Lael Brainard: Financial stability

Testimony by Ms Lael Brainard, Member of the Board of Governors of the Federal Reserve System, before the House Financial Services Subcommittee on Consumer Protection and Financial Institutions, US House of Representatives, Washington DC, 25 September 2019.

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Thank you, Chairman Meeks, Ranking Member Luetkemeyer, and members of the subcommittee. I appreciate the opportunity to be here today to discuss financial stability.

The Federal Reserve's Role in Promoting Financial Stability

Safeguarding financial stability is integral to achieving the Federal Reserve's objectives of full employment and price stability. We need only look back a decade to see the dramatic damage from financial vulnerabilities that increased unchecked: millions of Americans lost their livelihoods and their homes, businesses failed, and the government had to provide extraordinary support. We learned from this experience that we must be especially vigilant to fortify the resilience of our financial system in good times when vulnerabilities may be building.

Following the financial crisis, the Congress assigned important responsibilities for safeguarding the stability of the financial system to domestic regulators. The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council (FSOC) to identify, coordinate and respond to emerging threats to the financial system. The Federal Reserve was assigned responsibility for enhanced supervision of systemic firms, and we have placed great emphasis on strengthening our approach to promoting financial stability. Safeguarding financial stability is a shared responsibility, requiring cooperation across U.S. regulatory agencies, as well as with foreign regulators and central banks. Chair Powell represents the Federal Reserve in the FSOC, where we participate alongside other domestic regulators and the Treasury, and I am pleased to be joined today by Dino Falaschetti of the Office of Financial Research. We also participate in a variety of international forums, including the Financial Stability Board, which Vice Chair Randal Quarles chairs, and where I serve as the Federal Reserve representative.

The Board instituted a new organizational framework to carry out our responsibilities on financial stability. We created the Division of Financial Stability to strengthen our cross-disciplinary approach to the analysis of potential risks to the financial system and to support macroprudential supervision of large financial institutions. I serve as chair of the Committee on Financial Stability, which was created to guide staff work and make recommendations to the Board.[1] We develop a financial stability assessment four times per year that is discussed by the Board and the Federal Open Market Committee.

We have also taken steps to ensure transparency and accountability. Last year, I was pleased that the Board accepted my recommendation to publish a public *Financial Stability Report* twice a year.[2] The report provides an account of our assessment of vulnerabilities as well as a summary of market participants' views on potential risks to the financial system. Through this public communication, we hope to gain feedback from the broader financial stability community and the public on threats to the financial system.

How the Federal Reserve Approaches Financial Stability

Our approach to financial stability recognizes that the financial system and the broader economy are intertwined. The buildup of financial imbalances in good economic times has the potential to amplify shocks in a downturn and push the economy away from full employment and price stability. When financial vulnerabilities build, adverse developments can lead to disruptions in

credit and other financial services, potentially amplifying declines in employment and economic activity. Our goal is to promote a resilient financial system that is able to continue meeting the demands of households and businesses for financial services when faced with adverse events.

Accordingly, we have developed a systematic forward-looking approach to assessing financial vulnerabilities that could amplify negative shocks, transmitting damage more broadly. The historical record here and abroad points to several key areas of vulnerability. Vulnerabilities can build when there is excessive or poorly underwritten borrowing across many households, such that incomes are not keeping up with debt payments. Similarly, elevated levels of corporate debt can create problems not only for the borrowers, but also for lenders, when the business cycle turns, and debt servicing obligations or refinancing prove challenging, leading businesses to pull back on investment and employment. Vulnerabilities historically have often been associated with conditions where asset prices are higher than what economic fundamentals support, often because of elevated risk appetite, potentially leading to much larger-than-expected losses should a sharp correction occur. Separately, we track leverage in the financial system for signs that banks and other financial intermediaries potentially have inadequate buffers of capital to absorb adverse shocks, increasing the risk of their distress and possible spillovers to the financial system. We also monitor funding risk in the financial system. Where banks or nonbank financial intermediaries fund long-term lending through potentially flighty short-term borrowing, it may pose the risk of a loss of confidence, precipitating a withdrawal of short-term funding and strains on institutions as they try to meet withdrawals.

To illustrate, I will provide my brief assessment in each of these areas. In contrast to the years preceding the crisis, when household borrowing was growing at a pace far above that of gross domestic product (GDP), it has since come down and is now growing more slowly than the economy overall. Moreover, while much of the increase before the crisis reflected borrowing that proved unsustainable, more recent borrowing has been concentrated among households with strong credit profiles. That said, the increase in student debt in recent years deserves attention, although not primarily through the prism of financial stability.

The regulated financial sector is more resilient, owing to far-reaching reforms as well as favorable conditions. Insurers appear generally well capitalized, and broker-dealers, including those not affiliated with large bank holding companies, have reduced their leverage in recent years. In contrast, there has been some evidence of rising use of leverage by hedge funds over the past couple of years. Large banks increased both the size and quality of their capital buffers following the crisis, although the risk-weighted capital ratio at the largest banks has moved down somewhat as payouts have exceeded earnings over the past couple of years.

Financial reform has reduced funding risks associated with banks and money market funds. Large banks subject to liquidity regulation are less reliant on unstable short-term wholesale funding and have thicker liquidity buffers. Money market reforms have also reduced funding risks.

A range of asset prices remain high relative to historical benchmarks, even with the recent financial market volatility. In particular, yields on high-yield corporate bonds relative to Treasury securities remain somewhat narrow on a historical basis despite recent increases. Similarly, although they have moved up in recent months, spreads on leveraged loans remain in the bottom half of their range since the financial crisis, which is notable given the evidence of weakening protections. Finally, capitalization rates on commercial real estate properties, which measure annual income relative to prices for recently transacted properties, have been low relative to Treasury yields. In addition to generating losses for investors, declines in valuations could make it more challenging for firms to obtain or extend financing—especially among risky, indebted firms—which in turn could be amplified by the high levels of risky corporate debt.

Finally, business borrowing has risen more rapidly than GDP for much of the current expansion and now sits near its historical peak. The run-up in corporate debt has brought the ratio of debt to

assets close to its highest level in two decades on an overall basis, and this is also true for speculative-grade and unrated firms. And whereas previously, mostly high-earning firms with relatively low leverage were taking on additional debt, analysis of detailed balance sheet information indicates that firms with high leverage, high interest expense ratios, and low earnings and cash holdings have been increasing their debt loads the most. Historically, high leverage has been linked to elevated financial distress and retrenchment by businesses in economic downturns.

Regarding corporate bonds outstanding, recent years have witnessed little change in the relative shares of investment-grade bonds and high-yield bonds. Credit quality has deteriorated within the investment-grade segment, where the share of bonds rated at the lowest investment-grade level has reached near-record levels. As of mid-2019, just over half of investment-grade corporate bonds outstanding were at the lowest end of the investment-grade segment. In comparison, the share of high-yield bonds outstanding that are rated “deep junk” has stayed flat at about one-third over the past few years, well below the financial crisis peak of 50 percent.

In an economic downturn, widespread downgrades of these low-rated investment-grade bonds to speculative-grade ratings could induce some investors to sell them rapidly—for instance, because lower-rated bonds have higher regulatory capital requirements or because bond funds have limits on the share of non-investment-grade bonds they hold. This concern may be higher now than in the past, since total assets under management in bond mutual funds have more than doubled in the past decade, and these funds now hold about one-tenth of the corporate bond market. The redemption behavior of investors in these funds during a market correction is unclear.

Further down the credit quality ladder, there has been sizable growth in leveraged lending, accompanied by a notable deterioration in underwriting standards. Net issuance of leveraged loans to risky borrowers grew rapidly last year and boosted leveraged loans outstanding to a level exceeding $1 trillion overall, although the pace of issuance has slowed more recently as the interest rate environment has shifted. While leveraged loans have traditionally had important investor protections, covenants for leveraged loans issued in the past few years have weakened dramatically, and they often include features that increase opacity and risk. A substantial share of the leveraged loans are packaged in collateralized loan obligations (CLOs) whose issuance increased sharply in 2018 and has since moderated somewhat. Many large banks originate leveraged loans with an intent to distribute, often to CLOs. While the direct exposures of the banking system in the form of loan portfolios and warehousing exposures can be monitored, there are also indirect exposures, including through bank investments in CLOs and credit lines, which bear vigilance. By contrast, nonbank exposures are harder for us to track. To date, the default rate on leveraged loans has been at the low end of its historical range, and corporate credit conditions have been favorable, with low interest expenses and low expected default rates. However, if spreads rise sharply or economic conditions deteriorate significantly, we could see downgrades, refinancing challenges, rising delinquencies and defaults, and losses to investors.

Recognizing that financial imbalances played a key role in each of the past three U.S. downturns, policy should seek to moderate financial vulnerabilities when they are likely to materially exacerbate an economic downturn, leading to deeper declines in output and higher levels of unemployment. Both economic theory and econometric evidence point to the risk that excesses in corporate debt markets could amplify adverse shocks and contribute to job losses. Over-indebted businesses may face payment strains when earnings fall unexpectedly, and they may respond by pulling back on employment and investment. The slowdown in activity lowers investor demand for risky assets, thereby raising spreads and depressing valuations. As business losses accumulate, and delinquencies and defaults rise, banks are less willing or able to lend. This dynamic feeds on itself, potentially amplifying downside risks into more serious financial stresses or a downturn.

Recognizing this feedback loop between financial imbalances and the macroeconomy, in addition to strong through-the-cycle regulatory requirements, our toolkit includes a countercyclical capital buffer (CCyB). The CCyB is intended to require the nation's largest banks to build capital when conditions are favorable to sustain resilience for times when there is elevated risk of above-normal losses, which often follows periods of rapid asset price appreciation or credit growth. CCyB requirements are intended to lean against rising risks at a time when the degree of monetary tightening needed to achieve the same goal could be inconsistent supporting full employment and target inflation. And they build resilience, unlike monetary policy. Second, when conditions are favorable, the covered banks could build the modest additional buffer simply by moderately reducing payouts. Third, the CCyB is a simple, predictable, and slow-moving tool that applies equally across all large banks. It does not single out shortfalls in particular banks or result in volatility in individual banks' stressed capital requirements. Finally, the additional capital can be released when conditions deteriorate to ensure the ability of large banks to lend into a downturn.

The criteria for implementing the CCyB described in the Board's framework of September 2016 are calibrated so that the CCyB will be above its minimum value of zero about one-third of the time, when financial vulnerabilities are assessed to be in the upper one-third of their historical distribution.[3] The Board votes once a year on the level of the CCyB. The Board voted to set the CCyB at zero earlier this year.[4] Many other jurisdictions have raised their CCyB above zero.[5]

Going forward, we will continue to monitor financial vulnerabilities closely, recognizing the potential for such vulnerabilities to amplify any negative developments. We plan to share our assessment with you in our next *Financial Stability Report* later in the year and look forward to hearing from you about any issues that warrant further monitoring.

Thank you and I look forward to your questions.

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1 Federal Reserve Board www.federalreserve.gov/aboutthefed/bios/board/default.htm.

2 Board of Governors of the Federal Reserve, *Financial Stability Report* (Washington: Board of Governors).

3 Board of Governors of the Federal Reserve, "Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer (PDF)," September 8, 2016.

4 Board of Governors of the Federal Reserve, "Federal Reserve Board Votes to Affirm the Countercyclical Capital Buffer (CCyB) at the Current Level of 0 Percent," press release, March 6, 2019.

5 See the Basel Committee on Banking Supervision, updated August 21, 2019, www.bis.org/bcbs/ccyb/index.htm#table.