ELIZABETH WARREN
MASSACHUSETTS

COMMITTEES:
BANKING, HOUSING, AND URBAN AFFAIRS
HEALTH, EDUCATION, LABOR, AND PENSIONS
ARMED SERVICES
SPECIAL COMMITTEE ON AGING

# United States Senate

UNITED STATES SENATE
WASHINGTON, DC 20510–2105
P: 202–224–4543

2400 JFK FEDERAL BUILDING
15 NEW SUDBURY STREET
BOSTON, MA 02203
P: 617–565–3170

1550 MAIN STREET
SUITE 406
SPRINGFIELD, MA 01103
P: 413–788–2690

www.warren.senate.gov

November 14, 2018

The Honorable Steven T. Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

The Honorable Jerome Powell
Chairman, Board of Governors
Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

The Honorable Joseph Otting
Comptroller
Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

The Honorable Jelena McWilliams
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Dear Secretary Mnuchin, Chairman Powell, Comptroller Otting, Chairman Clayton, and Chairman McWilliams:

I am concerned about the rapid growth of leveraged corporate lending and the lack of appropriate response from the Financial Stability Oversight Council (FSOC) and your individual agencies. I fear that continued growth in leveraged lending – along with the steady degradation in loan terms – creates significant risk to the financial system and the American economy.

Leveraged lending – lending to companies that are already highly indebted – is at record levels. During the first nine months of this year, financial institutions issued an unprecedented $1.1 trillion in leveraged loans in the U.S.[1] These loans now make up about 25 percent of all business loans in America.[2] Loan underwriting is also weakening, as lenders are including fewer and fewer covenants to protect themselves in case of losses.[3]

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[1] Citi Research "Leverage Lending Risks," November 2, 2018.
[2] *Id.*
[3] *Id.*

Most of these loans are held by retail and institutional investors. More than 90% of leveraged loans are held by non-bank investors – up from 55% in 2000.[4] Securitizations like collateralized loan obligations (CLOs) have helped enable this shift, with CLOs outstanding increasing from $273 billion in the first quarter of 2013 to $598 billion today.[5]

A number of experts have recently rung alarm bells about the leveraged loan market. Former Federal Reserve Chair Janet Yellen said in October that she is "worried about the systemic risks associated with these loans," in part because "[t]here has been a huge deterioration in standards" and "covenants have been loosened."[6] Former Federal Reserve Governor Daniel Tarullo recently said the leveraged lending market "is an originate-to-distribute model again," and "[t]here is nobody charged with looking at whether it is creating a risk of cascading consequences."[7] And the Bank of England noted in October that the global leveraged loan market is bigger than the U.S. subprime mortgage market in 2006, and that like the American subprime market in the pre-crisis period, "underwriting standards [have] weakened."[8]

Under the last administration, banking regulators attempted to address the risks in the leveraged loan market. In 2013, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued new joint guidance setting out the agencies' risk management and underwriting expectations for leveraged lending.[9] In 2014, a dozen banks received letters from their primary regulators directing them to adhere to the guidance.[10] That year, the Federal Reserve also issued a supervisory finding to Credit Suisse, directing it to address its loose underwriting of high-risk leveraged loans to private equity funds, which were inconsistent with the guidance.[11]

The effect of the guidance on the leveraged lending market was modest but important. Leveraged lending continued to explode, growing from $550 billion when the guidance was announced to $1.1 trillion in the first nine months of this year.[12] Still, in the 2016 and 2017 reviews of credit risk, the banking agencies found that underwriting was improving, concluding that "improved underwriting and risk management practices related to the most recent leveraged loan originations as underwriters continued to better align practices with regulatory expectations, and

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[4] *Id.* at Fig. 11.
[5] Sifma, "US Bond Market Issuance and Outstanding," https://www.sifma.org/resources/research/us-bond-market-issuance-and-outstanding/.
[6] Business Insider, "Former Fed Chair Janet Yellen just joined the chorus of warnings about $1.6 trillion 'leveraged loan' market," Trista Kelley, October 25, 2018, https://www.businessinsider.com/janet-yellen-leveraged-loan-warning-2018-10.
[7] Bloomberg Law, "Wider Risk of Leveraged Loans Warrants Scrutiny, Tarullo Says," Craig Torres and Lisa Lee, October 30, 2018, https://news.bloomberglaw.com/banking-law/wider-risk-of-leveraged-loans-warrants-scrutiny-tarullo-say.
[8] The Guardian, "Bank of England raises alarm over surge in high-risk lending," Ricard Partington, October 17, 2018, https://www.theguardian.com/business/2018/oct/17/bank-of-england-high-risk-lending-leveraged-loans.
[9] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, "Agencies issue updated leveraged lending guidance," press release, March 21, 2013, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130321a.htm.
[10] Wall Street Journal, "Banks Sit Out Riskier Deals," Gillian Tan, January 14, 2014, https://www.wsj.com/articles/banks-sit-out-riskier-deals-1390350506.
[11] Wall Street Journal, "Credit Suisse Loans Draw Fed Scrutiny," Gillian Tan and Ryan Tracy, September 16, 2014, https://www.wsj.com/articles/credit-suisse-loans-draw-fed-scrutiny-1410910272.
[12] Citi Research "Leverage Lending Risks," November 2, 2018.

as investor risk appetite moderated away from transactions at the lower end of the credit spectrum."[13] This success suggests that the guidance was having some positive effect – though not enough to slow the rapid growth of riskier loans.

But instead of building on the 2013 guidance, your agencies appear to have backed off of it. This past February, Comptroller Otting said that "as long as banks have the capital, I am supportive of banks doing leveraged lending," even if those actions transgress the 2013 guidelines.[14]

I am concerned that the large leveraged lending market exhibits many of the characteristics of the pre-2008 subprime mortgage market. These loans are generally poorly underwritten and include few protections for lenders and investors. Many of the loans are securitized and sold to investors, spreading the risk of default throughout the system and allowing the loan originators to pass the risk of poor underwriting on to investors. And the loans include adjustable interest rates – which means that if the Federal Reserve continues to raise interest rates in the upcoming years, companies will face rising interest costs just as the economy starts to slow down.

Therefore, I ask that you answer the following questions:

<u>To Secretary Mnuchin</u>:

1. The leveraged lending market involves a number of different types of entities that are subject to oversight from a number of different federal regulators. Congress created FSOC to ensure adequate oversight of such cross-cutting markets. In your capacity as the head of FSOC, what is FSOC doing to monitor the growing leveraged lending market and to coordinate responses across the different agencies with relevant jurisdiction? Is the Office of Financial Research looking into the growing risks in this market?

<u>To Chairman Powell, Comptroller Otting, Chairman McWilliams, and Chairman Clayton</u>:

2. The Volcker Rule is intended to restrict bank involvement with external funds, including securitizations. Securitizations like CLOs are central to the leveraged lending market. Trade associations have asked you to significantly loosen Volcker Rule controls on bank involvement with CLOs, and questions in your latest Volcker Rule proposal suggest you are considering greatly broadening permissible external funds activities by banks. Expanding securitization exemptions as requested by industry trade groups could significantly increase such holdings and produce bank involvement in more complex CLO re-securitizations and synthetic securitizations. Have you investigated how such liberalization in Volcker Rule standards could affect underwriting in the leveraged lending market, and whether it could lead to a proliferation of complex leveraged lending securitizations that would be more difficult for ratings agencies and investors to assess?

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[13] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, "Shared National Credit Review Finds Risk Remains High, but Underwriting and Risk Management Improve," press release, July 29, 2016, https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-ia-2016-87.html.

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

To Chairman Powell, Comptroller Otting, and Chairman McWilliams:

3. Do you share the concerns of former Federal Reserve Chair Yellen, former Federal Reserve Governor Tarullo, and the Bank of England, among others, about the leveraged loan market?

4. How does your agency currently view the 2013 leveraged lending guidance? Is the guidance still in effect? Do your agencies monitor compliance with the guidance? If institutions under your supervision violate the guidance, will you issue supervisory findings or otherwise direct the institutions to come into compliance with the guidance?

5. What plans, if any, does your agency have to address growing risks in the leveraged lending market?

To Chairman Clayton:

6. Do you have concerns about CLO market for leveraged loans?

7. As you know, the Dodd-Frank Act established an Office of Credit Ratings within the SEC that is responsible for promoting the accuracy of credit ratings issued by Nationally Recognized Statistical Ratings Organizations (NRSROs) and ensuring that such ratings are not unduly influenced by conflicts of interest or sales considerations.

    a. In your supervision of NRSROs, do you find any evidence that ratings of leveraged loans and CLOs are lacking in accuracy or are unduly influenced by conflicts of interest or sales considerations?

    b. How is the increasing prevalence of "covenant-light" loans incorporated into the formal NRSRO ratings of such loans? For example, are the "covenant score" metrics generated by certain NRSROs incorporated or taken into account in their methodologies for producing ratings of securitized products, bonds, or notes related to those leveraged loans?

I respectfully request that you provide responses to these questions by December 11, 2018. I also ask that your staffs provide my staff with a briefing on this matter before December 11.

Thank you for your attention to this matter.

Sincerely,

Elizabeth Warren
United States Senator