Banks face losses in the billions as loans go bad

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Banks in Britain could face losses of more than £15 billion on loans that backed leveraged buyouts and other highly geared transactions, research suggests.

These loans risk going sour as an economic slump affects the cashflow of companies with heavy debts. Insurers, hedge funds and small investors in corporate bond funds are also at risk.

Fideres, a specialist finance consultancy based in London, expects direct losses worldwide from leveraged loans to top $100 billion, with losses in collateralised loan obligations of another $100 billion, based on information known so far.

Collateralised loan obligations are packaged-up pools of leveraged loans, which are then divided into different tranches of risk to suit different investors. They are similar to the sub-prime collateralised debt obligations — packaged pools of higher-risk mortgages — that went badly wrong in the 2007-09 financial crisis.

Alberto Thomas, co-founder of Fideres, predicted: “It is going to be two to three times worse than in the global financial crisis.” He put likely UK bank losses from leveraged loans alone at between £15 billion and £20 billion.

The scale of speculative-grade or “junk” lending to the world’s companies has exploded in the past decade. In December, the Financial Stability Board estimated it at somewhere between $1.4 trillion and $3.2 trillion, depending on definitions. These loans typically are below the lowest rung — BBB — of investment-grade securities, amount to more than four times profits before tax and other charges and have few or no covenants to protect lenders when borrowers get into difficulties.

Lenders today are much more exposed than they were in the aftermath of the banking crisis, Mr Thomas said. So-called covenant-lite loans accounted for only 14 per cent of leveraged loans in 2008, but that proportion has grown to 76 per cent today. Covenants are conditions attached to loans that give lenders much more protection in difficult times.

Struggling borrowers are also more likely to default than they were in the last crisis, he said, because central bankers then were able to slash interest rates, dramatically lessening interest bills on loans linked to benchmark rates, such as Libor. This time official interest rates are at or close to zero.

British banks own about $120 billion of leveraged loans on their balance sheets. They also invest in collateralised loan obligation bonds, although usually the more senior tranches, putting them at less risk of serious losses here. Hedge funds and some higher-risk corporate bond funds are likely to be the main losers from collateralised loan obligation investments because they buy the riskier tranches chasing yields as high as 14 per cent.

However, mainstream corporate bond funds bought by small investors will not be immune. M&G Optimal Income, a popular £16 billion fund, has 9 per cent of its assets in junk bonds.