THE VOLCKER ALLIANCE
Working for Effective Government

Testimony of Gaurav Vasisht
Senior Vice President and Director of Financial Regulation Initiatives
The Volcker Alliance
House Financial Services Committee
Subcommittee on Consumer Protection and Financial Institutions
Hearing, "Emerging Threats to Stability: Considering the Systemic Risk of Leveraged Lending"
June 4, 2019

Chairman Meeks, ranking member Luetkemeyer, members of the subcommittee, it is an honor and a privilege to testify at this hearing to consider the systemic implications of leveraged lending.[1] Leveraged loans are a key component of business debt in the United States. They provide credit to companies with high levels of debt or speculative credit ratings.

In recent years, because of their explosive growth and rapidly eroding underwriting standards, leveraged loans have increased vulnerability in the financial system. In an economic downturn, this vulnerability has the potential to disrupt the availability of credit and reduce economic output.[2] To address this weakness, regulators should take the necessary steps to better understand and mitigate the risks of this complex market.

Background on the Basic Structure of Leveraged Lending

Before I offer any specific approaches, let me spend a moment on the basic mechanics of leveraged lending, which in many ways are reminiscent of the funding structures of pre-crisis subprime mortgages. Usually arranged by a syndicate or group of banks, leveraged loans are made to private equity firms or corporations mostly to fund a merger or acquisition, pay dividends or effectuate share buy backs.[3]

Once made, loans are sold to investors. The largest buyers are collateralized loan obligations ("CLOs"), which pool the loans and sell securities based on their cash flow to investors globally. Although data are limited, CLO investors include foreign and domestic banks, as well as nonbank financial institutions such as insurance companies, asset managers and hedge funds.[4]

---

[1] All views expressed are my own and not necessarily of the board members, advisors, or affiliates of the Volcker Alliance.
[2] Board of Governors of the Federal Reserve System, "Financial Stability Report," (May, 2019), https://www.federalreserve.gov/publications/files/financial-stability-report-201905.pdf
[3] Tobias Adrian, Fabio Natalucci, and Thomas Piontek, "Sounding the Alarm on Leveraged Lending," IMF Blog (Nov. 15, 2018), https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/
[4] *Supra* note 2.

Explosive Growth and Deteriorating Underwriting Standards

In recent years, as overall business debt in the United States has skyrocketed, so too has the size of the leveraged lending market.[5] Fueled by a combination of low interest rates, high investor risk tolerance and low financing costs, leveraged loans have grown to a total of nearly $1.2 trillion—roughly equivalent to the size of the subprime mortgage market at its peak.[6]

As the leveraged lending market has swelled in size, its underwriting standards have rapidly deteriorated. So-called covenant lite loans, which lack basic protections for lenders and investors, now account for nearly 80 percent of new issuances.[7] Moreover, most of the recent growth in lending has been concentrated in the riskiest borrowers, those with debt of more than six times earnings.[8]

The Need for Action

Late in the credit cycle, as investor risk tolerance and asset prices peak, the leveraged lending market could amplify losses. In an inevitable economic downturn, as investors pull back and the price of speculative debt declines, highly leveraged firms will have difficulty obtaining financing and repaying their loans. This could precipitate downgrades and a selloff in the broader corporate bond market where a record 50 percent of investment grade bonds are now rated at the lowest level of BBB. As default rates spike and prices fall, firms will shrink their economic activity and cut jobs.[9]

In such a scenario, the stability of the financial system would depend on the ability of banks and investors to absorb losses. Fortunately, large banks have more capital and liquidity than they did before the financial crisis. But deregulatory efforts underway since 2017—including regulators' step back from the 2013 leveraged lending guidance[10] and the recent weakening of capital requirements and stress testing standards—undermine confidence.[11]

---

[5] *Id.*
[6]Sheila C. Bair, "How regulators can stop leveraged lending from becoming the new subprime," Yahoo Finance, (May 20, 2019), https://finance.yahoo.com/news/leveraged-lending-subprime-125426980.html
[7] 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
[8] *Supra* note 2.
[9] *See e.g.,* 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
[10] 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
[11] 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/wp-content/uploads/2019/05/Tarullo-AFR-Talk.pdf; *see also*, Sheila C. Bair and

What's more, significant data gaps on CLO investors and the lack of a comprehensive analysis of CLO funding structures render a full assessment of potential losses challenging and highly speculative. What is clear, however, is that in the event of a downturn or of sharp declines in asset prices, the impact on the real economy will be consequential, even if it doesn't lead to a collapse of the financial system in a repeat of 2008.
For this reason, it is important for policymakers to act now.

Suggested Measures

First, regulators must better understand the leveraged lending market. Put simply, you cannot effectively regulate something you do not understand. But given the number of market participants and regulators involved, it can be challenging to gather and analyze all the data. It was precisely for this reason that Congress established the Office of Financial Research ("OFR") as part of the Dodd-Frank Act. But the OFR's budget is being cut and its independence compromised.[12] I recommend that, as proposed in the "Leveraged Lending Data and Analysis Act," the OFR fill any data gaps and produce a comprehensive analysis on the risks of the leveraged lending market. I also recommend that the OFR's budget be restored and kept off congressional appropriations.

Second, regulators must safeguard the banking system. Recessions caused by instability in the banking system last longer and run deeper than other recessions. Since banks operate at the core of the leveraged lending market, it is important that they remain resilient.[13] I propose that regulators reinstate the substance of their 2013 leveraged lending guidance, which helped improve banks' risk management and curtailed the dollar volume of such loans.[14] Regulators should also refrain from further weakening capital requirements and diluting stress tests. Instead, they should require the nation's systemic banks to build their capital by raising the countercyclical capital buffer and strengthening the stress testing process.

Third, regulators should address risks outside the regulatory perimeter. Tighter bank regulation can cause risks to migrate outside the prudentially regulated sector, as it reportedly did after the 2013 leverage lending guidance was issued. It can be important, therefore, for regulators to enlarge the perimeter of regulation for financial stability purposes. It was for this reason that Congress established the Financial Stability Oversight Council ("FSOC") as part of Dodd-Frank.

Gaurav Vasisht, "The Shutdown Isn't the Only Threat to the Economy," The New York Times (Jan. 10, 2019), https://www.nytimes.com/2019/01/10/opinion/shutdown-economy-recession.html

[12] 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
[13] Mayra Rodrigues Valladares, "Big Banks Are Very Exposed to Leveraged Lending and CLO Markets," Forbes (April 15, 2019), https://www.forbes.com/sites/mayrarodriguezvalladares/2019/04/15/big-banks-are-very-exposed-to-leveraged-lending-and-clo-markets/#4f9475867309
[14] 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

But FOSC's recently proposed interpretive guidance would tie the FSOC up in knots, effectively ending its ability to designate nonbanks as systemically important. I recommend that the FSOC's proposed interpretive guidance be withdrawn. Absent action from the FSOC, banking regulators should explore how they could mitigate risks in the nonbank sector—for instance, by tightening supervisory standards that apply to the credit lines and warehouse financing that regulated banking organizations provide to nonbank lenders.

Thank you, and I look forward to answering your questions.