Turns Out Leveraged Loans Aren't a Systemic Risk After All

Bill Nelson | Feb. 8, 2020

SUMMARY

Analysis that BPI published on Nov. 14, 2017 – "Why leveraged lending guidance is far more important, and far more misguided, than advertised" – questioned the facts and motivation behind the Fed's invocation of systemic risk as a reason for its 2014 guidance on bank origination and sale of risky leveraged loans; we also called out the dangers of the Fed being able to cry "systemic risk" as a reason to dictate bank behavior. We now have some relevant new information on this issue. A GAO report issued in December 2020 ("Agencies Have Not Found Leveraged Lending to Significantly Threaten Stability but Remain Cautious Amid Pandemic") concluded that leveraged loans do not present systemic risk. Moreover, recently released transcripts of the 2015 meetings of the FOMC call into question whether there is *any* Fed analysis that actually found that leveraged loans presented systemic risk.

BACKGROUND[1]

In October 2017, the GAO determined that the 2013 Interagency Guidance on Leveraged Lending was a "rule" under the Congressional Review Act ("CRA") and should have been submitted to Congress. See "The GAO's Determination that Leveraged Lending Guidance is a "Rule" under the Congressional Review Act: Key Issues & Ramifications" for an explanation of the ramifications of this determination.[2] The usual legal basis for such restrictions by the banking agencies is that there is a risk to the safety and soundness of the bank, but because the bank has sold the loan, there is no risk to its safety and soundness. Instead the agencies pointed to "risks for the financial system" in the 2013 guidance and risks to the "banking system or the broader financial system" in the FAQs as reasons to prohibit banks from originating what the agencies deem to be "poor quality" loans.

Section 165 of the Dodd-Frank Act grants the Federal Reserve the authority to issue prudential standards on large banks "[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions." As we discuss in our earlier note, it is unclear that this authority can rightly be relied upon to support the leveraged lending guidance and FAQs, especially since Congress clearly expected such matters to be handled by the FSOC, but it is unambiguous that the OCC and FDIC have no such authority. But even stipulating that the Federal Reserve has the authority to dictate bank behavior that does not threaten the bank's safety and soundness but does increase risk to the financial system (and ignoring the fact that the OCC and FDIC unambiguously do not have such

[1] Additional background information is available in our 2017 note.

[2] In October 2017, the GAO concluded that the "guidance" is actually a "rule" under the Congressional Review Act.

authority), at a minimum the Fed must conclude that the behavior increases systemic risk. Recently released information, however, calls into question whether any such conclusion was reached.

DID ANYONE EVER ACTUALLY THINK THAT LEVERAGED LOANS CAUSED SYSTEMIC RISK?

Leveraged loans are large syndicated loans extended to highly leveraged corporations. Starting in 2013, terms on such loans had become slacker, driven in part by high demand for collateralized loan obligations (CLOs), which are structured products collateralized by loans, as well as demand from mutual funds that held the loans directly. In particular, the typical leverage of the borrowers had increased and the covenants included in the loan to protect the lender (or, more accurately, owner of the loan) had been eased. While such changes unquestionably make the loans riskier, many financial products are riskier still (such as equities). In general, leveraged loans would only present systemic risk if they were being held by investors that were themselves highly leveraged and funded with short-term debt.

Were leveraged loans originated by a bank that the bank cannot itself hold contributing to systemic risk? While banks are highly leveraged and funded with short-term debt, banks can't and didn't hold the loans in question. The mutual funds that held the loans can be exposed to liquidity challenges if many investors demand their funds simultaneously, but the assets of the funds are marked to market, which reduces (although does not eliminate) the first-out-the-door advantage; and the funds are not themselves leveraged, so the pressures do not get amplified by a deleveraging cycle. Banks invest in the AAA-tranches of CLOs, and similar investment certainly increased systemic risk in the runup to the Great Financial Crisis, but the design of CLOs changed after the crisis and they were judged to be much more stable. For example, the 2013 annual financial stability report of the FSOC issued in early 2014, in its section on "Potential Emerging Threats," concluded that CLOs were not a systemic risk:

> The high volume of CLO issuance is indicative of broader issuance trends in the leveraged loan market, where financial conditions are getting less tight. Increased issuance of leveraged loans has historically served as an early warning indicator. However, since the financial crisis, rating agencies have revised criteria to require higher credit enhancements for rated CLO tranches, which provide additional protection for senior note investors. Today, CLO structures are generally less complex than they were before the crisis. While leverage and illiquidity were key vulnerabilities for structured products during the crisis, CLOs today are primarily funded either by non-levered investors or commercial banks, which tend to buy senior tranches. There is little evidence that CLOs are funded by leveraged, short-term funded investors outside of depository institutions. Besides banks, CLO investors are often long-term, fully capitalized entities whose holding periods are less sensitive to short-term funding conditions. Furthermore, many CLOs are floating rate, and as a result protect investors against interest rate risk. p. 144

Conceivably, the Fed thought that leveraged loans were a systemic risk in 2013 and 2014 even if the FSOC (of which it is the most prominent member) did not. However, the transcripts of the 2015 FOMC meetings, which were released last month, suggest that the Fed did not, in fact, see leveraged loans as a systemic risk, at least as of 2015. In July 2015, then-Governor Daniel Tarullo, who had responsibility for bank supervision, stated about leveraged loans:

> MR. TARULLO. I just want to make sure everybody is clear. Very little of this stuff is held on the balance sheet of regulated institutions. What Nellie's charts are showing is the originations of this stuff—but, Nellie, you have to help me here, because you haven't done a recent detailed briefing on this—most of which is being held by quite non leveraged institutions. And so I actually don't think, as we have looked at this, that we have seen it as a financial stability risk, as conventionally understood, so much as, instead, a potential macroprudential risk because of what would happen to the real economy if there were an awful

> lot of bankruptcies, which then carried through into affecting the end investors. p. 109

The "Nellie" he mentions is Nellie Liang, then Director of the Office of Financial Stability Policy and Research, who had just delivered to the FOMC a briefing on financial stability. Tarullo made a similar remark in October 2015, again following the financial stability briefing, which, this time, had been delivered by Andreas Lehnert (who is now the Director of the Division of Financial Stability).

> MR. TARULLO. President Williams was, I think, implicitly drawing an important distinction between, on the one hand, financial stability considerations, in which leverage is implicated—meaning that there's some significant risk to the intermediation function—and, on the other hand, the potential effect of leverage as a macroeconomic matter. Nellie and Andreas, I thought we had a pretty good case study of at least thinking that through in the leveraged-lending context that Governor Fischer was mentioning a moment ago. In that case we were pretty confident that financial-stability risks, as conventionally understood, were not all that implicated by this big growth of leveraged-lending originations because so much of that was getting passed on to ultimate holders who were not themselves intermediators, or at least not highly leveraged intermediators. p. 86

Ultimately, the proof is in the pudding. In December 2020, the GAO issued a report on how leveraged loans and CLOs had performed during the intense financial strains caused by the pandemic. The report found that the COVID-19 shock severely affected the leveraged loan market (p. 28). Nevertheless, the report observes that analyses by the relevant regulators have concluded that leveraged lending activities have "not posed significant threats to the stability of the U.S. financial system" (p. 32). In particular, the report stated

- "…exposure to leveraged lending has not contributed significantly to the distress of any large, potentially systemically important bank, insurance company, or other financial entity…" (p. 33),
- "…post Covid-19 shock asset sales from mutual funds that invest primarily in leveraged loans may have contributed to downward pressure on loan prices in an already declining market but had not posed a significant threat to financial stability…", and
- "…present-day CLO securities have not posed the same risks to financial stability as those posed by similar securities common during the 2007-2009 financial crisis…" (p. 39)

Thus, it appears that the Fed, or at least the Board staff responsible for financial stability and the Governor over bank supervision and regulation, did not think leveraged lending posed systemic risk around the time that the leveraged lending guidance and FAQs were issued. And it appears that they were right – after weathering the worst macroeconomic shock on record, the GAO found no evidence that leveraged loans posed systemic risks.[3]

WHAT THEN WAS GOING ON?

If the Fed did not, in fact, see leveraged loans as a systemic risk, why did it issue the guidance and FAQs? We argued in our earlier note that the explanation lies in the monetary policy debate that was playing out at the time. In 2014, the FOMC was winding down its asset purchases and deciding on how strongly to indicate that it intended to keep interest rates near zero after the purchases were over. At the same time, several FOMC participants were concerned that low rates were causing investors to seek higher yield by choosing riskier products. The leveraged lending guidance was touted in FOMC meetings as intended to address those risks, but the guidance by itself did not appear to have been having much of an effect, strengthening the case of those participants that wanted to

[3] For an alternative point of view, amusingly free of facts or knowledge, see "The Looming Bank Collapse," in the July/August 2020 issue of The Atlantic.

raise interest rates sooner rather than later. Ultimately, the Fed issued the FAQs in November 2014, which were much more forceful than the guidelines, and deployed its supervisors to rein in leveraged lending. The lending slowed considerably at the end of 2014 and in early 2015.

In short, the Fed appears to have expediently "concluded" that, even if leveraged lending did not pose a risk to individual banks' safety and soundness, it did pose a risk to the financial system and therefore needed to be curtailed, as a way to justify actions that facilitated continued easy monetary policy. The resulting reduction in such lending had real consequences, preventing nonfinancial businesses from receiving credit and those businesses, in turn, from pursuing economic opportunities. In reality, at least as demonstrated by the performance of leveraged loans during the COVID-19 crisis, no such systemic risk existed, and those economic opportunities were needlessly lost.

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