Capital markets

OECD warns on risk of 'fallen angels' in swollen bond markets

Decade-long boom in debt issuance creates $500bn of debt on the cusp of junk rating

In January Federal Reserve chairman Jay Powell cited corporate debt as a risk that could amplify a potential downturn © Bloomberg

Delphine Strauss in London 10 HOURS AGO

Corporate bonds worth about $500bn could become "fallen angels" within a year of a downturn, according to the OECD, after a decade-long boom in debt issuance.

The volume of outstanding corporate debt has doubled in real terms in the ten years since the global financial crisis, the Paris-based international organisation noted on Monday, with bonds issued by non-financial companies totalling almost $13tn at the end of 2018.

Companies from advanced economies, which account for four-fifths of the total bonds outstanding globally, have seen volumes grow from almost $6tn in 2008 to $10.2tn in 2018. The total outstanding from companies in emerging markets, meanwhile, has almost quadrupled over the same period, as Chinese issuance grew from negligible amounts to $590bn in 2016.

That explosion of issuance, however, has driven down the overall quality of corporate debt. Triple B-rated bonds, the lowest investment-grade rating, accounted for 30 per cent of all investment grade bonds outstanding in 2008. By 2018, they made up 54 per cent of issuance, according to the OECD, with a corresponding decrease in highly rated bonds.

The OECD notes that its own proprietary index of corporate bond ratings, weighted according to the amounts outstanding, has now been below triple B plus for nine consecutive years — the longest period since 1980. That raises the risk that a future downturn would result in significantly higher default rates than in previous credit cycles.

“We are in quite different territory [from 2008],” said Mats Isaksson, head of corporate governance and corporate finance at the OECD.

The OECD’s comments echo recent warnings from central bankers and investors, who worry that corporate bond markets may be vulnerable if global growth slows and central banks put crisis-era asset purchase programmes into reverse.

In January Jay Powell, chairman of the US Federal Reserve, cited corporate debt as a risk that could amplify a potential downturn, if highly leveraged companies were forced to resort to lay-offs.

The OECD’s analysis suggests that in a market shock similar to 2008, corporate bonds worth about $275bn could be downgraded to non-investment grade within a year. Including debt issued by financial companies, this group of “fallen angels” could total almost $500bn in total outstanding within the year.

This would put significant pressure on the relatively illiquid market for non-investment grade debt. Because many investors are unable to hold junk-rated bonds, companies can face a sudden rise in borrowing costs if their rating slips below investment grade.

The OECD also notes there has been a marked decrease in bondholder rights, in the form of scrapped or weakened covenants, that could “amplify negative effects in the event of market stress”. Covenants are clauses in a bond contract designed to protect the interests of investors, such as capping the total amount of debt that a company is allowed to take on.

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