

Bank Loans – Risks are Rising

By Larry Eiben and Eric Newman
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As you know by now, Thirdline's primary expertise is real estate credit though our broader mission is to help "income seeking" investors. As the U.S. population continues to age (e.g., we now have over 55.8 million citizens that are 65 or older)¹, finding quality income tools is a key objective for many investment advisers. We hope to assist in this effort by occasionally providing research on income tools outside of real estate. Today's topic is the "bank loan" market. We hope to answer some key questions about the potential risk/return of this segment and offer our overall opinion on the asset class.

To Get Started: Some High-Level Definitions

Bank Loans: Bank loans are floating-rate senior loans provided by banks to corporate borrowers. Though underwritten by banks, the loans are typically sold to third parties. The corporate borrowers tend to have very low credit ratings.

CLOs: Collateralized Loan Obligations (CLOs) are the largest purchaser of bank loans.² They are entities that hold a portfolio of bank loans and have a manager. CLOs issue equity and debt to fund their operations which can be purchased by investors.

Tranche: CLOs are often funded in various slices (tranches) of debt and equity ranked based on payment priority which leads to materially different risk/return characteristics of each tranche. For example, investors may obtain senior debt from a CLO which is the lowest risk tranche or "CLO equity" which is the highest risk and sits in a first-loss position.

Some Quick Observations

A few things are worth noting immediately from these definitions:

1. Bank loans are predominantly variable rate. This is good news for income investors that are looking to avoid duration risk. However, one must keep an eye on the Federal Funds Rate as it will drive the various bank indices (e.g., SOFR) which in turn determine loan payment levels which are passed through to the investor.
2. Bank loans are generally senior in the capital stack. This fact means that they would have a payment preference over other forms of debt such as mezzanine debt or bonds.
3. CLOs are actively managed. Bank loans are bought & sold on a secondary market. So, CLOs may be a better way to participate in the leveraged loan market if you believe there are inefficiencies that can be capitalized on by smart managers.

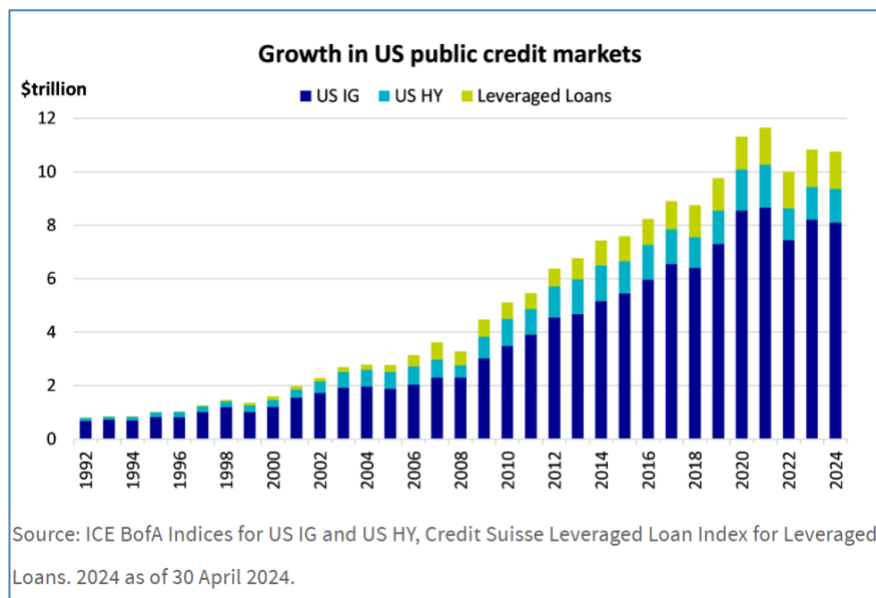
4. CLOs offer materially different risk exposures. Tranches allow investors to target specific risk/return characteristics from the same collateral pool of bank loans which allows investors to dial up or dial down the risk of this sector.
5. Bank loans are typically sold to third parties. In our opinion, whenever there is a situation where a bank performs underwriting but then sells the loan to a third party, it creates an added layer of risk. As has been well documented in the aftermath of the Great Financial Crisis (GFC), this type of arrangement presents conflicts of interest and, often, higher levels of fraud that may be hard to detect by the buyers of the collateralized assets.³

Market Trends

The bank loan market has grown considerably since the GFC. Bank loans have grown in popularity with the explosion of private equity (i.e., the funding behind many private equity deals is, in fact, bank loans). Most market observers also point to performance and investor demand as contributing drivers of growth. As of today, the leverage loan market exceeds \$1.4 trillion in assets.⁴

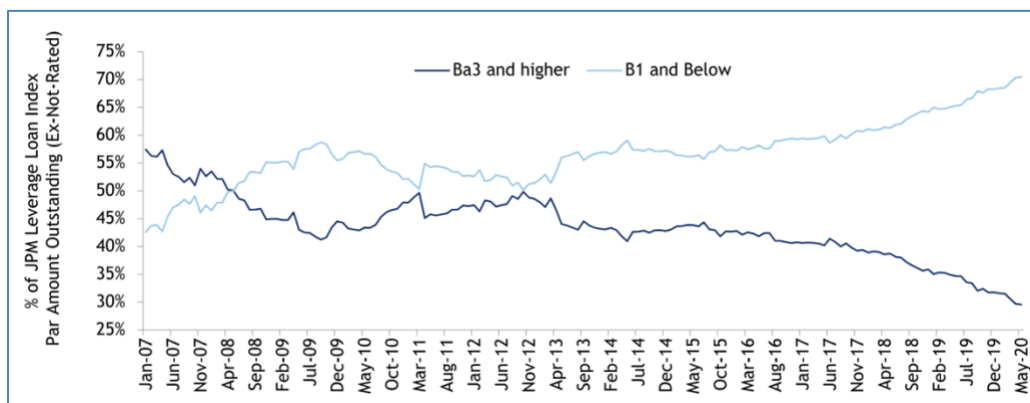
It's noteworthy that "below investment grade" public credit (i.e., corporate bonds) has been expanding alongside bank loans (see Figure 1).⁵ Moreover, Figure 1 excludes other forms of private corporate credit (e.g., private credit funds that do direct lending) so the market size below is understated. This data also highlights for us that around one third of corporate loans go to "junk" rated companies - a stunning percentage given the difference in enterprise values between these segments (e.g., the investment grade universe is, at least, 20 times larger).

Figure 1



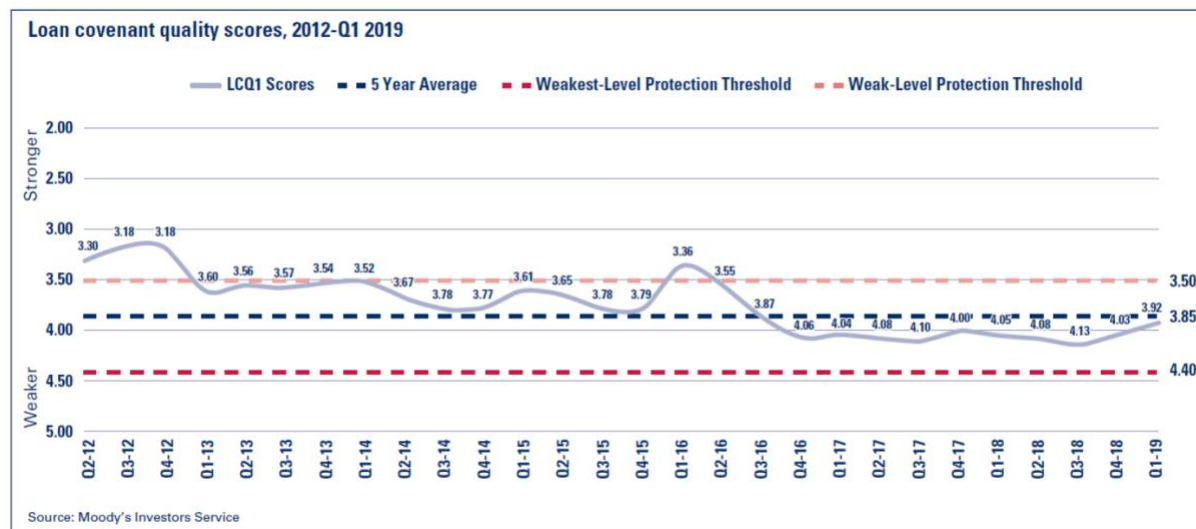
With the rise in capital deployment into the (below investment grade) corporate lending sector, it begs the question of whether lending standards have been degrading. Banks loans are rated by agencies (e.g., S&P and Moody's) so we can evaluate how the universe has changed over time. Evidence suggests that, in aggregate, the bank loan market is, in fact, degrading substantially in credit quality (see Figure 2). This fact is noteworthy for investors as a broadly diversified portfolio of bank loans (e.g., basic beta exposure) appears to be getting riskier over time.⁶

Figure 2



It's also noteworthy that the FDIC, Standard & Poors, and others, have documented a downward trend in the quality of the covenants put in the loan agreements (see Figure 3).⁷ Covenants are provisions in loan agreements that are intended to reduce risk so this information further supports the notion that the bank loan market, as a whole, has seen an increase in risk.

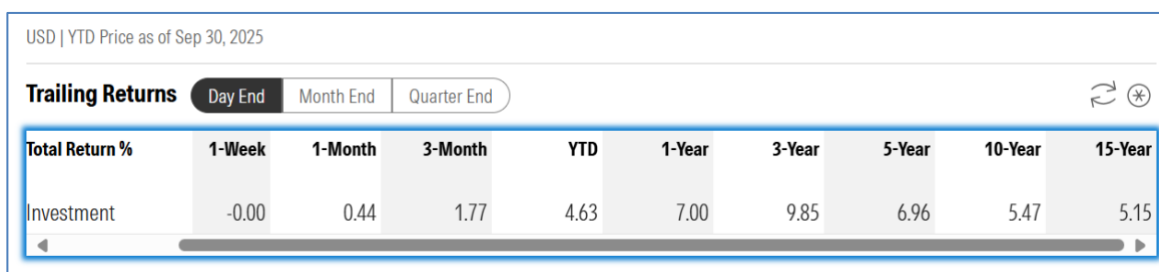
Figure 3



Performance

Morningstar has been tracking the U.S. bank loan (leveraged loan) market since December 31, 2000, via the Morningstar Leveraged Loan Index. Figure 4 shows a summary of performance from inception through September 30, 2025.⁸

Figure 4

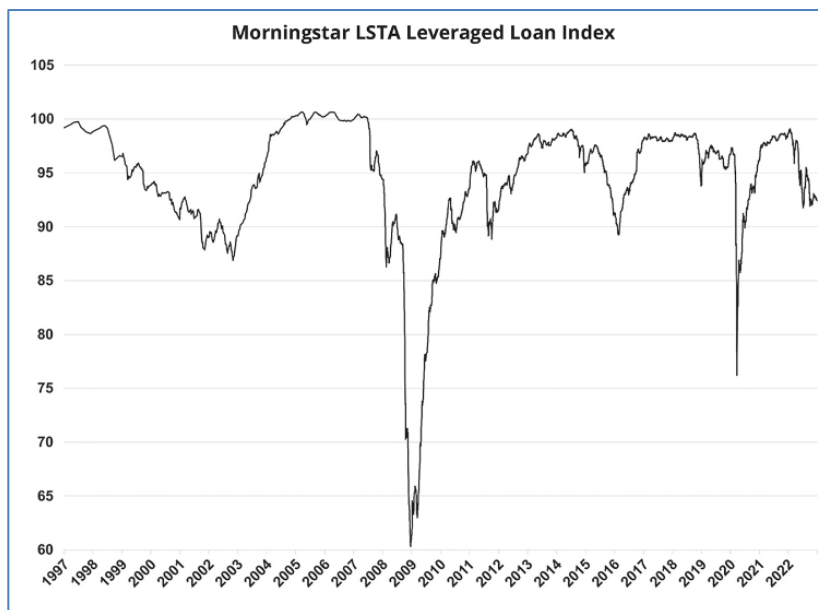


One can see from Figure 4 that this index produced only a 5.15% annual return over the last 15 years. While the accessibility of this income tool (e.g., via Bank Loan and CLO ETFs) makes it attractive, this return clearly does not match that of the direct lending corporate credit fund universe which has achieved a nearly 10% annualized return over the past twenty years.⁹

Risk Metrics

Morningstar does not offer these statistics without a subscription, but we can see drawdown results from the index growth curve. Figure 5 shows the peak-to-valley drawdowns of this index through time. The leveraged loan secondary market is not designed for active trading, so these securities are considered illiquid and are therefore prone to large price fluctuations in times of limited liquidity. We see this in Figure 5 where the GFC resulted in a peak-to-valley price drawdown of over 35%.

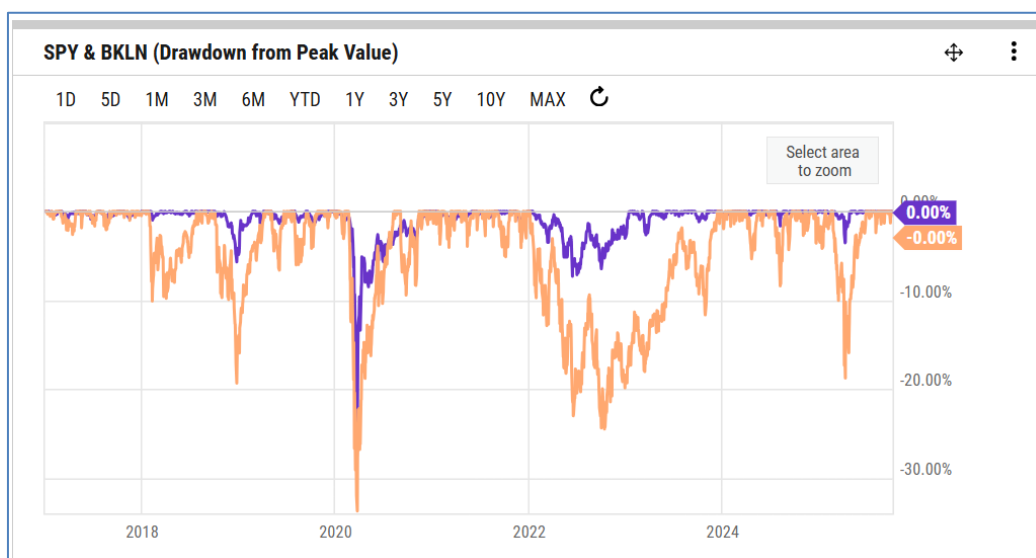
Figure 5



Correlation Metrics

Correlation is a key foundation of Modern Portfolio Theory (i.e., combining non-correlated assets in a portfolio can shift the “Efficient Frontier” – meaning the maximum return per unit of risk). However, we’ve learned that historical correlation relationships tend to break down during periods of low liquidity. We most recently observed this during the COVID crisis. As can be seen from Figure 6, the correlation converged for the S&P 500 Index and the bank loan market (as measured by BKLN) at the very moment some diversification was most needed.

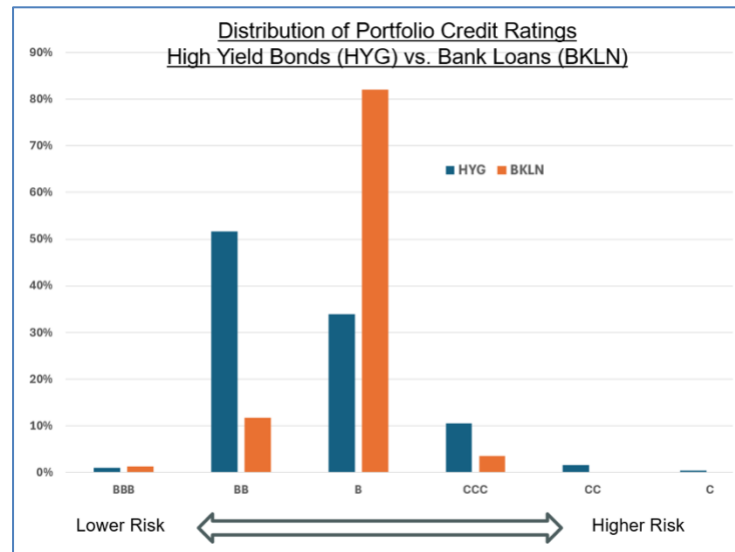
Figure 6



Bank Loans vs High Yield Bonds – A Note of Caution

While bank loans have many advantages over corporate bonds (e.g., no duration risk, a better position in the capital stack, typically shorter maturities, etc.), there appears to be a material disconnect in inherent risk levels. Figure 7 compares the distribution of security ratings from Moody's across all the individual holdings of BKLN (our bank loan universe proxy) and HYG (our high yield bond universe proxy). To the extent that these proxies are representative of the overall investment universes (and we believe they are) the investment universe of bank loans appears to be materially riskier than the universe of high yield bonds.

Figure 7



In Conclusion – What is an Investor to Do?

In our view, the bank loan and CLO world are best avoided for the moment. For one, the long-term returns of the universe are, in our opinion, not that compelling. Also, the Federal Funds Rate is projected lower from here meaning that these variable rate products are projected to be losing yield as the Yield Curve un-inverts. Moreover, it's clear that there has been a material change in the risk of the overall bank loan universe. Some will point to CLOs (e.g., actively managed pools of bank loans) as a solution to the risk problem. However, data shows that CLOs are the largest buyer of Bank Loans (and growing). As such, CLOs are, over time, slowly becoming a conduit to the beta of the bank loan world. CLO risk tranches may help (e.g., one could limit investment to only AAA CLO tranches) but the yield and return targets will fall. We simply don't think the reduced yield spread justifies the drawdown risk which likely will emerge in times of crisis. In comparison to this universe, we personally prefer corporate credit funds that are doing their own sourcing, vetting and underwriting which we believe will yield better long-term performance.

As we wrap up this letter, one last headline caught our attention. Glen Fest of Pitchbook wrote an article on October 1, 2025, with the following headline: CLOs see \$2B of exposure to bankrupt First Brands debt as 'manageable'. Glen points out that First Brands exposure averaged 0.24% across 69 different managers. Only time will tell whether the rising risk of bank loans is, in fact, manageable or whether First Brands is the "canary in the coal mine" of a much larger issue.

About the authors

Mr. Eiben is Co-Founder and Co-Portfolio Manager at Thirdline Capital, an investment advisor and manager of a real estate credit interval fund and other private real estate investments. Prior to Thirdline, Mr. Eiben spent over 15 years at TFS Capital, a firm that specialized in developing liquid alternative investment strategies, where he served as a Portfolio Manager and Chief Operating Officer.



Mr. Newman serves as Director of Public Investments at Thirdline Capital Management, LLC. Prior to joining Thirdline, Mr. Newman spent over 15 years at TFS Capital LLC, an asset management firm specializing in alternative investment strategies. TFS Capital, LLC managed two hedge funds and three mutual funds totaling \$2.5B in assets. TFS Capital, LLC won the first-ever Morningstar “Alternatives Fund Manager of the Year” award in 2012 and was a 4-time Lipper Fund Award winner. In his various roles, including Partner and Chief Investment Officer, Mr. Newman managed a team of analysts and data scientists responsible for developing investment trading strategies.



Notes

1. U.S. 2020 Census (<https://www.census.gov/>) (2020)
 2. Guggenheim (<https://www.guggenheiminvestments.com/>), “Understanding Collateralized Loan Obligations” (2025)
 3. Berkeley IRLE, Erin Coghlan, Lisa McCorkell and Sara Hinkley, “What Really Caused the Great Recession?” (2018)
 4. Morningstar (<https://indexes.morningstar.com/indexes/>), Morningstar LSTA US Leveraged Loan Factsheet (2025)
 5. AXA Investment Managers (<https://www.axa-im.com/>), Jack Stevenson & Mike Graham, “US high yield: Broader financing options soften impact of higher rates” (2024)
 6. Loomis Sayles (<https://info.loomissayles.com/>), Michael Herald, “COVID-19 Impacts on the CLO Market” (2020)
 7. FDIC (<https://www.fdic.gov/bank-examinations/>), “Leveraged Lending: Evolution, Growth and Heightened Risk”
 8. Morningstar (<https://indexes.morningstar.com/indexes/>)
 9. Cliffwater LLC (<https://www.cliffwaterdirectlendingindex.com/>), Cliffwater Direct Lending Index Returns Since Inception (2025)
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