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Edison Explains

The global credit market

Has the global credit market recovered from the 2008 financial collapse?

Why was the European credit market hobbled by the 2008 financial collapse?

During the financial crisis, a significant proportion of bank assets had to be written down because of mark-to-market (MTM) accounting.

MTM required assets to be revalued quarterly in reference to the price they would fetch on the open market. So when the market became paralysed by the financial crash, these assets could no longer be sold at a reasonable price as there was no demand for them.

This caused the value of the banks' assets to fall, even when the underlying loans and bonds were being serviced and the borrowers were financially stable, shrinking the global credit market significantly.

How has the modern credit market been affected by the 2008 financial collapse?

Following the financial crisis, banks were more wary of risky debt and slowly receded from the market.

At the same time, regulators put in place new rules, such as the Basel III regulations, requiring high bank capital ratios, more stringent stress assessments and clear requirements on liquidity, making it unattractive for banks to retain sub-investment-level debt.

Especially for large investment and wholesale banks designated, as Global Systemically Important Banks, on which much tougher requirements were levied.

As a result, the market has shrunk somewhat as banks withdrew from global credit, allowing new investors to enter the market.

Smaller investors are now purchasing sub-investment-grade debt from lending banks, as well as originating loans themselves.

What are primary and secondary investments?

Primary investments are made close to par value, the face value of a bond when it was released. An investor buys secondary investments from the original lender or another investor.

As the value of investments rises and falls due to the market perception of their credit quality, overall demand and the liquidity of the market, secondary investments can give investors the opportunity for capital gains, often as a result of buying at an attractive entry point rather than when bonds are released at face value.

How diversified is the modern global credit market?

Since the financial crisis, the credit market has diversified heavily, with banks representing a smaller percentage of the market than before.

This is especially the case in the US, where direct lending institutions and collateralised loan obligations (CLOs) are growing in popularity.

In Europe, the market remains undiversified, but is catching up to the US with banks comprising 25% less of the leveraged market in 2016 than in 2002–2016. This compares favourablasy to an equivalent decrease of only 9% in the US.

How do capital structures work?

Bank capital ratios

Bank capital ratios are the percentage of a bank's core capital to its risk-weighted assets

Basel III's regulatory framework has required banks, since 2015, to have a bank capital ratio of 7.0%.

It is partly this high ratio of capital to assets that has made banks wary of retaining large amounts of sub-investment loans.

Capital structures define who gets returns on their investments and in which order.

Those who are high up in the capital structure get repaid first and would get a return from any sold assets in the event of bankruptcy before those with a lower standing in the structure.

First-lien senior secured loans are the first to be repaid and provide some security on repayment, but offer low yields on regular payments.

Second-lien loans offer high yields, but on bankruptcy would be repaid if there were sufficient assets remaining after the repayment of first-lien lenders.

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A payment-in-kind (PIK) is traditionally a high-risk investment, as all of the return comes at the end of the investment term, rather than in regular payments.

Is the European market competitive post-2008?

The size of the European credit market is smaller than that of the US.

This is a result of European assets being excluded from EU (open-ended) funds because of a lack of liquidity that leaves them too risky for the EU's risk management regulations, leaving European access to the market limited.

As a result, European managers can take a long-term view as the closed-ended structure of European funds means they do not have to cope with frequent inflows and outflows of capital.

On the other hand, with spreads on investment-grade and high-yield corporate bonds at low levels, and risk-free rates also close to historical lows, funds with the ability to invest more flexibly across credit markets, such as those in the US, may hold greater appeal for investors.

Which funds are developing well in the specialist global credit market?

Specialist debt is a relatively new area of focus for funds and investment trusts, with few trusts having a 10-year track record.

Two investment funds with records of more than three years are Alcentra Euro Floating Rate (AEF.L, Mcap $154m) and the NB Global Floating Rate Income Fund (NBLS.l, Mcap $967m).

At 30 June 2017, the Alcentra fund had a five year cumulative net asset value (NAV) total return of 32.0% and a income only yield of 4.3%. NB Global's five-year cumulative NAV total return was 18.9%, with a dividend yield of 3.8%.

Meanwhile, CVC Credit Partners (CCPG.L, Mcap $445m) saw a NAV total return of 23.2% in a 3 year period, while Chenavari Capital Solutions' three-year cumulative NAV return was 14.3%.