GAO Highlights

Highlights of GAO-21-167, a report to agency officials

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FINANCIAL STABILITY

Agencies Have Not Found Leveraged Lending to Significantly Threaten Stability but Remain Cautious Amid Pandemic

Why GAO Did This Study

The market for institutional leveraged loans grew from an estimated $0.5 trillion in 2010 to $1.2 trillion in 2019, fueled largely by investor demand for CLO securities. Some observers and regulators have drawn comparisons to the pre-2008 subprime mortgage market, noting that loan origination and securitization may similarly spread risks to the financial system. These fears are being tested by the COVID-19 pandemic, which has significantly affected leveraged businesses.

This report examines assessments by regulators, FSOC, and others—both before and after the COVID-19 shock to the economy—of the potential risks to financial stability stemming from leveraged lending activities, and the extent to which FSOC monitors and responds to risks from broad-based activities like leveraged lending, among other objectives.

GAO examined agency and private data on market size and investor exposures; reviewed agency, industry, and international reports; and interviewed federal financial regulators and industry participants.

What GAO Recommends

GAO recommends that the Secretary of the Treasury, as Chairperson of FSOC, conduct scenario-based exercises intended to evaluate capabilities for responding to crises. GAO also reiterates its 2016 recommendation (GAO-16-175) that Congress consider legislative changes to align FSOC's authorities with its mission. FSOC neither agreed nor disagreed with the recommendation, but said that it would take further actions if it determined necessary.

View GAO-21-167. For more information, contact Michael E. Clements at (202) 512-8678 or ClementsM@gao.gov.

What GAO Found

In the years before the economic shock from the COVID-19 pandemic, the Financial Stability Oversight Council (FSOC) and others assessed the potential risks to financial stability that leveraged loans and collateralized loan obligation (CLO) securities may pose. Generally, leveraged loans are those made to businesses with poor credit and high debt, and CLO securities are backed by these loans. FSOC and others found that riskier borrower profiles and looser underwriting standards left leveraged lending market participants vulnerable to losses in the event of a downturn. After the COVID-19 shock in March 2020, loans suffered record downgrades and increased defaults, but the highest-rated CLO securities remained resilient. Although regulators monitoring the effects of the pandemic remain cautious, as of September 2020, they had not found that leveraged lending presented significant threats to financial stability.

- Based on regulators' assessments, leveraged lending activities had not contributed significantly to the distress of any large financial entity whose failure could threaten financial stability. Large banks' strong capital positions have allowed them to manage their leveraged lending exposures, and the exposure of insurers and other investors also appeared manageable.
- Mutual funds experienced redemptions by investors but were able to meet them in part by selling leveraged loan holdings. While this may have put downward pressure on already-distressed loan prices, based on regulators' assessments, distressed leveraged loan prices did not pose a potential threat to financial stability.
- Present-day CLO securities appear to pose less of a risk to financial stability than did similar securities during the 2007–2009 financial crisis, according to regulators and market participants. For example, CLO securities have better investor protections, are more insulated from market swings, and are not widely tied to other risky, complex instruments.

FSOC monitors leveraged-lending-related risks primarily through its monthly Systemic Risk Committee meetings, but opportunities exist to enhance FSOC's abilities to respond to financial stability threats. FSOC identified leveraged lending activities as a source of potential risk to financial stability before the COVID-19 shock and recommended continued monitoring and analysis. However, FSOC does not conduct tabletop or similar scenario-based exercises where participants discuss roles and responses to hypothetical emergency scenarios. As a result, FSOC is missing an opportunity to enhance preparedness and test members' coordinated response to financial stability risks. Further, as GAO reported in 2016, FSOC does not generally have clear authority to address broader risks that are not specific to a particular financial entity, such as risks from leveraged lending. GAO recommended that Congress consider better aligning FSOC's authorities with its mission to respond to systemic risks, but Congress had not done so as of September 2020. GAO maintains that changes such as broader designation authority would help FSOC respond to risks from activities that involve many regulators, such as leveraged lending.