

United States House of Representatives  
Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, D.C. 20515

May 30, 2019

## Memorandum

**To:** Members, Committee on Financial Services

**From:** FSC Majority Staff

**Subject:** June 4, 2019, “Emerging Threats to Stability: Considering the Systemic Risk of Leveraged Lending,”

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The Subcommittee on Consumer Protection and Financial Institutions will hold a hearing entitled, “Emerging Threats to Stability: Considering the Systemic Risk of Leveraged Lending,” on Tuesday, June 4, 2019, at 2:00 p.m., in room 2128 of the Rayburn House Office Building. This single-panel hearing will have the following witnesses:

- **Erik F. Gerding**, Professor of Law & Wolf-Nichol Fellow, University of Colorado Law School
- **Victoria Ivashina**, Lovett-Learned Chaired Professor of Finance, Harvard Business School
- **Gaurav Vasisht**, Senior Vice President and Director, Financial Regulation Initiatives, The Volcker Alliance
- **Gregory Nini**, Assistant Professor of Finance, LeBow College of Business, Drexel University

### Overview

As the U.S. economy recovered after the 2008 financial crisis, corporate debt has grown rapidly, reaching record levels, including as a share of GDP.<sup>1</sup> Leveraged loans are a component of corporate debt and are defined broadly as loans extended to highly indebted, nonfinancial businesses. Generally, leveraged loans are originated by banks, who syndicate, or group the loans together, and then sell them to investors. It is estimated 62 percent of leveraged loans are purchased by collateralized loan obligations (CLOs), while 20 percent are sold to mutual funds, and the remaining are sold to other market participants.<sup>2</sup> As described below, the leveraged lending market is relatively opaque with a range of potential risks policymakers should consider. The hearing will provide the Committee an opportunity to review what is known about leveraged lending, the tools available to regulators to identify and mitigate risks to the U.S. economy and financial stability, recent regulatory actions and potential legislative proposals.

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<sup>1</sup> Robert S. Kaplan, “Corporate Debt as a Potential Amplifier in a Slowdown,” Federal Reserve Bank of Dallas (Mar. 5, 2015), <https://www.dallasfed.org/research/economics/2019/0305.aspx>. Also see Figure 1 in Appendix.

<sup>2</sup> Chairman Jerome Powell, “Business Debt and Our Dynamic Financial System,” at ‘Mapping the Financial Frontier: What Does the Next Decade Hold?’ 24th Annual Financial Markets Conference, Federal Reserve Bank of Atlanta (May 20, 2019), <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>. Also see Figure 3 in Appendix.

## Leveraged Lending and Collateralized Loan Obligations

Globally, new issuance of leveraged loans hit a record of \$788 billion in 2017, surpassing the pre-crisis high of \$762 billion in 2007. The United States was by far the largest market last year, accounting for \$564 billion of new loans,<sup>3</sup> and as noted above, about 62 percent of these loans are purchased by CLOs.

Collateralized loan obligations are special purpose vehicles established to pool nonfinancial corporate debt for the purpose of issuing tranching debt-like securities to investors who seek diversified exposure to the corporate lending market. Like mortgage-backed securities (MBS), which pooled mortgage loans and repackaged these securities for issuance to investors, and other collateralized debt obligations (CDOs), CLOs seek to decouple the underwriting and borrower risks of individual loans. However, unlike other CDOs including MBS, banks that originate the underlying loans pooled in CLOs often retain an interest in the commercial loan.

## Regulatory Guidance on Leveraged Lending

On March 21, 2013, the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) jointly issued an interagency guidance on leveraged lending.<sup>4</sup> The guidance served to update and replace the previous guidance, issued in 2001. Key proposals from the guidance aimed to assist regulated banks in implementing sound practices including “[t]ransactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute; [...] well-defined underwriting standards [...]; and guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.”<sup>5</sup>

The 2013 guidance and related efforts by regulators led to a 20 percent decline in dollar volume of leveraged loans in 2015.<sup>6</sup> However, there have been recent efforts to ease supervision of the leveraged lending market. In a March 2017 letter, Senator Patrick Toomey (R-PA) challenged the validity of the 2013 guidance, arguing that it should be considered by the Government Accountability Office (GAO) to be a rule as defined by the Congressional Review Act (CRA).<sup>7</sup> The CRA requires a rule be submitted to both chambers of Congress and to the Comptroller General within 60 days of being finalized, and before the rule can take effect. In an October 2017 response letter, GAO concluded that the 2013 guidance was indeed a rule for purposes of CRA.<sup>8</sup> Subsequently, prudential regulators communicated publicly a move away from the 2013 guidance, including Fed Chairman Powell stating before the Committee on February 27, 2018, that “in the case of the leverage lending guidance, we do accept and understand that’s nonbinding guidance. And in fact . . . we’ve made it a point to go out and make sure that that message is getting out

<sup>3</sup> Tobias Adrian, Fabio Natalucci, and Thomas Piontek, “Sounding the Alarm on Leveraged Lending,” IMFBlog (Nov. 15, 2018), <https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/>. Also see Figure 2 in Appendix.

<sup>4</sup> Federal Reserve, “Interagency Guidance on Leveraged Lending” (Mar. 21, 2013), <https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf>.

<sup>5</sup> *Id.*

<sup>6</sup> Ryan Tracy, “Feds Win Fight Over Risky-Looking Loans,” Wall Street Journal (Dec. 2, 2015), <https://www.wsj.com/articles/feds-win-fight-over-risky-looking-loans-1449110383>.

<sup>7</sup> See Letter from Senator Pat Toomey to Comptroller Dodaro (Mar. 31, 2017), <https://www.consumerfinance.com/wp-content/uploads/sites/14/2017/05/Toomey-letter-to-GAO.pdf>.

<sup>8</sup> See Letter from GAO General Counsel Susan A. Poling to Senator Pat Toomey (Oct. 19, 2017), <https://www.gao.gov/assets/690/687879.pdf>.

to supervisors of banks.”<sup>9</sup> On the same day, Comptroller Otting said in a speech to a bank industry group that, “as long as banks have the capital, I am supportive of banks doing leveraged lending.”<sup>10</sup>

### **Potential Risks to the Economy and Financial System**

With the rise in nonfinancial corporate indebtedness, parallels between CLOs and similarly securitized debt obligations at the heart of the 2008 financial crisis, and the voiding of the 2013 guidance, a growing number of experts and stakeholders are raising concerns about the risks posed by leveraged lending. For example, the Dallas Fed President raised concerns about the risks to the broader economy of the rapid growth in corporate debt, highlighting that most of the growth in new debt issued narrowly qualifies as investment grade (at least BBB rated), which poses a significant risk for an explosion of sub-investment grade debts in the event of downgrades in a slowing or contracting economy.<sup>11</sup> In a December 2018 speech, Fed Governor Lael Brainard also raised a series of concerns, noting that,

While leveraged loans have traditionally had important investor protections, loan covenants for new leveraged loans have weakened dramatically. Covenant-lite, or cov-lite, transactions now represent roughly 80 percent of the entire leveraged lending market--up from less than 30 percent a decade ago, when they were associated primarily with stronger borrowers. Deals increasingly involve features that increase opacity and risk.... Previously, much of this deterioration in underwriting appeared to be concentrated among nonbank lenders, but this year has witnessed a deterioration in underwriting at the largest banks. The widening adoption of practices that make risk harder to measure suggests a heightened focus on industry risk-management practices is warranted.<sup>12</sup>

In a recent speech, Fed Chairman Jerome Powell argued that, “In assessing financial stability risks, we constantly consult our four-point checklist: borrowing by businesses and households, valuation pressures, leverage in the financial system, and funding risk,” and that he believes that leveraged lending poses a risk primarily as a recession amplifier, and not a systemic risk. Specifically, he argues that “business debt is near record levels, and recent issuance has been concentrated in the riskiest segments. As a result, some businesses may come under severe financial strain if the economy deteriorates. A highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments. Investors, financial institutions, and regulators need to focus on this risk today, while times are good. Second, today business debt does not appear to present notable risks to financial stability. The debt-to-GDP ratio has moved up at a steady pace, in line with previous expansions and neither fueled by nor fueling an asset bubble. Moreover, banks and other financial institutions have sizable loss-absorbing buffers.”<sup>13</sup>

Former Fed Chair Janet Yellen stated that, “what I would worry about is if the economy encounters a downturn, we could see a good deal of corporate distress. If corporations are in distress, they fire workers and cut back on investment spending. And I think that’s something that could make the next recession a

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<sup>9</sup> See FSC, “Monetary Policy and the State of the Economy” (Feb 27, 2018),

<https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=401195>.

<sup>10</sup> Eleanor Duncan, “Banks can ‘do what they want’ in leveraged lending: Otting,” Reuters (Feb. 27, 2018),

<https://www.reuters.com/article/us-usa-banks-lending-otting/banks-can-do-what-they-want-in-leveraged-lending-otting-idUSKCN1GC0B5>.

<sup>11</sup> *Supra* note 1. Also see Figure 4 in Appendix for growth in investment grade nonfinancial corporate bonds.

<sup>12</sup> Governor Lael Brainard, “Assessing Financial Stability over the Cycle,” Peterson Institute for International Economics, Washington, D.C. (Dec. 7, 2018), <https://www.federalreserve.gov/newsevents/speech/brainard20181207a.htm>.

<sup>13</sup> *Supra* note 2.

deeper recession.”<sup>14</sup> Experts from the International Monetary Fund (IMF) concluded that, “it is crucial for policymakers to develop and deploy new tools to address deteriorating underwriting standards. Having learned a painful lesson a decade ago about unforeseen threats to the financial system, policymakers should not overlook another potential threat.”<sup>15</sup> In a February 2019 report, the Financial Stability Board (FSB) recommended, “Given these developments, the complexity and lack of transparency (i.e. data constraints) of the leveraged loan market, as well as the potential of spillovers to other markets, it is important to consider enhancing data/information collection so as to have clearer view of the market and its risks.”<sup>16</sup>

### **Financial Stability Oversight Council and Office of Financial Research**

The Dodd–Frank Wall Street Reform and Consumer Protection Act established the Financial Stability Oversight Council (FSOC) to, among other things, “identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.”<sup>17</sup> The Office of Financial Research (OFR) was established to support FSOC’s work and to, in part, “develop and maintain metrics and reporting systems for risks to the financial stability of the United States [and] to monitor, investigate, and report on changes in systemwide risk levels and patterns to the Council and Congress.”<sup>18</sup> Congress created the FSOC and OFR to address an observed failure of the pre-2008 financial crisis regulatory structure to consider the interconnectedness of the system, to coordinate among agencies on financial crisis planning, and to quantify and map system-wide risks.

With respect to leveraged lending risks, Fed Chair Powell acknowledged that “the world would benefit greatly from more information on who is bearing the ultimate risk associated with CLOs. We know that the U.S. CLO market spans the globe, involving foreign banks and asset managers. But right now, we mainly know where the CLOs are not—only \$90 billion of the roughly \$700 billion in total CLOs are held by the largest U.S. banks. That is certainly good news for domestic banks, but in a downturn institutions anywhere could find themselves under pressure, especially those with inadequate loss-absorbing capacity or runnable short-term financing.”<sup>19</sup>

However, during the Trump Administration, regulators have been criticized for being more focused on implementing a number of financial deregulatory proposals than on addressing financial stability concerns.<sup>20</sup> For example, the FSOC under the leadership of Treasury Secretary Mnuchin has proposed a cumbersome designation process that, according to former officials, could make it difficult for the body to designate a future nonbank financial company that poses a systemic risk as AIG and other companies did in the last financial crisis. Specifically, in a recent letter to Treasury Secretary Mnuchin and Fed Chair Powell from former Fed Chairs Bernanke and Yellen, along with former Treasury Secretaries Geithner and Lew, the group warned, “Though framed as procedural changes, these amendments amount to a substantial weakening of the post-crisis reforms. These changes would make it

<sup>14</sup> Joy Wiltermuth and Kristen Haunss, “Yellen warns of corporate distress, economic fallout,” Reuters (Feb. 27, 2019)

<https://www.reuters.com/article/us-yellen-distressed/yellen-warns-of-corporate-distress-economic-fallout-idUSKCN1QG2CZ>.

<sup>15</sup> *Supra* note 3.

<sup>16</sup> FSB, “Global Monitoring Report on Non-Bank Financial Intermediation 2018,” (Feb. 4, 2019), <https://www.fsb.org/2019/02/global-monitoring-report-on-non-bank-financial-intermediation-2018/>.

<sup>17</sup> 12 U.S.C. § 5322.

<sup>18</sup> 12 U.S.C. § 5344.

<sup>19</sup> *Supra* note 13.

<sup>20</sup> Mayra Rodriguez Valladares, “Mnuchin Should Require More Transparency About Leveraged Lending and CLO Markets,” Forbes (May 2, 2019), <https://www.forbes.com/sites/mayrarodriguezvalladares/2019/05/02/mnuchin-should-require-more-transparency-about-leveraged-lending-and-clo-markets/#3e71c6394d50>.

impossible to prevent the build-up of risk in financial institutions whose failure would threaten the stability of the system as a whole.”<sup>21</sup>

Furthermore, even though former President Obama’s fiscal year 2017 budget estimated the OFR would expend about \$104 million, in part to employ a staff of 255 full-time equivalent (FTE) employees,<sup>22</sup> President Trump’s fiscal year 2020 budget estimates the OFR will expend \$75 million, in part to employ a staff of 145 FTEs.<sup>23</sup> This represents a staff budget reduction of more than 43 percent. OFR’s funding comes directly from an assessment charged to the largest banks and any nonbank financial company designated by FSOC, and it was intended to give OFR political independence. Financial regulators have, in the words of former Fed Governor Dan Tarullo, been engaging in, “a kind of low-intensity deregulation, consisting of an accumulation of non-headline-grabbing changes and an opaque relaxation of supervisory rigor.”<sup>24</sup> This approach may leave financial institutions less prepared for a future downturn, including a downturn related to leveraged lending.<sup>25</sup>

### Legislative Proposals

There are several legislative actions the Committee could consider to enhance oversight of the leveraged lending market and mitigate risks to financial stability and the U.S. economy, including:

- Discussion Draft of Protecting the Independent Funding of the Office of Financial Research Act. This legislation, sponsored by Rep. Bill Foster (D-IL), would give the Director of the Office of Financial Research (OFR) within the Department of the Treasury sole discretion over the OFR’s annual budget, which would be not less than the OFR’s FY2017 budget.
- Discussion Draft of Leveraged Lending Data and Analysis Act. This legislation would require the OFR, in coordination with FSOC member agencies and other appropriate government agencies, to utilize all available authorities necessary, including subpoena power if necessary, to gather information on the leveraged lending and CLO market to assess the risks these transactions pose to the U.S. economy or financial stability. OFR would be required to issue a semiannual report over the next two years to the FSOC and the Congress describing its efforts to gather the data, along with an analysis of the data and any regulatory or legislative recommendations to mitigate identified risks to the U.S. economy or financial stability.
- Discussion Draft of Leveraged Lending Examination Enhancement Act. This legislation would require the Federal Financial Institutions Examination Council’s (FFIEC) to establish uniform examination procedures for bank regulators to supervise leveraged lending activity to ensure such activities are done in a safe and sound manner. The bill would also require bank regulators to issue a quarterly report to Congress analyzing risk management of leveraged lending activities.

<sup>21</sup> See Alan Rappeport, “Former Top Financial Regulators Warn Against Move to Ease Oversight of Firms,” New York Times (May 13, 2019), <https://www.nytimes.com/2019/05/13/us/politics/financial-regulation-trump-administration.html>. See also Letter from Timothy F. Geithner, Jacob J. Lew, Ben S. Bernanke, and Janet L. Yellen to Steven L. Mnuchin and Jerome H. Powell (May 13, 2019), <https://int.nyt.com/data/documenthelper/887-bernanke-geithner-lew-yellen-letter/a22621b202dfcb0fe06e/optimized/full.pdf>.

<sup>22</sup> Treasury, “Office of Financial Research: Program Summary by Budget Activity, FY 2017,” <https://www.treasury.gov/about/budget-performance/budget-in-brief/BIB17/15.%20OFR%20FY%202017%20BIB-1.pdf>.

<sup>23</sup> Treasury, “Office of Financial Research: Congressional Budget Justification and Annual Performance Report and Plan, FY 2020,” <https://home.treasury.gov/system/files/266/16.-OFR-FY-2020-CJ.pdf>

<sup>24</sup> Governor Daniel K. Tarullo, “Taking the Stress out of Stress Testing,” Americans for Financial Reform Conference on Big Bank Regulation Under the Trump Administration, Washington, D.C. (May 21, 2019), <https://ourfinancialsecurity.org/2019/05/speech-former-fed-governor-tarullo-decries-low-intensity-deregulation/>.

<sup>25</sup> Mayra Rodriguez Valladares, “The Weakening Of Big Bank Regulations Under Trump Is The Seed For The Next Financial Crisis,” Forbes (May 22, 2019), <https://www.forbes.com/sites/mayrarodriguezvalladares/2019/05/22/the-weakening-of-big-bank-regulations-under-trump-is-the-seed-for-the-next-financial-crisis/#2c8040ee4f4c>.

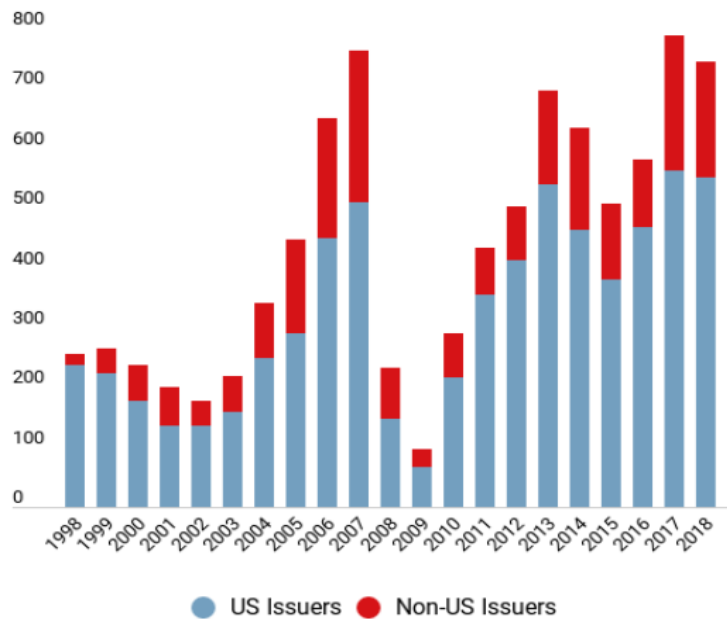
**Appendix**

**Figure 1. Nonfinancial Corporate Debt as a Percent of GDP<sup>26</sup>**



NOTES: Nonfinancial corporate debt includes debt securities and loans. The shaded bars indicate National Bureau of Economic Research (NBER) recessions. SOURCES: Federal Reserve Board of Governors; NBER.

**Figure 2. Global Issuance of Leveraged Loans (\$bn)<sup>27</sup>**



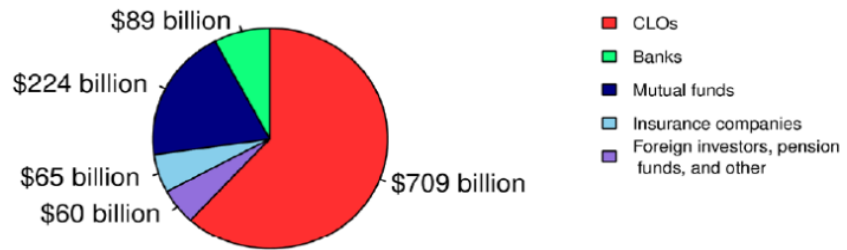
Sources: Standard & Poor's Leveraged Commentary and Data and IMF staff calculations. Note: 2018 data is through Q3 and annualized to estimate full-year 2018 issuance.

<sup>26</sup> *Supra* note 1.

<sup>27</sup> *Supra* note 3.



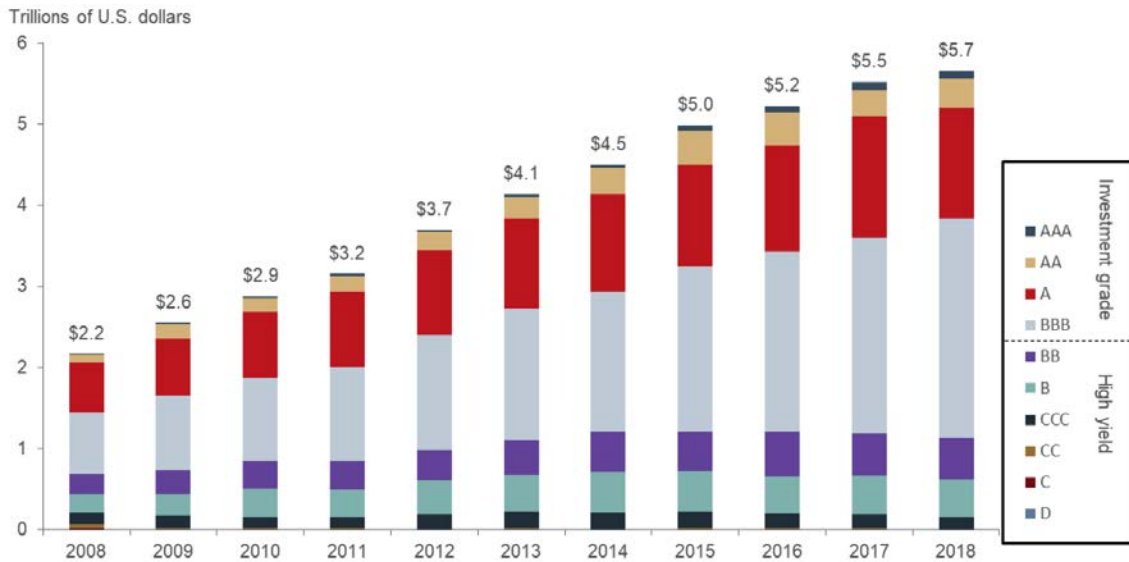
**Figure 3. Leveraged Loans by Type of Holder<sup>28</sup>**



Note: The data, which are taken from 2018:Q4, are for institutional leveraged loans and generally exclude credit lines and the share of term loans primarily held by banks. "Other" includes the household sector; nonfinancial corporate and noncorporate business; federal, state, and local governments; federal, state, and local government retirement funds; money market funds; closed-end funds; exchange-traded funds; government-sponsored enterprises (GSEs); agency- and GSE-backed mortgage pools; asset-backed securities issuers; hedge funds; finance companies; real estate investment trusts; broker-dealers; holding companies; and funding corporations. CLO is collateralized loan obligation.

Source: For leveraged loans, S&P Global Market Intelligence, Leveraged Commentary & Data; for all other items, Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

**Figure 4. U.S. Nonfinancial Corporate Bonds by Ratings<sup>29</sup>**



NOTE: Data are calculated using the ICE (Intercontinental Exchange) investment-grade and high-yield bond indexes, excluding the issues of financial firms, as of Dec. 31 for each year shown.  
SOURCE: Bloomberg.

<sup>28</sup> *Supra* note 2.

<sup>29</sup> *Supra* note 1.