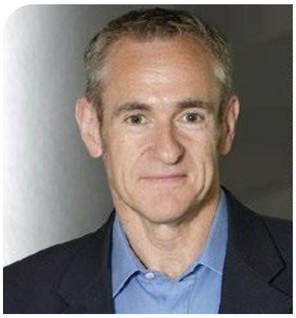
New accounting rules could be the axe that decapitates zombie credits



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Weak borrowers are likely to be hit as lenders start accounting for expected losses

When the debt capital markets imploded in the wake of the global financial crisis, weak companies were able to turn to banks for help. The banks looked through covenant breaches, negotiated waivers and rolled lines until — newly flush with central bank largesse — the public debt markets once again opened for business. However, a joint project between the International Accounting Standards Board and the Financial Accounting Standards Board has produced new methodologies — IFRS 9 and Current Expected Credit Loss (CECL), respectively — for loan-loss recognition, which could change bank (and possibly non-bank) behaviour towards weak borrowers.

The rules come into play over the next two years and may result in less favourable pricing, shorter maturities or possibly even non-extension of credit to weak companies in the corporate sector. Given already stretched valuations in high yield and loans, this could be a cause for concern.

The logic is sound enough. The old regime, which booked reserves against losses that had actually been incurred on a loan asset, meant that the reserves functioned as an umbrella that only opened once the storm had passed. It was argued that such an approach also fostered pro-cyclical behaviour in lenders, forcing them to withdraw capital from lending at the very time when credit was squeezed. Although IFRS 9 and CECL differ on some key details, the thrust of their approach is the same: to book reserves at the inception of a loan against expected credit losses over the life of the loan, thereby boosting loss-absorbing capital in anticipation of a loss (and theoretically in times of plenty) rather than after its occurrence (when money is tight).

This approach involves estimating future cash flows from the loan asset, calculating remaining cash flows should a default occur and applying a probability of default to the shortfall to produce an expected loss reserve. In other words, banks must develop modelling systems that include longer-term economic projections. They must also produce auditable forecasts to assess the collectability of cash flows from a loan. IFRS 9 is slightly less draconian in allowing a bank to use a 12-month expected credit loss until the level of risk in a loan rises, whereas CECL demands a lifelong measure from the outset.

While the regulators tolerate a range of risk models, there are clear external signals that betoken a deterioration in a borrower and the need for the lender to assume a higher probability of default and, by extension, higher reserves. The most obvious of these are rating agency downgrades, especially when a credit crosses from investment grade to high yield and begins an exponential rise in default probability. In addition, the longer the maturity of a loan, the higher its lifetime probability of default (all other things being equal). These considerations may give lenders pause for thought when extending credit to high yield companies. More onerous reserving requirements may lead to higher pricing, credits being kept on a shorter leash in terms of facility maturities or possibly lenders simply saying 'no thanks' to certain kinds of business.

Not just banks and loans are affected

Covenant breaches, inasmuch as they signal a deterioration in credit quality, could also result in banks rethinking their positions and discourage waiver negotiation and facility extensions — a marked departure from behaviour after the last crisis. Note, too, that these initiatives encompass not merely banks but all entities holding financial assets not accounted for at fair value through net income. They stretch beyond loans to undrawn facilities, other debt securities, trade receivables and off-balance sheet credit exposures.

To date, we have not seen too much fall out. Indeed, most European banks experienced falls in CET1 ratios of only 10-34 basis points, with outliers posting 80-100bp declines on implementation of IFRS 9. However, the impact on lending to weak credits if the economy deteriorates and downgrades gather steam is a concern. The ranks of drain-circlers (credits rated B3 negative outlook or below) swelled 10% over the course of 2019 and their access to bank credit could become, at the very least, prohibitively expensive.

These rules could prove to be the axe that decapitates zombie credits, should the debt capital markets tire of propping them up. With high yield spreads barely providing breakeven compensation for average cumulative five-year default rates, this new liquidity challenge to high yield does not appear to be priced in. Levering investment grade looks safer and more lucrative.