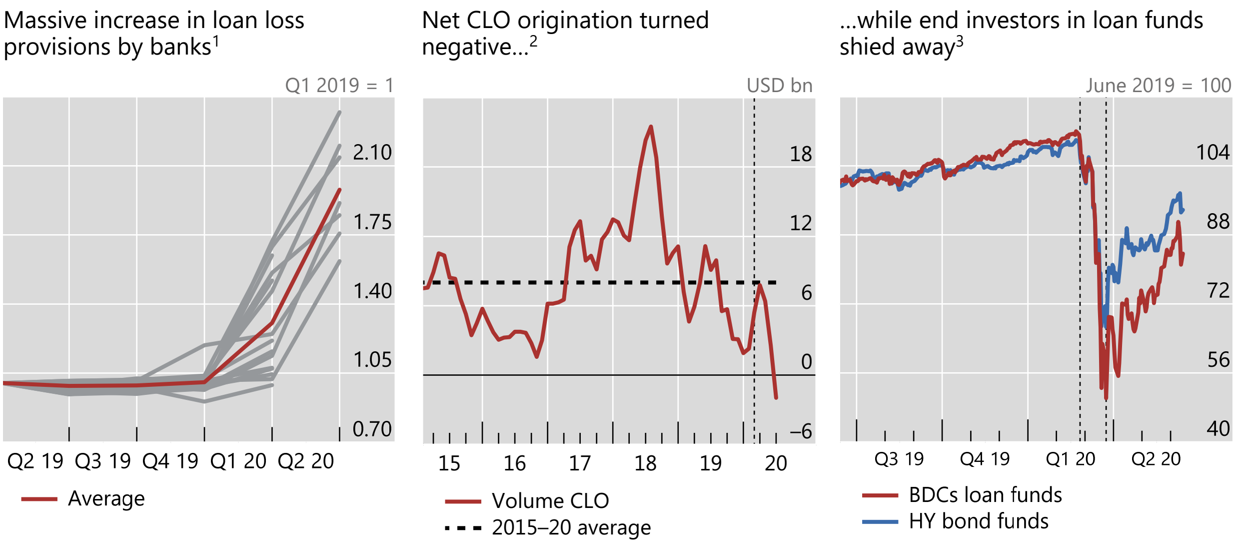
Yet the boom was mainly led by bond markets, while the syndicated loan market trailed (Graph 1, centre panel). Net bond issuance rose substantially relative to levels seen during the previous year. In contrast, syndicated loan originations did not follow the surge in bond issuance. This decoupling between bond and syndicated loan markets recalls a similar divergence observed during the GFC when market- and bank-based finance parted ways (right-hand panel and eg Adrian et al (2012)). A crucial difference, however, is that the current crisis, unlike the GFC, did not originate in the banking sector per se. This underscores the resilience of market-based finance in supporting firms when other forms of finance are strained (Claessens (2016)).

Drivers of strains in the syndicated loan market

Strains in the syndicated loan market stem from blockages in its complex plumbing, which features dependence on banks, CLOs and end investors.

Indeed, amid heightened global uncertainty and lower lending capacity, banks have become more cautious and have pulled in their horns. For one, large drawdowns of credit lines have increased the outstanding credit amount on banks' balance sheets. In the US, for instance, the total stock of drawn credit lines increased from about $650 billion as of end-2019 to $1,050 billion as of Q1 2020 (Federal Reserve Board et al (2020)). This increase amounts to almost 15% of the total (drawn and undrawn) credit line commitments by US financial institutions as of end-2019. The increase in credit exposure is likely to have pushed banks closer to regulatory and internal risk management limits, not least because of an increase in the risk weight of the exposures. In addition, the expected surge in non-performing assets has led banks to massively increase loan loss provisions (Graph 2, left-hand panel), which has probably hampered both balance sheet space and risk appetite.

Drivers of strains in the syndicated loan market — Graph 2



[1] Loan loss provisions by 15 major syndicated loan-arranging banks globally. Q2 2020 data are not available for some banks. [2] Net issuance of collateralised loan obligations, as a three-month moving average. The dashed vertical line marks February 2020, when the turmoil spread to debt markets. [3] BDCs loan funds = Wells Fargo Business Development Company Scoreboard Weighted Index. HY bond funds = PIMCO High-Yield Corporate Bond Index. The dashed vertical lines indicate the last week of February (24 February–1 March) and third week of March (16–22 March), marking the spread of the turmoil to debt markets and the beginning of credit policies by the major central banks, respectively.

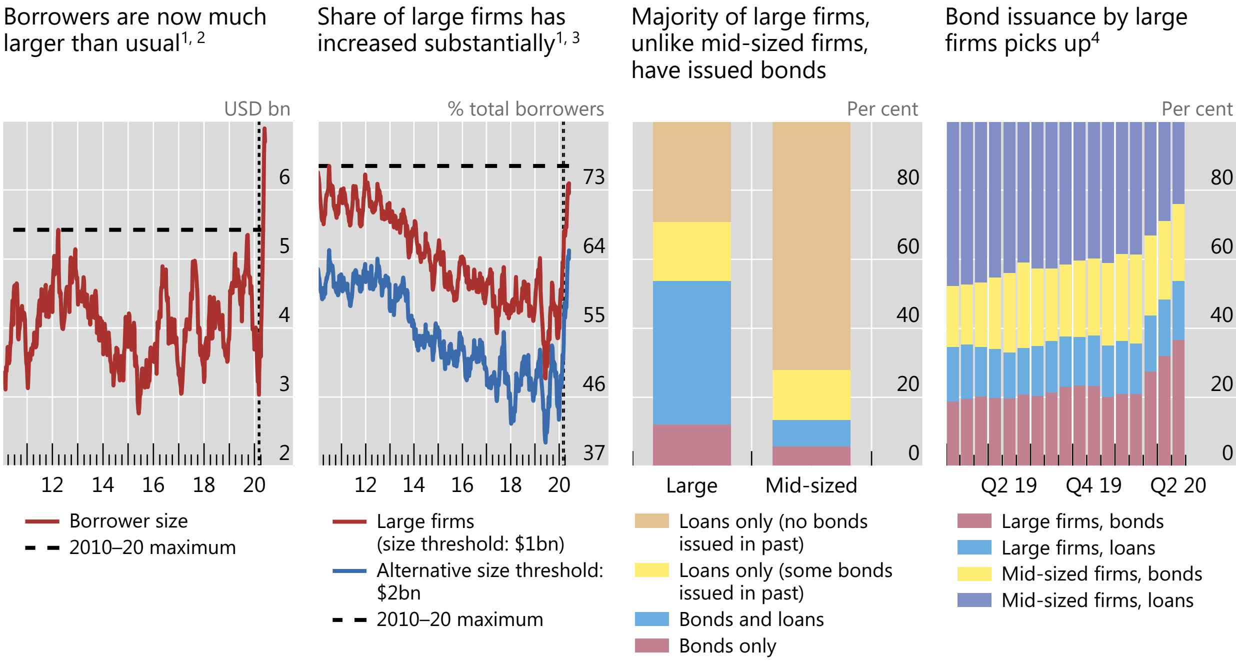
Sources: Dealogic; Refinitiv; SNL; authors' calculations.

At the same time, other parts of the syndicated loan market have faltered too. For one, issuance of CLOs, which pool and securitise syndicated loans to sell rated tranches to end investors, has slowed and turned negative in net terms (Graph 2, centre panel). Likewise, loan funds and exchange-traded funds, a major source of liquidity in the secondary market, have seen large outflows. In addition, a larger decline in loan fund indices relative to bond fund indices of similar credit rating suggests potential investor aversion (Harmon and Ivashina (2020)) to the syndicated loan market (right-hand panel).

Large firms capitalise on easier access to bond markets

A firm-level perspective shows that borrowing by large firms in debt markets has outpaced that of mid-sized firms. The average size of borrowers (in revenue terms) in debt markets is twice that at the beginning of the crisis, and well above the levels registered during the GFC (Graph 3, first panel). One manifestation of this shift is the fact that the number of large firms – with annual revenues above $1 billion – tapping debt markets, has risen. By late May, they accounted for more than 70% of all borrowers, which is close to the highest level in the last 10 years (second panel). Alternative thresholds for identifying large firms, such as $2 billion, lead to a similar takeaway. The share of the rest of the firms borrowing in debt markets, mid-sized firms, has shrunk as a result.

Large firms used easier access to bonds to gather the bulk of the new borrowing | Graph 3



[1] Three-month moving average. The dashed vertical line indicates the third week of March (16–22 March), marking the beginning of credit policies by the major central banks. [2] Revenue of firms issuing bonds and syndicated loans (median value). Korean bond issuers are excluded due to the idiosyncratic characteristics of the domestic bond market where they borrow, featured by frequent issuances of small amounts. [3] Large firms are those with revenues above $1 billion. [4] Number of borrowers, as a three-month moving average. Korean companies are excluded due to the idiosyncratic characteristics of the domestic bond market where they borrow, featured by frequent issuances of small amounts.

Sources: Refinitiv; Dealogic; authors' calculations.

The preponderance of large firms in new borrowing reflects their better access to the booming bond market and the lesser reliance on the strained syndicated loan market. More than 70% of the large borrowers had outstanding bonds at the onset of the pandemic or have issued bonds in the past. By contrast, two thirds of mid-sized borrowers have never issued a bond (Graph 3, third panel). For large firms, widespread experience in bond markets makes it easier to issue bonds now. For one, they have the right relationships with security underwriters. In addition, informational asymmetries vis-à-vis investors are smaller (Diamond (1984)) – indeed, investor demand is probably stronger for larger firms that tend to be more well known. Moreover, these firms have already paid the fixed costs associated with bond issuance (eg registrations), which can be prohibitively high for an entrant (Krishnaswami et al (1999)). All these aspects seem to have paved the road to bond market access for large firms during the current crisis, thus driving a pickup in the share of bond issuance by these firms during Q2 2020 (fourth panel).

The greater share of large firms in new borrowing occurs despite the fact that they may be facing lower or comparable liquidity shortfalls compared with mid-sized firms. First, large firms are not concentrated in the harder-hit sectors (Graph 4, first panel), suggesting that the negative shock to revenues is not stronger than that experienced by mid-sized firms. Second, large firms face lower near-term refinancing needs on the back of longer average maturity of their debt and a much smaller share of debt maturing in 2020 (second panel). Third, a lower pre-crisis labour expense-to-revenue ratio suggests that, all else equal, the contraction of revenues coupled with sticky labour expenses is likely to lead to lower funding needs compared with mid-sized firms (third panel). Moreover, large firms are unlikely to be on the receiving end of a flight to quality by risk-averse investors. The financial soundness of large firms, as assessed by the Altman Z-score is only marginally better than that of mid-sized firms (third panel).

Large and mid-sized firms: liquidity shortfalls and credit quality — Graph 4

Large firms are less prevalent in harder-hit sectors…[1] | …and face lower rollover risks[2] | Large firms have lower sticky expenses and similar credit quality[2] | Large firms had lower cash ratios at the onset of the shock[3]

[1] Based on US firms. The drop in employment during March–May reflects the size of the shock to the sector. The red dots represent the two hardest-hit sectors (left to right): Accommodation and Food Services; Arts, Recreation and Entertainment. R-squared upon excluding these sectors is 0.16. [2] The boxes show the interquartile ranges for public firms with outstanding loans and bonds as of end-2019. [3] Cash ratio is the cash and short-term assets to total assets.

Sources: Refinitiv; US Bureau of Labour Statistics; authors' calculations.

The rationale for borrowing by large firms: liquidity shortfalls or precautionary motives?

While large firms have probably used borrowing proceeds to meet short-term liquidity shortfalls, some indicators suggest that these firms are building precautionary buffers too. Plummeting revenues have most likely created liquidity shortfalls (Banerjee, Illes, Kharroubi and Serena (2020)) and companies may be using proceeds to meet operating expenses. But at the same time, economic uncertainty may have induced these firms to self-insure by raising their cash buffers via new borrowing. This motive may be particularly strong in the case of large firms that typically had lower cash buffers compared with mid-sized firms before the crisis (Graph 4, fourth panel). Indeed, a positive correlation between new long-term borrowing and change in cash-to-asset ratios during the first half of 2020 (Graph 5, first panel) suggests that large firms used part of the proceeds to increase their liquidity buffers. Relatedly, the cash ratios of large firms rose sharply – a pattern which recalls a similar experience in the aftermath of the GFC (second panel).[2]

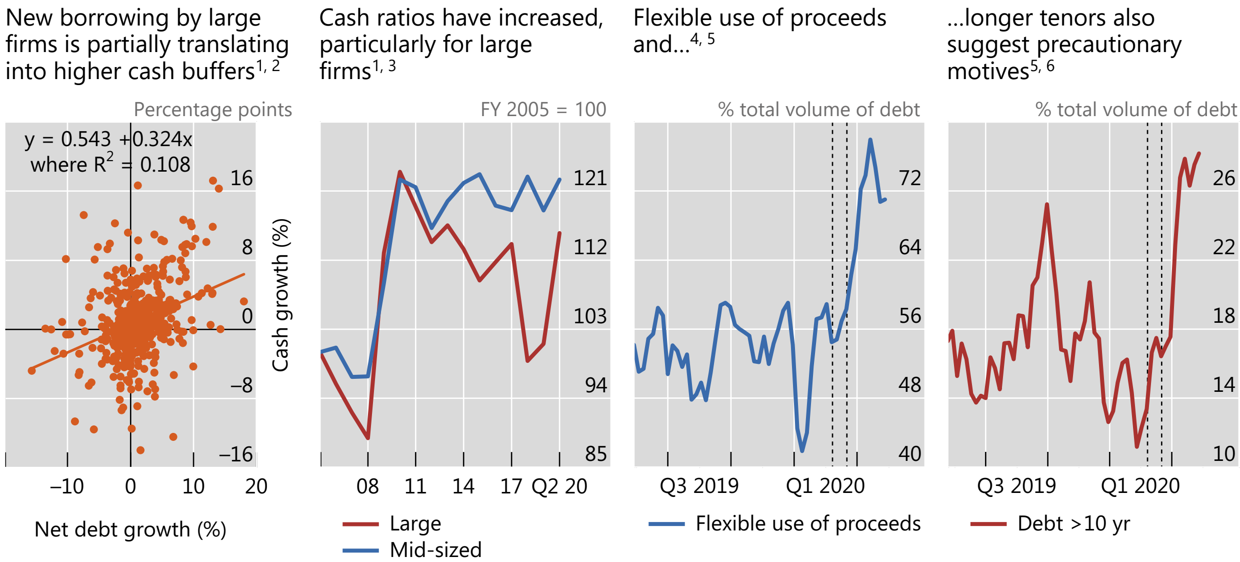
Contractual features of new security issuances also point to precautionary motives. The share of new borrowing that is not earmarked for specific purposes (such as capital expenditures) increased significantly, which suggests that borrowers aimed for financial flexibility (Graph 5, third panel). Likewise, an increase in the average tenor of issuances points to firms' striving to avoid near-term refinancing needs (fourth panel).

Our analysis suggests that large firms have used fertile conditions in bond markets to not only meet funding shortfalls but also secure precautionary liquidity buffers. Like in the aftermath of the GFC, large firms may gradually use or decommission these buffers (Graph 5, second panel), and thus better cope with

[2] The increase in buffers is also likely to be driven by drawdowns of credit lines to which large firms typically have access.

economic uncertainty. However, dominance in bond-based borrowing by large firms could crowd out mid-sized firms, which are also creditworthy and may exhibit significant liquidity needs.

How are firms using borrowing proceeds? Graph 5



[1] Sample of firms includes all the constituents of the Thomson Reuters Global Index which had disclosed financial information for Q2 2020 as of 6 August 2020. [2] Large firms are those with revenues above $1 billion. Net debt is the long-term debt-to-total assets ratio. Cash is the short-term assets-to-total assets ratio. Growth between Q4 2019 and Q2 2020. [3] Cash ratio is cash and short-term assets to total assets. [4] Flexible use of proceeds debt excludes debt raised specifically for capital expenditures, working capital, refinancing debt, buyouts or financial purposes (eg share buybacks). [5] The dashed vertical lines indicate the last week of February (24 February–1 March) and third week of March (16–22 March), marking the spread of the turmoil to debt markets and the beginning of credit policies by the major central banks, respectively. [6] Originations with an original maturity above 10 years.

Sources: Dealogic; Refinitiv; author's calculations.

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