Summary

The balance of power in the U.S. leveraged loan market continued to shift from creditor to borrower as protective covenant packages declined further during the first five months of 2007. The deterioration occurred amid vibrant and aggressive overall leveraged loan issuance. Fitch's recent review of 4,500 rated leveraged loans that came to market between January 2006 and May 2007 revealed that the pronounced drop in the frequency of certain key covenants—a trend that began in 2005—persisted in 2006 and accelerated in the first five months of 2007. Among our findings:

- The percentage of leveraged loans containing a coverage covenant of any type dropped to 44.3% from 68.1% in 2006 and below the 1996–2006 average of 78.1%.
- The percentage of loans containing leverage covenants of any type fell to 51.1%, down from 69.6% in 2006 and below the 1996–2006 average of 72.8%.
- Along with the general demise of covenant packages has been the growth of specific “covenant-lite” loan issuance. In 2007 through May, $47 billion of “covenant-lite” transactions—those typically containing no financial covenants at all—have come to market; more than twice the level of covenant-lite issuance in all of 2006.

![Graph showing Frequency of Occurrence of Key Covenants and Non-Investment Grade Ratings Mix](image)
U.S. Leveraged Loan Covenant Decline Accelerating in 2007

The torrid pace of overall leveraged loan issuance has continued in 2007 (see Leveraged Loan chart above). After topping $600 billion in 2006, leveraged loan issuance totaled $217 billion in the first quarter of 2007—a 65% increase over the first quarter of 2006. The high level of activity is being made possible largely by the demand coming from non-bank investors, such as CLOs and hedge funds, that continue to pump liquidity into the market. These non-bank investors appear willing to absorb the increasingly “protection-lite” transactions. Banks, meanwhile, in addition to playing a smaller role in the market, have begun to signal a shift to a more neutral stance in terms of their credit standards (see Net Percentage of Banks chart below).

Covenant Decline Is Broad-based
Examining data from Reuters/LPC, Fitch conducted a review of 4,500 rated leveraged loans ($2 trillion in par value) that came to market between January 2006 and May 2007 and which contained at least one covenant. Fitch’s survey revealed that the pronounced drop in the frequency of many key covenants—a trend that began in 2005—persisted in 2006 and has visibly accelerated in the first half of 2007. Further, the decline in covenant protection, with the exception perhaps of sweep covenants, has been broad-based (see Frequency of Covenants table on page 3).

The percentage of loans containing an interest coverage covenant—a critical protection for creditors to low-rated firms—fell to 29.5%, down from 42.1% in 2006 and well below the 1996–2006 average of 50.9%. With the frequency of other types of coverage covenants declining, the percentage of loans containing a coverage covenant of any type dropped to 44.3% from 68.1% in 2006 and below the 1996–2006 average of 78.1%.

The percentage of loans containing a leverage covenant, another important creditor protection, declined as well, falling to 51.1%, down from 69.6% in 2006 and below the 1996–2006 average of 72.8%.
Corporate Finance

**U.S. Leveraged Loan Covenant Decline Accelerating in 2007**

The percentage of loans containing a debt-to-cash flow covenant—the most common type of leverage covenant—declined to 44.3% from 59.9% in 2006 and well below the 1996–2006 average of 60.4%.

Concomitant with the general demise of covenant packages has been the growth of specific “covenant-lite” loan issuance (see Covenant-Lite chart at left). Historically, covenant-richness has been one of the defining characteristics of the leveraged loan market, but through May, $47 billion of “covenant-lite” transactions—those typically containing no financial covenants at all—have come to market. This is more than twice the level of covenant-lite issuance in all of 2006.

**Aggressiveness of Deals Coming to Market Continues to Rise**

In nearly any environment, such a radical deterioration in creditor protection would be cause for concern. Exacerbating the current trend, however, is that it is occurring amid an evermore aggressive rating mix of deals coming to market. One metric of this aggressiveness—the number of single-B and lower rated loans as a percentage of total leveraged loan issuance—rose to more than 65% in the first five months of 2007, an 11-year high (see Frequency of Occurrence chart on page 1).
Benign Default Environment
Enabling Structural Weakening

The near absence of corporate defaults appears to be a major factor behind the decline of key structural protections in the leveraged loan market. The trailing 12-month U.S. high yield default rate continued to run well below average at the end of May, ending the month at just 0.6%, down from the 0.8% recorded at year’s end (see High Yield Default chart above). As Fitch discussed in a recent commentary (see the Fitch report, “Scarce Defaults in the First Quarter Continue to Fuel Low Quality Issuance,” dated April 23, 2007), this lack of defaults is helping to create a self-perpetuating and troubling pattern, whereby the low default rate enables deep speculative grade borrowers to get easy access to the loan and bond markets, and at increasingly favorable terms, as shown by the covenant trends discussed above. The result: near-term defaults are avoided, which fosters some level of complacency and higher risk tolerance, ultimately allowing new issuance to take on even more aggressive characteristics. However, should economic growth soften more than anticipated or some other shock hit the market, the growing share of low quality loans and bonds (at the end of May for example, bonds rated ‘CCC’ or lower represented a very meaningful 18% of outstanding high yield issues) will come under significant pressure. In other words, while defaults remain very low, risk in fact continues to move in the opposite direction.

*As of May 31 year to date. Source: Fitch calculations.