

A finance view on EU Bankruptcy Reform

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Leverage trends

- Corporate debt used to fund investment
- Now, leverage in healthy firms is falling
- Leverage levels are becoming skewed
- Concentrated in HLT/buyouts
 - Rising in sunset sectors, sharply

Soft or hard bankruptcy ?

- Choice depends on cause of excess debt
 - **Bad market conditions ?**
 - Then soft rules are helpful
 - **Deliberate leveraging up ?**
 - Not to encourage withdrawal of committed capital

How to favor the right motive

- APR serves to protect dispersed, unsecured debt
- If not.. claw back option ?
 - Last 2 years of payment to equity must be returned to the estate
 - Not likely to be introduced

Stability concerns about RPR

- Greater risk for unsecured debt
 - Secured creditors become kingmakers
 - Huge incentive to withdraw equity
 - Less capital commitment by shareholders
- Risk not priced in nonmarket debt
 - Weak position for trade, labor, tax claims
- Market discipline: is bond risk well priced?

Late stage in a long credit cycle

Bond pricing tends to miss rising risk late in the cycle

Lenders now accepting very low risk pricing
Covenants have become dramatically thin

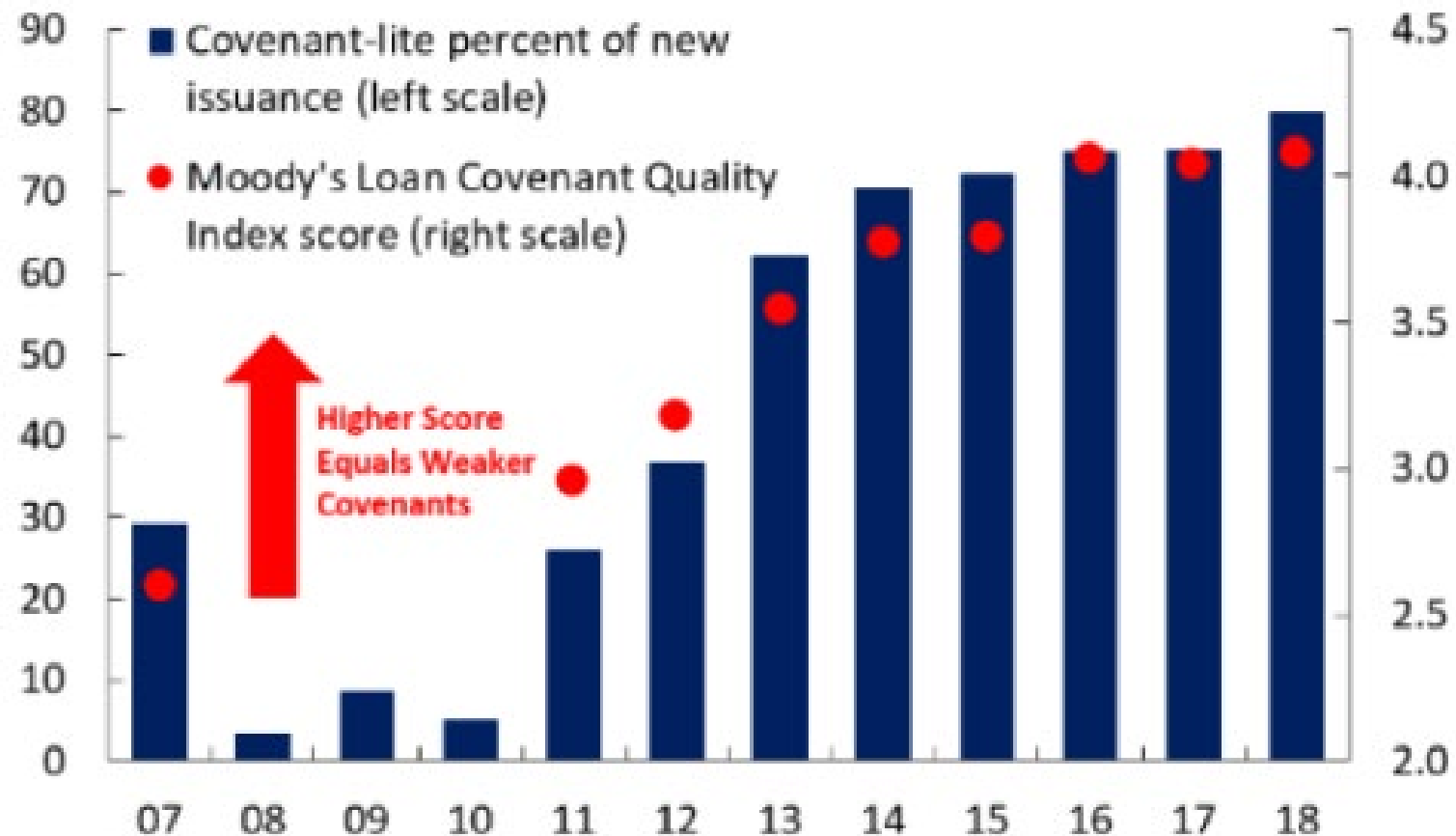
Unsecured bonds only protected by cash flows
In a recession, only by APR

High default and illiquidity risk in next recession

Less investor protection

The volume of loans with fewer investor protections, known as covenants, has grown in the United States, and quality has weakened.

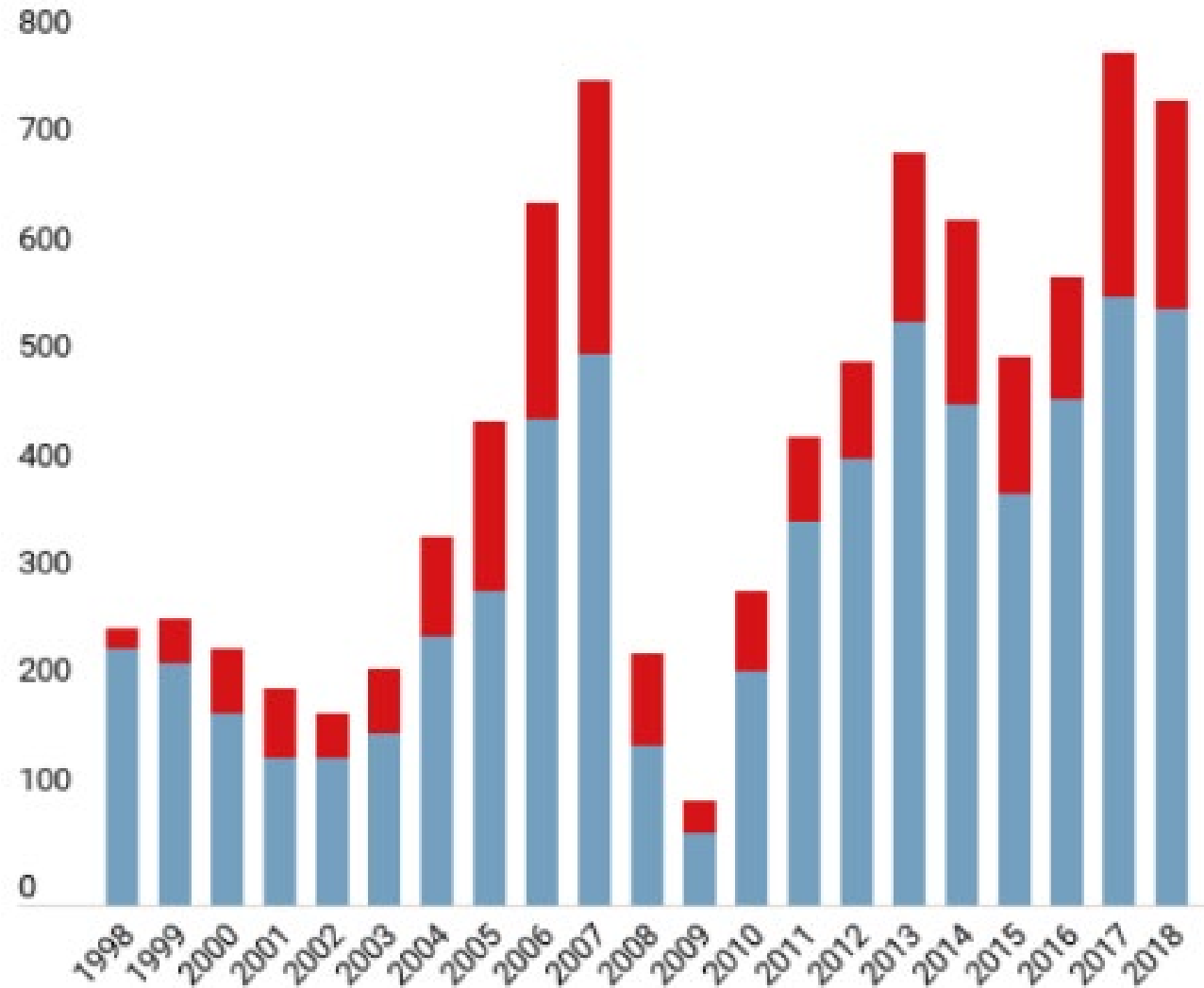
(percent of issuance)



Levering up

Global issuance of leveraged loans has been growing since the global financial crisis.

(in billions of dollars)



Data suggests excess credit supply

Savings may exceed profitable investment

Financial stagnation: more money than good ideas

Low growth and zero interest rates

Credit supply pressure reduces standards

- Banks desperate to lend
- Agree to a steep fall in standards
 - Covenant-light debt, wafer-thin EBITDA
- Securitized as CLOs
 - However, large European banks are retaining a lot of CLOs

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 - Déjà vu...

Comments by Prof Jeremy Stein from his ESRB speech
(Dec 2019)

Top Harvard professor, ex Fed board member

Comments by
Prof Jeremy Stein
(Harvard, ex Fed
board member)

ESRB speech Dec
2019



Rapid credit expansions with

High share of HLT

Aggressive pricing

Lower-quality issuance

Falling covenants

end badly

for lenders and the real economy

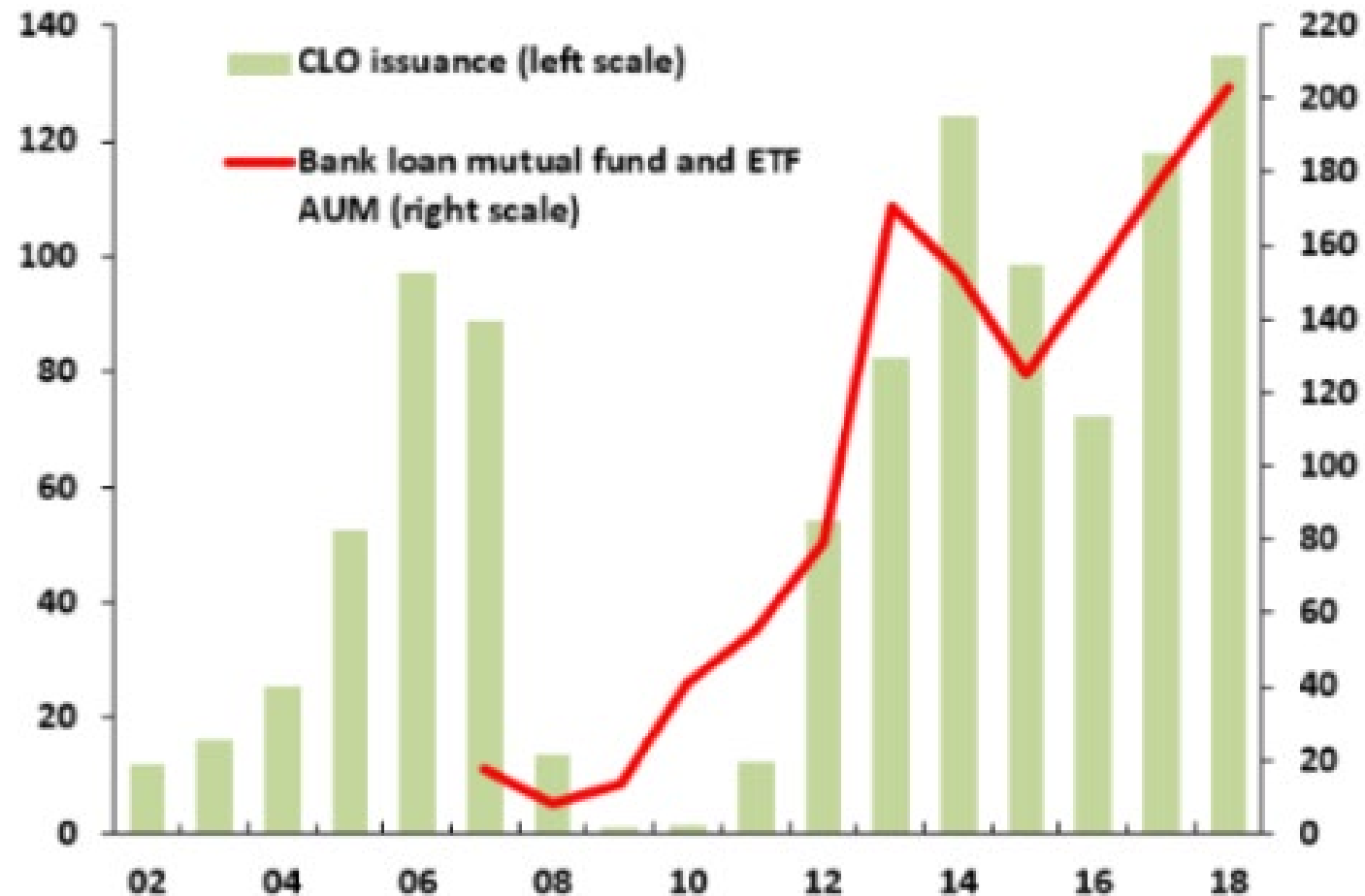
Minimal debate so far

- Bankruptcy rules obscure
- Central banks worried about NPLs
 - May be complacent about non bank creditors
- Inattention to illiquidity risk
 - Lots of central bank liquidity
- Legal uncertainty creates huge unknown risk factor
- Concerns emerging:
 - FSB alarmed by rapid rise in covenant-light CLOs
 - Bank of England: huge liquidity risk in redeemable bond funds

Less transparent

Increasingly, leveraged loans in the United States are held by collateralized loan obligations and asset managers.

(CLO issuance and loan fund assets, in billions of dollars)



Bankruptcy always affect stability

- Every **bankruptcy reform shifts risk bearing**
- Eg: tightening of safe harbor norms in 2004-05
- Led to repo and derivative boom
- Collateral demand boosted subprime mortgage lending
- Fire sales of collateral upon default
- Key to liquidity crisis 2007-2008

Effects of illiquid securitization



Effects on liquidity risk

- RPR likely effects
- Losses given default > historical experience
 - Covenant-light debt already less protected
- Higher legal uncertainty on recovery
- **Risk of major jump in illiquidity**
 - Runs on bond funds holding CLOs
 - Some European banks quite exposed

Dropping APR may be a bombshell

- Losses given default would be way above historical experiences
- Covenant light debt tightly priced
- Legal uncertainty on RPR would lead to jump in illiquidity
- Run on bond funds holding CLOs

What about the Capital Market Union ?

- European finance system is heavily bank based (esp after Brexit)
 - Countries where banks are dominant have higher cyclical risk, force larger bailouts
- To boost bond markets, EC push for a EU directive to harmonize bankruptcy rules
 - In the end, risk of creating a soft bankruptcy hub
- Undermining APR would undermine bond markets