AFR Americans for Financial Reform

AFR Submission for the Record to House Financial Services Committee

Hearing on "Emerging Threats to Financial Stability: Considering the Systemic Risks of Leveraged Lending", June 4, 2019

Americans for Financial Reform ("AFR") appreciates the opportunity to comment on today's hearing. We are a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry.[1]

Today's hearing addresses the financial stability and economic risks of the growth of leveraged lending to non-financial businesses. The rapid growth and poor underwriting of high-risk corporate debt is clearly a significant current threat to financial and economic stability. Non-financial corporate debt has reached the highest level on record as a percentage of total GDP, and observers of the market are warning that much of this debt has gone to companies who would have difficulty paying it back if the economy slowed.

Analysts and regulators have issued numerous warnings concerning the dangers of leveraged lending. Just within approximately the last eight months, there have been warnings regarding the economic risks of leveraged lending from the following sources:

- Federal Reserve Board reports on systemic risk in November 2018 and May 2019 highlighted leveraged lending as a significant threat to the economy.
- Federal Reserve Bank of Dallas President Robert Kaplan gave a speech describing leveraged lending as a likely amplifier of the next recession.[2]
- The 2018 annual report of the Financial Stability Oversight Committee (FSOC) singled out nonfinancial corporate debt and specifically leveraged lending as an economic threat.
- The International Monetary Fund warned on the risks of the overheated leveraged lending and corporate debt markets to the global economy.[3]
- Most recently, Federal Reserve Chair Jerome Powell gave a speech identifying leveraged lending as a significant threat to amplify the next recession.[4]

With all these alarm bells going off, it is clear that Congress needs to take a close look at this issue.

Given all the research and analysis on this issue that is in the public domain, such as the sources cited above, this statement will not focus on the evidence that leveraged lending is a threat to the

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[1] Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Robert Kaplan, *Corporate Debt As A Potential Amplifier In A Slowdown*, Federal Reserve Bank of Dallas, March 5, 2019, http://bit.ly/2FtBvqZ

[3] International Monetary Fund, "Global Financial Stability Report", April, 2019. https://bit.ly/2YXQbq9

[4] Powell, Jerome, *Business Debt and Our Dynamic Financial System*", at "Mapping the Financial Frontier" Conference, Federal Reserve Bank of Atlanta, May 20, 2019. https://bit.ly/2HWBCfK

economy. Instead, we will first make several general points concerning leveraged lending, and then examine a set of policy options to address issues related to leveraged lending markets.

The discussion of policy options includes comments on the legislative proposals advanced in connection with this hearing. It also briefly outlines several additional legislative ideas aimed at the ways in which leveraged loans are distributed in the capital markets. As discussed by several witnesses today, the "originate to distribute" model of leveraged lending, under which the loans are sold on by banks to capital markets investors, bears certain resemblances to practices in the subprime mortgage market prior to the 2008 financial crisis. The proposals we outline here are aimed at preventing a repeat of the risks created by that model.

In addition to the proposals outlined in this statement, we believe additional policy changes are needed. As we point out below, much of the increase in leveraged lending has been driven by forms of financial engineering such as leveraged buyouts and debt-financed share buybacks, which use corporate lending in ways that advantage financial insiders but are often unproductive or harmful for the broader public. Significant legislative changes need to be made to remove incentives for this kind of financial engineering. While these changes are beyond the scope of this statement, we look forward to the opportunity to discuss them with the committee.

Leveraged Loans: Risk to the Financial System vs. Risk to the Economy

There are at least two separate and distinct economic threats that leveraged lending could pose. One threat is to the stability of the financial system. Financial intermediaries who extend credit or deal in credit in the leveraged lending markets could experience large losses if the market weakened. If these losses were large enough, financial intermediaries like banks or insurance companies could be forced to engage in asset fire sales, or even become insolvent. This could destabilize the broader financial system.

A second threat is to the non-financial companies burdened with excessive debt in the leveraged lending market, and to the workers employed there and their broader communities. Even in today's strong economy, the high debt burdens associated with leveraged lending drain the resources of non-financial companies and divert resources that could go to investment and to workers. We have already seen examples of major companies such as Toys R' Us that have been driven into bankruptcy by the unsustainable debt burden associated with leveraged lending, with catastrophic consequences for their employees. In a future economic downturn it is likely that the consequences of excessive debt burdens for companies will be even greater. The next recession may even result in a wave of corporate bankruptcies related to leveraged lending.

Thus, even if there is no threat to the stability of the financial system or to financial intermediation, the impact of leveraged lending on excessively indebted non-financial corporations could still be very harmful.

AFR strongly believes that both of these issues – the potential threat to the stability of the financial system, and the potential impact of excessive debt burdens on non-financial companies – need to be priorities for regulators and for Congress and the financial committees in Congress. More broadly, the mandate to address systemic risk needs to incorporate the full range of ways the financial system poses excessive risk to the economy and communities. In extreme cases this can involve bank failures and the full-scale failure of financial intermediation as occurred in 2008. In others it may involve financial engineering that is harmful to investors, borrowers, workers, and communities but may not result in the failure of financial intermediaries.

This second form of systemic risk may be less dramatic then the kind of financial collapse that occurred in 2008. But by transferring wealth from workers and communities to a small number of financial insiders it fuels the growth of economic inequality in ways that cause grave long-term damage.

Leveraged Lending, Private Equity, and Share Buybacks

The expansion of the leveraged lending market is deeply connected to two forms of financial engineering that create excessive levels of corporate debt for the benefit of Wall Street insiders.

The first form of financial engineering is the use of leveraged buyouts by private equity funds. Leveraged buyouts are a mechanism by which funds force target firms to take on substantial debt to finance their own purchase by the private equity fund. The amount of leverage involved in these takeovers has been increasing to record levels.[5] The private equity fund does not experience the full risk of the excessive leverage on the target firm, as the fund itself will not be responsible for the debt if the firm goes bankrupt. While private equity firms do face some loss if a portfolio firm goes bankrupt, this loss is limited. Furthermore, funds are often able to use their control of the target firm to transfer value to the parent fund and recoup their own capital even if the firm fails.[6]

This "heads I win, tails you lose" situation means that leveraged buyouts create mis-aligned incentives to increase corporate debt to excessive levels, reduce productive investment, and harm workers and communities. Studies show that LBO acquisitions reduce investment as funds are diverted from investing in the future to making debt payments.[7] A number of recent notable bankruptcies of retail firms, such as Toys R Us, Gymboree, and Payless, are directly connected to the debt burden created by private equity acquisitions.[8]

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[5] Schwarzberg, Jonathan, "Leverage Levels Peaking Again on U.S. Mega Buyouts", Reuters, March 22, 2019. https://reut.rs/31hWZA6

[6] Appelbaum, Eileen, and Rosemary Batt, *Private Equity At Work: When Wall Street Manages Main Street,* Russell Sage Foundation, May 1, 2014.

[7] Brian Ayash, *The Origin, Ownership and Use of Cash Flows In Leveraged Buyouts*, (California State Polytechnic University, September 6, 2018) http://bit.ly/2HKnyGB

[8] McElhaney, Alicia, "Privae Equity's Trail of Bankrupt Retailers", *Institutional Investor,* October 26, 2017. https://bit.ly/2jHRohF

Since the financial crisis, private equity has experienced a historic boom in size and acquisitions. There is no question that this boom has been a major driver of the growth in leveraged lending. The International Monetary Fund found that over half of leveraged lending in 2018 was acquisition-related.[9]

Companies are also using corporate leverage to fund other financial engineering techniques to reward shareholders and insiders. Corporations have capitalized on the post-crisis low interest rate environment for "leveraged buybacks" – the issuance of new corporate debt in order to fund share buybacks. This reduces investment and future performance but enriches shareholders in the short term by boosting stock prices.[10] Buyback debt does not enhance broader economic productivity, but transfers funds to corporate insiders. The top executives who implement the buyback can also reap tremendous personal rewards by selling their own equity stakes during the buyback.[11]

The role of unproductive financial engineering strategies such as leveraged buyouts and leveraged buybacks in fueling the dangerous growth of leveraged lending means that record levels of corporate debt have not been accompanied by high levels of corporate investment.[12] When the next recession occurs, many companies will have to grapple with higher debt burdens without the improved productivity that should have resulted from forward-looking investment of borrowed funds. In thinking about the problem of leveraged lending, Congress should seek out ways to reduce incentives to load excessive debt on corporations for unproductive financial engineering such as LBOs and stock buybacks.

Legislative Recommendations to Address Leveraged Lending

Drafts under Discussion at Today's Hearing

There are three pieces of draft legislation under discussion at this hearing, the "Protecting the Independent Funding of the Office of Financial Research Act", the "Leveraged Lending Data and Analysis Act", and the "Leveraged Lending Examination Enhancement Act".

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[9] Tobias Adrian and Fabio Natalucci and Thomas Piontek, "Sounding The Alarm On Leveraged Lending", International Monetary Fund Blog (Blog), International Monetary Fund, November 15, 2018 http://bit.ly/2Jv6h6K

[10] Zicheng Lei and Chendi Zhang, *Leveraged Buybacks* (Journal of Corporate Finance, April 19, 2016) http://bit.ly/2Cw2AYG; William Lazonick, William, *Profits Without Prosperity,* (Harvard Business Review. September, 2014). https://hbr. org/2014/09/profits-without-prosperity
Heitor Almeida and Vyacheslav Fos and Mathias Kronlund, *The Real Effects Of Share Repurchases*, (University of Illinois at Urbana-Champlaign, October 22, 2014) http://bit.ly/2Hx78Cd

[11] Commissioner Robert J. Jackson Jr., "Stock Buybacks And Corporate Cashouts," Securities and Exchanges Commission, June 11, 2018 http://bit.ly/2Fl7V5P

[12] U.S. Library of Congress, Congressional Research Service, *Business Investment Spending Slowdown,* by Marc Labonte, (April 9, 2018) http://bit.ly/2TOk0uh

AFR is supportive of the goals and principles of all of these pieces of legislation. However, in we believe that there a number of ways in which the legislation could and should be significantly strengthened. We hope to work with the introducing members and the Committee on the details of some of these bills as they move through the legislative process.

The "Protecting the Independent Funding of the Office of Financial Research Act" – This legislation reverses the significant cuts made in to the Office of Financial Research (OFR) by the Trump Administration and ensures that no such wholesale cuts will be made in the future. From 2017 to 2019 the budget of the OFR was cut by 16% and the number of full time equivalent positions was cut by 36%.[13] At less than $90 million the budget of the OFR prior to cuts was very small compared to the responsibility of researching a multi-trillion dollar financial sector, and tiny compared to the potential economic benefits of spotting threats to financial stability before they damage the economy.

It is entirely appropriate to reverse these unjustified cuts and AFR endorses this legislation. Given the large cuts in head count at the OFR, we would also suggest that Congress consider a minimum floor on the number of qualified employees at the agency.

"The Leveraged Lending Data and Analysis Act" – This legislation mandates that the OFR, in consultation with the line FSOC agencies, issue semi-annual reports assessing the risks of leveraged lending, and gather the necessary data to do so.

We support the concept of this legislation. However, the directive in the discussion draft as to the contents of the report is very broad and general. We are concerned that without more specific instructions, the OFR may produce a report that does not contain significant new information beyond what has already been covered in the various Federal Reserve, IMF, and private sector reports on the leveraged lending issue. While the bill does instruct the OFR Director to use subpoena power if necessary to gather new information, it is likely that the OFR will be reluctant to do so. In addition, we are concerned that FSOC member agencies may be either reluctant to share supervisory information with OFR that is relevant to the leveraged lending market, or even legally limited from sharing important information.

We would encourage the drafters to be more specific in their mandate as to the data that should be gathered. Drafters should also consider charging the Federal Reserve, OCC, and SEC with sharing specific supervisory information with the OFR that is relevant to the leveraged lending market. This should include information regarding credit to non-banks that is used to finance leveraged loans, bank activities as managers or "bookrunners" of leveraged lending deals, and information drawn from SEC oversight of credit rating agencies (NRSROs) regarding to rating

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[13] Department of the Treasury, Office of Financial Research, *Congressional Budget Justification and Annual Report and Plan, FY 2019*, United States Department of the Treasury, https://bit.ly/2MsAAMS

practices used for Collateralized Loan Obligations (CLOs).. We would be glad to work with drafters on these and related issues.

Leveraged Lending Examination Enhancement Act – This legislation mandates that the Federal Financial Institution Examination Council (FFIEC) establish uniform examination procedures to ensure that leveraged lending is done in a safe and sound manner. This would create a new supervisory track for oversight of leveraged lending, in addition to current and past practices of issuing guidance related to leveraged loan underwriting under the general safety and soundness supervisory authority of the banking agencies.

We strongly support the principle of improving supervision of leveraged lending that is reflected in this draft bill. However, we have not yet fully analyzed the potential interactions between this legislation and the use of general safety and soundness supervisory authority to provide oversight of leveraged lending. We would also encourage the drafters to avoid any implication that certain types of leveraged lending, which by definition involves loans made to highly indebted companies with poor credit history, can necessarily be made safe and sound through an examination procedure.

Additional Legislative Ideas Related to Leveraged Lending

In addition to the three draft bills raised at today's hearing, we outline below several other legislative and oversight ideas that would act to make the leveraged lending market safer. These ideas are targeted at the link between leveraged lending and the capital markets. Other initiatives, for example related to the use of leveraged lending to finance leveraged buyouts and share buybacks, are needed but are not discussed in this statement.

As pointed out by witnesses today, the leveraged lending market has been fueled by an "originate to distribute" model that has some marked similarities to the securitization of subprime and alt-A mortgages prior to the financial crisis. According to the committee memo, over sixty percent of leveraged loans are sold to securitization trusts that issue Collateralized Loan Obligations (CLOs) to outside investors. Many loans are also held by investment funds, sometimes as shares in CLOs and sometimes directly as loans. The ideas below would all improve capital markets protections for leveraged loans in ways that would increase market discipline for bad debt and prevent such debt from being distributed widely throughout the financial system to investors who did not fully understand the risks involved.

Idea #1: Make the CLO Market Safer by Restoring Risk Retention for CLOs: Section 941 of the Dodd-Frank Act required securitizers of loans to retain some of the risk in each security they sold to the public. The intent of Section 941 was to avoid a repeat of the securitized "toxic assets" that drove the 2008 financial crisis, by ensuring that securitizers had incentives not to package bad debt in securitizations.

Last year the Loan Securitization and Trading Association (LSTA) successfully challenged the application of this rule to arrangers of CLOs.[14] The court ruled that risk retention did not apply to CLO arrangers, on the technical grounds that CLO arrangers were not "securitizers". The basis for this decision was that CLO arrangers did not actually hold securitized loans, even though they were the critical designers and sellers of the final securities. Because of this decision, risk retention does not apply to the CLO market. This thwarts the intent of the Dodd-Frank Act, which was to ensure that the designers and sellers of securitizations have incentives that are aligned with investors in their products.

Re-applying Section 941 to CLOs would be relatively straightforward, and would simply involve amending the definition of "securitizer" in the Dodd-Frank Act to clearly include CLO arrangers. Congress should act to do this.

Idea #2: Make the CLO Market Safer by Better Oversight of Ratings Agencies: The key institutional quality control for securitized products such as CLOs is provided by large Nationally Recognized Statistical Rating Organizations (NRSROs) such as Standard and Poors and Moodys. These agencies notoriously failed to properly rate mortgage securitizations prior to the 2008 financial crisis. Their role as a central driver of the crisis was highlighted by the Financial Crisis Inquiry Commission, and the major credit rating agencies were fined billions of dollars by the Justice Department for their fraudulent practices in rating securitizations.

It is our view, and the view of many other knowledgeable observers, that the fundamental conflicts of interest driving poor ratings have not been adequately addressed through the SEC inspection regime mandated under the Dodd-Frank Act. Ratings agencies are still paid by the issuers of the securities they rate, and still do not face a significant disincentive for ratings inflation. SEC examinations are limited in scope, and even when they have found violations of the NRSRO's own stated policies and procedures they have not imposed penalties. These conflicts of interest are particularly strong in the area of securitized products, where large revenue flows are at stake in gaining repeat business from securitization issuers. Continued incentives for ratings inflation may be permitting poorly designed or underwritten CLOs to inappropriately receive investment-grade ratings.

Oversight of ratings agencies should be strengthened and clear disincentives and penalties for ratings inflation should be put in place. AFR has previously suggested ideas for doing this based on holding credit ratings agencies accountable for their own forecasts of securities performance.[15] However, a variety of approaches could work as long as they changed current dysfunctional incentives.

Idea #3: Improve Liquidity Rules and Disclosures for Registered Funds: The proportion of leveraged loans held by registered funds such as mutual funds and exchange traded funds (ETFs) has grown enormously over the past decade. Today, these funds hold hundreds of billions of

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[14] The Loan Syndications and Trading Association v. SEC, No. 17-5004 (D.C. Circuit 2018), https://bit.ly/2JWQFbz

[15] Americans for Financial Reform, *Outcomes Based Accountability for Credit Rating Agencies*, AFR, June, 2014. https://bit.ly/2wAjzFN

dollars in leveraged loans, creating substantial retail investor exposure through 401-K plans and the like.[16]

Registered funds such as mutual funds and ETFs are supposed to hold liquid assets that can easily be converted to cash in the event of investor redemption requests. However, leveraged corporate loans are fundamentally illiquid and would only become more so in a situation of financial stress. Recent efforts by the SEC were described as moves to strengthen liquidity requirements for registered funds, but in our view have failed to do so.[17] Stronger limits on the holding of illiquid assets by registered funds, better fund planning for redemptions, and better disclosures of illiquid holdings could reduce the risk that funds would not be able to meet redemption demands under stress, and prevent possible fire sales in the event of market pressures.

Idea #4: Improve Volcker Rule Enforcement and Disclosures: The Volcker Rule statute limits proprietary trading by banks and bank investments in external funds, including securitization vehicles. Bank involvement in CLOs is directly restricted by the Volcker Rule. However, thanks to exemptions put in place by regulators, large bank holding companies are still permitted to play a central role as securitizers of debt, including by creating, selling, and dealing in CLOs.

The original regulatory exemptions did restrict bank involvement in securitizations to less complex loan securitizations, preventing bank involvement in excessively complex re-securitizations and synthetic securitizations. In the subprime CDO market that was central to the 2008 financial crisis, there was a direct connection between securitization complexity and performance, with more complex securitizations experiencing the highest loss rates.

However, it is difficult to tell whether the Volcker Rule has been effective in steering banks toward safer securitization structures. There has been very little public disclosure regarding Volcker Rule enforcement, and it is unclear whether securitization limits have been properly enforced. In addition, recent proposals to weaken the Volcker Rule could substantially expand existing exemptions, including by permitting banks to substantially expand their role in the CLO market. Congress should mandate improved disclosures regarding the implementation of the Volcker Rule. Congress should also take a hard look at whether current securitization exemptions are justified, and act to prevent any expansion in securitization exemptions that permits increased involvement by large banks in complex CLOs.

In addition to the ideas above, it may be reasonable to directly restrict the complexity of CLO structures in the broader market. A stronger Volcker Rule could restrict their complexity in the case of securitizations generated by large banks, but might not touch other areas of the market.

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[16] Smith, Colby, “Who’s Buying Leveraged Loans, Anyway?”, *Financial Times,* FT Alphaville, November 20, 2018. https://on.ft.com/2HUIjiI

[17] Americans for Financial Reform Education Fund, “Letter to the SEC Concerning Investment Company Liquidity Disclosure”, May 18, 2017. https://bit.ly/2XlolTr

Thank you for the opportunity to comment on this hearing. If you have questions or wish to discuss any of the issues raised in this statement, please contact AFR's Policy Director, Marcus Stanley, at 202-466-3672 or marcus@ourfinancialsecurity.org.