United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

May 13, 2019

Hon. Randal K. Quarles
Vice Chair for Supervision
Board of Governors of the
Federal Reserve System
Constitution Avenue & 20th Street, N.W.
Washington, D.C. 20551

Hon. Jelena McWilliams
Chair
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Hon. Joseph Otting
Comptroller
Office of the Comptroller of the Currency
400 7th Street, N.W.
Washington, D.C. 20219

Hon. Rodney E. Hood
Chair
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Dear Vice Chair Quarles, Comptroller Otting, Chair McWilliams, and Chair Hood,

Banks' increased exposure to the leveraged loan market continues to concern me. As you know, earlier this week the Federal Reserve released its Financial Stability Report, which highlighted excessive leverage in corporate lending as a financial system vulnerability. In 2018, leveraged lending increased by 20 percent to $1.1 trillion outstanding, and has continued to increase in the first quarter of 2019. Lending standards and loan covenants have continued to deteriorate. Despite more and more evidence of risky corporate debt threatening our financial system, the agencies have not taken action.

Last month, I asked the Chair of the Financial Stability Oversight Council (FSOC) Treasury Secretary Mnuchin and the members of FSOC to demonstrate how they are responding to this emerging threat. Chair Mnuchin, however, failed to answer substantively any of the questions in my April 11, 2019 letter.

In light of this inadequate response from Chair Mnuchin, please be prepared to share detailed responses to the questions in my April 11, 2019 letter and provide supporting data to the Committee on these topics as part of your testimony during the Committee on Banking, Housing, and Urban Affairs Hearing on May 15, 2019.

Sincerely,

Sherrod Brown

Sherrod Brown
Ranking Member

Enclosures

lending and might have far-reaching economic consequences.[6] Former Federal Reserve Chair Janet Yellen recently raised similar concerns about the impact of increased leverage in an economic downturn.[7]

The marked increase in the volume of leveraged loans originated by financial institutions has been accompanied by a notable decrease in underwriting standards. Like many financial activities, leveraged lending benefits banks and financial intermediaries that profit by packaging and selling risky loans. As we learned in the run-up to the financial crisis of 2008, the health of the economy can't be judged by the short-term profitability of Wall Street. Remember, when Citigroup CEO Chuck Prince was asked in 2007 whether he was worried about the risks in his bank's leveraged lending portfolio, he said: "as long as the music is playing, you've got to get up and dance. We're still dancing."[8] As was true of that crisis, when poorly underwritten loans go bad, it is not the banks or even the investors that take the brunt of the pain – it's hardworking families and local communities.[9]

FSOC must consider whether this additional risk to the banking system serves as a public benefit to the real economy. For example, leveraged loans are often used to fund risky private equity transactions, many of which struggle and fail under unsustainable debt loads, causing harm to local and regional economies. These types of transactions can cause booms and busts that harm workers and the environment,[10] facilitate the concentration or even dissolution of important democratic institutions like local newspapers,[11] make housing less accessible and more costly,[12] or even undermine the provision of the most basic and critical government services.[13]

In short, an overheated leveraged lending market rewards bad investments that will have negative repercussions for the workers and businesses that create economic growth.

While this administration has bragged about the stock market, household debt has grown to record highs,[14] student loan delinquencies have accelerated,[15] and more Americans are falling behind on their car payments.[16] Families across the country are struggling and can't afford to be squeezed any harder. We must pay attention to the workers on Main Street who drive our economy and make sure speculation and greed on Wall Street do not cause another financial crisis.

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[6] https://www.reuters.com/article/us-boe-loans-carney/leveraged-loans-echo-pre-crisis-subprime-crash-boes-carney-idUSKCN1PA1SX
[7] https://www.reuters.com/article/regulatory-crackdown-unlikely-in-us-leve/regulatory-crackdown-unlikely-in-us-leveraged-loan-market-idUSL1N2120Q6
[8] https://www.reuters.com/article/us-citigroup-lbo/citigroups-lbo-dance-card-proves-too-full-idUSN0132320120071003
[9] https://www.reuters.com/article/regulatory-crackdown-unlikely-in-us-leve/regulatory-crackdown-unlikely-in-us-leveraged-loan-market-idUSL1N2120Q6
[10] https://www.wsj.com/articles/from-2-billion-to-zero-a-private-equity-fund-goes-bust-in-the-oil-patch-1500210002
[11] https://prospect.org/article/saving-free-press-private-equity;
[12] https://www.theatlantic.com/technology/archive/2019/02/single-family-landlords-wall-street/582394/
[13] https://www.nytimes.com/interactive/2016/08/02/business/dealbook/this-is-your-life-private-equity.html
[14] https://www.newyorkfed.org/newsevents/news/research/2019/20190212
[15] https://www.bloomberg.com/news/articles/2019-02-22/u-s-student-loan-delinquencies-hit-record
[16] https://www.bloomberg.com/news/articles/2019-02-12/auto-loan-performance-worsens-on-rise-in-subprime-delinquencies

The Council should not wait to see what happens when the music stops. Regulators must demonstrate that they are responding to threats to financial stability before the real economy suffers. To that end, please provide me the following no later than April 23, 2019:

1) Any analyses of the leveraged lending market that the Council and its member agencies have performed in the last two years;
2) Any other Council documents discussing the risks of leveraged lending and staff recommendations to address those risks;
3) A list of all Council meetings where leveraged lending was discussed, including the dates of those meetings, attendees, and materials presented;
4) A list of supervisory or other actions that the Council and its member agencies have taken at regulated institutions in order to address risks in the leveraged lending market, especially with regard to weak underwriting standards; and
5) A description of how FSOC is monitoring leveraged lending markets and what actions it plans to take to protect the economy from threats in credit and lending markets.

Sincerely,

Sherrod Brown

Sherrod Brown
Ranking Member

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
Hon. Kathleen Kraninger, Director, Consumer Financial Protection Bureau
Hon. Jay Clayton, Chair, Securities and Exchange Commission
Hon. Jelena McWilliams, Chair, Federal Deposit Insurance Corporation
Hon. J. Christopher Giancarlo, Chair, Commodity Futures Trading Commission
Hon. J. Mark McWatters, Chair, National Credit Union Administration
Hon. Thomas E. Workman, Independent Member Having Insurance Expertise, Financial Stability Oversight Council
Hon. Mark Calabria, Director, Federal Housing Finance Agency
Ken Phelan, Acting Director, Office of Financial Research
Steven Seitz, Director, Federal Insurance Office
Charles G. Cooper, Commissioner, Texas Department of Banking
Eric Cioppa, Superintendent, Main Bureau of Insurance
Melanie Lubin, Securities Commissioner, Maryland Office of the Attorney General

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 30, 2019

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Brown:

I write in response to your April 11, 2019 letter regarding the Financial Stability Oversight Council's (Council) monitoring of risks in the leveraged loan market.

The Council annually provides Congress with a report that identifies potential emerging threats to U.S. financial stability. The Council's 2018 annual report—unanimously adopted by the Council on December 19, 2018—did just that, evaluating developments in corporate borrowing and corporate credit markets. The analyses in the report included trends in nonfinancial corporate debt relative to the size of the U.S. economy; nonfinancial business leverage and interest coverage ratios; nonfinancial corporate liquid assets; corporate credit spreads; and issuance of corporate bonds and collateralized loan obligations.[1]

The Council determined that while U.S. nonfinancial businesses have continued to service their debt burdens with low delinquency rates due to their strong interest coverage and liquidity positions, these factors may not prevent increased defaults in the event of a recession or other shock to business earnings. The Council concluded that the potential impact on financial stability would depend on the extent and severity of business defaults, the extent of spillovers to other markets, and the ability of investors and intermediaries to manage their losses.[2]

As referenced in your letter, the 2018 annual report further included a recommendation that agencies continue to monitor levels of nonfinancial business leverage, trends in asset valuations, and potential implications for the entities they regulate in order to assess and reinforce their ability to manage severe, simultaneous losses in those markets. The Council noted that actions to ensure that the relevant investors and intermediaries can manage such losses, rather than amplify or transmit them, will reduce the threat to financial stability posed by such a scenario.[3]

The Council continues to monitor developments in nonfinancial corporate credit. Most recently, at its meeting on March 6, 2019, the Council received a presentation from staff of the Board of

[1] *See* Fin. Stability Oversight Council, 2018 Annual Report, at 25-27, https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf.
[2] *See id.* at 112.
[3] *See id.* at 11.

Governors of the Federal Reserve System (Federal Reserve) and the Office of Financial Research. Council members discussed trends in credit quality and outstanding debt volumes, as well as potential vulnerabilities.

Individual Council member agencies with supervisory or other responsibilities also are continuing to monitor the potential effects of developments in the leveraged lending market on their respective regulated entities. For example, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency review and assess risk in leveraged lending, among other lending types, through their Shared National Credit (SNC) Program. In their 2018 SNC Program Review, the federal banking agencies found that risks associated with leveraged lending activities were building. They stated, among other things, that banks engaged in originating and participating in leveraged loans should ensure that risk-management processes keep pace with changes in the leveraged lending market and ensure that their risk-management processes and limits fully consider the potential direct and indirect risks associated with these loans.[4] I respectfully refer you to those regulators for additional information on their activities in this area.

If you have any other questions, please direct your staff to contact the Office of Legislative Affairs.

Sincerely,

Frederick W. Vaughan

Frederick W. Vaughan
Deputy Assistant Secretary
Office of Legislative Affairs

cc: The Honorable Jerome H. Powell
The Honorable Joseph M. Otting
The Honorable Kathleen Kraninger
The Honorable Jay Clayton
The Honorable Jelena McWilliams
The Honorable J. Christopher Giancarlo
The Honorable Rodney Hood
The Honorable Thomas E. Workman
The Honorable Mark Calabria
Director Steven Seitz
Commissioner Charles G. Cooper
Superintendent Eric Cioppa
Securities Commissioner Melanie Lubin

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[4] Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., & Office of the Comptroller of the Currency, Shared Nat'l Credit Program, 1st and 3rd Quarter 2018 Examinations, at 3 (Jan. 2019), https://www.occ.treas.gov/news-issuances/news-releases/2019/pub-snc-review-2018.pdf.