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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

WASHINGTON, DC 20510–6075

Honorable Steven T. Mnuchin
Chair
Financial Stability Oversight Council
U.S. Department of the Treasury
1500 Pennsylvania Ave. NW
Washington, D.C. 20220

December 3, 2019

Dear Chair Mnuchin and Members of the Financial Stability Oversight Council:

Despite years of warnings, prudential regulators have yet to take substantive efforts to contain risks to the economy from leveraged lending. Instead, those responsible for the protection of our financial system have weakened oversight of the markets and institutions whose reckless bets could harm economic stability, amplify losses in a recession, and cost hardworking families their jobs.

Just as alarming as the risk these poorly regulated financial activities create is their failure to generate real economic value. Big companies are using leveraged loans to finance corporate stock buybacks and leveraged buyouts.[1] Private equity firms structure company debt to be highly risky in order to juice return on equity – in other words, they use expensive loans that strip equity from non-financial firms to line investors' pockets.[2] Much of this asset stripping is occurring in critical services like healthcare and transportation; if these companies are unable to refinance this debt in the future, it could endanger access to important services ordinary Americans rely on.[3]

Corporate debt now occupies a higher share of U.S. GDP than before the crisis, and the share of debt owed by highly leveraged U.S. companies has reached pre-crisis levels of above 40%.[4] According to the Federal Reserve's November Financial Stability Report, half of current investment-grade debt, a near record high, is in the riskiest tier (BBB) of the investment-grade range.[5] Of all the asset markets measured in the Federal Reserve report, leveraged loans are the

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[1] Tobias Adrian et al., Sounding the Alarm on Leveraged Lending, Int'l Monetary Fund Blog (Nov. 15, 2018) *available at* https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/ (last visited June 1, 2019).

[2] Moody's May 29 2019 Report – "On the Precipice: B3 Issuers." Available upon request.

[3] Ibid.

[4] Bank of England Financial Stability Report, July 2019. Available at: https://www.bankofengland.co.uk/financial-stability-report/2019/july-2019.

[5] Federal Reserve Financial Stability Report, page 20, Nov 2019, https://www.federalreserve.gov/publications/2019-november-financial-stability-report-purpose.htm

fastest growing over the last twenty years, expanding at twice the rate of the next fastest market.[6] Financial analysts estimate that poorly underwritten, or "covenant lite" loans, make up 80% of the $1.3 trillion domestic market, 60-70% of which is sold into securitizations (CLOs).[7] By comparison, the percentage of U.S. covenant-lite leveraged loans in 2007 was approximately 30%.[8] The leveraged loan market appears far riskier than it was even at the start of the financial crisis.

Globally, banks hold 45% of the $3.2 trillion in leveraged loans, not counting their CLO holdings.[9] According to the Bank of England, regulated financial institutions hold 60% of worldwide leveraged loans when their CLO investments are included,[10] but this figure still does not include exposures related to underwriting and structuring transactions, providing financing or risking exposure via repos, total return swaps, or other derivatives, and other secured financing.[11]

These risks are as concentrated as they are large. U.S. banks own 50% of senior CLO securities[12], and just three of the largest domestic G-SIBs hold more than 10% of the AAA rated tranches of leveraged loan CLOs, with the balance held by other financial institutions such as foreign banks, insurance companies, money managers, pension funds and hedge funds.[13] Many of these financial entities receive credit lines, loans, derivatives and prime brokerage services from the banks' affiliates.

Furthermore, the increase of non-standard covenant amendments in CLO indentures may obscure the true riskiness of the underlying loans, or the entire securitization.[14] And in yet another echo of the 2008 crisis, market participants have reported concerns of ratings shopping, and reverse engineering in order to game ratings and increase risks in senior CLO tranches.[15] Banks and other regulated financial institutions may be exploiting CLOs to lower dramatically their regulatory capital ("regulatory capital arbitrage") as they take more risk on their balance sheets. This mimics the abuse of similar securitizations that camouflaged the rising risk to large banks in the years leading up to the financial crisis.[16]

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[6] Ibid, page 9

[7] S&P Presentation to Minority Staff of the Senate Banking, Housing, and Urban Affairs Committee. Available upon Request.

[8] Tobias Adrian et al., Sounding the Alarm on Leveraged Lending, Int'l Monetary Fund Blog (Nov. 15, 2018) available at https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/.

[9] SIFMA Fact Sheet, March 2019 https://www.sifma.org/wp-content/uploads/2019/03/Leverage-Lending-FAQ.pdf

[10] Bank of England Financial Stability Report, July 2019 https://www.bankofengland.co.uk/financial-stability-report/2019/july-2019

[11] Moody's May 29 2019 Report – "On the Precipice: B3 Issuers."

[12] Rodriguez Valladares, Mayra. "Big banks are very exposed to leveraged lending and CLO markets," Forbes, April 15, 2019. Available at: https://www.forbes.com/sites/mayrarodriguezvalladares/2019/04/15/big-banks-are-very-exposed-to-leveraged-lending-and-clo-markets/

[13] S&P Presentation to Minority Staff of the Senate Banking, Housing, and Urban Affairs Committee. Available upon Request.

[14] Analysts have highlighted covenants that require no investor consent, contain opaque EBITDA add-backs, and offer little governance over the exchange of assets over the life of a CLO as examples of declining standards in CLO documentation. See S&P Presentation, available on request, and Moody's Report December 13, 2018 – "From covenants to cushions: Top 10 credit challenges CLOs face today," also available upon request.

[15] Testimony of Professor Erik Gerding, September 19, 2019 to the SEC Investment Advisor Committee. Available at:https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac091919

[16] Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRIT. REV. 195, 201 (2009); Viral V. Acharya et al., *Securitization Without Risk Transfer*, (Nat'l Bureau of Econ. Research Working Paper No. 15730, 2010); Viral V. Acharya et al., *Capital, Contingent Capital, and Liquidity Requirements*, *in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 143, (Viral V. Acharya et al. eds., 2011). *See also* David Jones, *Emerging Problems*

Banks face additional exposures to leveraged lending risks as well. As mentioned above, banks supply credit lines, other loans, derivatives and prime brokerage services to non-bank entities that securitize and invest in CLOs – revenue streams and debts that could evaporate in a market downturn. Banks are also at risk if they are unable to sell loans they are holding into the securitization market. While exact data are not available due to the opacity of this market, one financial analyst estimates pipeline risk to be at least $10 billion and as much as $25 billion at each of the largest banks.[17] Alarmingly, studies have shown that banks also time securitization transactions to close just before key reporting periods, further shrouding risk from supervisors and the markets.[18] Banks also face an unknowable amount of residual liability arising from representations and warranties related to arranging and underwriting securitizations that, as evidenced by the subprime crisis, could take years to sort out in the event of heavy defaults.

The risks of leveraged loans and CLOs are not limited to banks. Insurance companies and pension funds also have substantial holdings of CLOs, including in riskier, mezzanine tranches.[19] This means that losses on leveraged loans could impact these investors before investors in senior tranches.

With reckless disregard for these aforementioned threats, this administration and its appointees have torn down numerous bulwarks protecting us from another financial crisis.

For example, Federal financial regulators may not even have adequate information about the buildup of risk in leveraged loan and CLO markets, thanks to a decision by the Comptroller Otting to lift the 2013 Interagency Guidance on Leveraged Lending.[20] Bank examiners may not be collecting vital information from banks on their exposure to these markets.

In addition, rather than take an opportunity to limit risk by prohibiting banks from structuring CLOs backed by leveraged loans, banking regulators approved revisions to the Volcker rule in September that allow banks to increase their exposure to hedge funds and other non-bank entities that invest in leveraged loans.[21] This comes on top of an earlier decision by federal financial

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with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues, 24 J. BANKING & FIN. 35 (2000); Erik F. Gerding, *The Dialectics of Bank Capital: Regulation and Regulatory Capital Arbitrage*, 55 WASHBURN L.J. 357 (2016).

[17] Moody's May 29, 2019 Report – "On the Precipice: B3 Issuers."

[18] Patricia M. Dechow and Catherine Shakespear (*2009*) Do Managers Time Securitization Transactions to Obtain Accounting Benefits?. The Accounting Review: January 2009, Vol. 84, No. 1, pp. 99-132.

[19] Emily Liu and Tim Schmidt-Eisenlohr, Who Owns U.S. CLO Securities?, FEDS Notes (July 19, 2019), https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-20190719.htm; Brian Chappatta, Risky Loans Aren't Just for the Market's Insiders, Bloomberg (Oct. 4, 2019), https://www.washingtonpost.com/business/on-small-business/risky-loans-arent-just-for-the-markets-insiders/2019/10/04/5bc66ee8-e696-11e9-b0a6-3d03721b85ef_story.html;

[20] Duncan, Eleanor, "Banks can 'do what they want' in leveraged lending: Otting," Reuters, February 27, 2018. Available at: https://www.reuters.com/article/us-usa-banks-lending-otting/banks-can-do-what-they-want-in-leveraged-lending-otting-idUSKCN1GC0B5

[21] https://www.fdic.gov/news/board/2019/2019-08-20-notice-dis-a-fr.pdf

regulators to exempt from the Volcker Rule collateralized loan obligations backed by loans,[22] an exemption that the securitization industry now seeks to expand.[23]

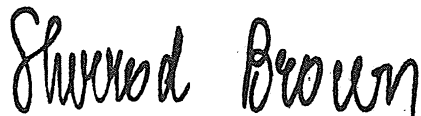
Banking watchdogs have also allowed banks to put short-term profits over long-term preparedness – weakening the stress test and capital requirements meant to protect us from the very type of risks that leveraged lending pose. For example, the Federal Reserve recently finalized a set of proposals reducing capital and liquidity requirements and the frequency of stress tests at the U.S. operations of globally systemic foreign banks with enormous exposure to leveraged lending risks.[24] Financial analysts estimate that Deutsche Bank could experience losses of 521% to 1,043% of its annual firm-wide pretax earnings in a stressed credit environment.[25]

The Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Federal Reserve have also reduced the efficacy and frequency of company run stress tests for domestic banks.[26] Finally, the Federal Reserve has allowed the largest banks in the U.S. to pillage their loss-absorbing capital in exchange for hundreds of billions of dollars in stock buybacks and dividend increases.[27]

The health of the economy must not be measured in bank or private equity profits. As stewards of the financial system, it is your job to protect working families from the fallout of reckless behavior on Wall Street. I am deeply concerned that the only steps regulators haven taken in the face of overwhelming evidence of dangerous risk taking is a promise to study the data.

Though I am sending this letter to all members of the Council, I expect regulators appearing in front of the Senate Committee on Banking, Housing, and Urban Affairs on December 5th to explain what steps they are taking to mitigate these risks.

Sincerely,



Sherrod Brown
Ranking Member
United States Senate Committee on Banking, Housing, and Urban Affairs

[22] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 and 79 Fed. Reg. 5807 (Jan. 31, 2014). 12 C.F.R. Parts 44 (OCC), 248 (Federal Reserve) and 351 (FDIC); 17 C.F.R. Parts 75 (SEC) and 255 (CFTC).
17 C.F.R. § 270.3a-7.

[23] Loan Syndications & Trading Association, Volcker 2.0: the LSTA Comments, https://www.lsta.org/news-resources/volcker-20-the-lsta-comments/.

[24] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm

[25] Moody's May 29 2019 Report – "On the Precipice: B3 Issuers."

[26] See https://www.fdic.gov/news/board/2019/2019-10-15-notice-sum-b-mem.pdf; https://occ.gov/news-issuances/bulletins/2019/bulletin-2019-47.html, and also https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a2.pdf.

[27] "Banks Announce Billions in Share Buybacks After Fed Approval," Associated Press, June 27, 2019. Available at: https://www.usnews.com/news/business/articles/2019-06-27/fed-approves-buyback-dividend-plans-for-all-largest-banks

cc: Hon. Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System
Hon. Joseph Otting, Comptroller, Office of the Comptroller of the Currency
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