AFR EF Americans for Financial Reform Education Fund

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SUBPRIME CORPORATE DEBT PAPER

EXECUTIVE SUMMARY

AMERICANS FOR FINANCIAL REFORM EDUCATION FUND (AFREF)

Americans for Financial Reform Education Fund (AFREF) is a nonpartisan, nonprofit coalition of more than 200 civil rights, community-based, consumer, labor, small business, investor, faith-based, civic groups, and individual experts.

We fight for a fair and just financial system that contributes to shared prosperity for all families and communities. www.ourfinancialsecurity.org

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EXECUTIVE SUMMARY

Once a niche market to finance speculative industries and hostile corporate takeovers, subprime corporate debt has become a vast and mainstream market. After years of growth, evolution, and financial engineering, this riskier corporate debt issued either as leveraged loans or non-investment grade "junk bonds" have spawned a complex and highly fragmented market at the heart of the US financial system.

Lightly regulated and invisible to most market participants and regulators, this "shadow banking" industry poses systemic risks to financial stability and has far-reaching impacts on the economy. Subprime corporate debt has enabled the widespread transfer of wealth from workers and communities to a small group of financiers, exacerbating income and wealth inequality, and benefiting private equity firms and hedge funds at the expense of corporate America's long-term health and resilience.

Origins, debt instruments, & key players

Starting in the 1980s, pioneered by Michael Milken of the investment bank Drexel Burnham, a new market emerged for non-investment grade "junk bonds" – a category of debt previously considered untouchable to most investors.

These early adopters exploited the fact that debt issued for hostile takeovers is assumed by the companies being acquired, not the acquirers – allowing "corporate raiders" to push through leveraged buyouts while facing little financial risks to themselves. Eventually, these practices became institutionalized in the private equity and hedge fund industries, growing exponentially to approximately $4.7 trillion in assets today.

Following the Great Financial Crisis of 2008, amid historically low interest rates, corporations were one of the US economy's few sectors that could take on new debt – just as investors were hungry for higher-yielding assets. Private equity firms, hedge funds, and other unregulated non-bank financial institutions (NBFIs) helped issue large amounts of high-risk corporate debt during this period, often packaged into securitizations known as Collateralized Loan Obligations (CLOs).

Between 2008 and 2021, corporate debt doubled from $6.6 trillion to $11.6 trillion.

WHY SUBPRIME CORPORATE DEBT IS A PROBLEM?

The risks posed by subprime corporate debt can be grouped into five broad categories.

1. Wasted capital. High-risk corporate debt is often not used productively; most is used to acquire more companies, refinance old debt, and fund share buybacks or dividend payments back to investors.

   The average private equity-owned company typically sees employment fall by 13% compared to non-PE owned companies. [1] Often, these firms will do whatever is necessary to extract value – as illustrated by recent notorious examples like J. Crew (declared bankruptcy) and Art Van Furniture (declared bankruptcy and laid off 4,500 employees). [2]

2. Lack of regulation. Outdated financial regulations mean that most subprime corporate lenders are lightly monitored and under-regulated – and the $1.2 trillion leveraged loan market (as much as 70% of which is CLOs) is entirely exempt from securities laws.

   As a result, disclosure requirements are diluted, anti-fraud rules do not apply, and loan originators face few penalties for misstatements or omissions, leaving secondary investors with few protections. Meanwhile, credit ratings agencies provide ratings on subprime corporate debt despite their well-known conflict of interest: they are paid by the issuers and sellers of the debt products they rate.

3. Earnings manipulation. The true risks of subprime corporate debt are disguised by lenders' tendency to rely on easily manipulated figures for corporate earnings: Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) – which is not an audited financial figure.

   Its use allows companies to make themselves look less risky than they are (e.g., by inflating "add-backs" – projections of future earnings and cost savings that might be realized following a leveraged buyout). By 2019, an estimated 65% of leveraged loans in exceeded the regulators' threshold for "six times EBITDA."

4. Incentives to securitize. CLOs pool hundreds of different corporate loans, bonds, or receivables into a single security that can be sold to many new investors. The "originate-to-distribute" model offers fees to a wide array of financial players for creating and selling the securities, but they exit quickly.

   This further weakens investor protections and creates incentives to conceal quality or risk issues with the underlying loans – not unlike the mortgage industry in the lead-up to the 2008 crisis. To date, efforts to create rules and regulations around corporate debt securitizations have not gained traction.

5. Insurance companies more exposed to this debt. The search for high-yielding assets following the 2008 crisis led many institutional investors, especially insurance companies (which faced rising liabilities and increased losses), to significantly expand their holdings of higher-risk subprime corporate debt.

   By 2019, insurers held 44% of non-investment grade-rated CLO debt [3] and an unholy alliance had emerged, whereby private equity firms acquire insurance companies then use them to purchase more debt. [4] This leaves insurers in a precarious situation and poses systemic financial security risks.

HOW THE PANDEMIC RESPONSE POURED FUEL ON THE FIRE

The economic fallout from the COVID-19 pandemic might have been expected to rein in subprime corporate lending, but the opposite occurred: the Federal Reserve's unprecedented backstop of corporate credit markets in 2020 inadvertently protected shadow banks, saving the subprime corporate debt market from risks that had long been bubbling up. Corporate debt issuance reached new records in 2021.

A few features in the resulting chain of events are worth noting:

- **The Fed's actions super-sized the subprime corporate debt problem.** While COVID-19 created economic pain for millions of Americans, the Fed's interventions sparked one of the biggest corporate borrowing binges in U.S. history – most of which has not been used productively. 2021 saw a record $58.5 billion of debt issued for "dividend recapitalization" (i.e. paying dividends to private equity owners). [5] Now as interest rates rise in 2022 and 2023, many companies who significantly increased their debt burdens may be put to the test.

- **The economic disruption from COVID-19 gave a stark preview of the problems subprime corporate debt could experience in a prolonged economic slowdown.** While the economic fallout from COVID-19 did not trigger a cascade of corporate debts, bankruptcies, and mass layoffs due to the unprecedent support they received, the pandemic did offer a shocking preview: a sharp selloff across all forms subprime corporate debt, including for the holders of the first-loss pieces of CLOs temporarily experiencing a 100% loss on their holdings in March 2020.

- **Direct lending by private equity firms is a risky new frontier.** An even more opaque form of highly leveraged corporate debt accelerated during the pandemic, with private equity firms increasingly participating in closed-loop systems to finance themselves by making direct loans to the companies they acquire. This market could be as big as $1 trillion; but unlike other subprime corporate debt, no banks or other regulated entities are involved, leaving its exact size and related risks unknown. [6]

CONCLUSION & POLICY RECOMMENDATIONS

While there is a place for leveraged lending in the economy, there are important questions to be asked about whether that debt is being used productively and whether companies are becoming more indebted only to enrich their owners. Leveraged buyouts, share buybacks, dividend recapitalizations, and the growth of already-massive corporations do little for the average worker.

These trends threaten to reduce competition, concentrate market power among a few industry leaders, and increase the risk of predatory business practices that are bad for consumers, bad for the environment, and bad for workers – ultimately reducing job quality, worsening inequality, and hurting the US economy's dynamism, competitiveness, and growth.

All is not lost, however. Several regulatory, policy, and legislative steps can be taken to bring oversight to subprime corporate debt markets, reduce the systemic risks they pose, and create a safer and more transparent financial system.

1. Treasury should focus on these crucial financial stability issues

- Rescind the 2019 Trump Administration guidance making non-bank SIFI designation more challenging and quickly identify and designate non-bank SIFIs. The Financial Stability Oversight Council (FSOC) was given the authority under Dodd-Frank designate non-banks as Systemically Important Financial Institutions (SIFIs) which would give the Federal Reserve. Treasury must first rescind a 2019 guidance that hampered the SIFI designation process and prepare to use such authority so that non-banks that pose risks to the financial system finally have supervision.

- Strengthen monitoring of leveraged lending markets. The Treasury Department's Office of Financial Research (OFR) should be centrally tasked to collect all data on corporate lending from the SEC and other regulatory agencies, and the FSOC should elevate issues of systemic risk stemming from subprime corporate debt.

2. Collect the necessary data to get transparency into the subprime corporate debt markets

- Collect critical data on the size of opaque, under-regulated corporate lending. To address these weaknesses in the regulatory system, Congress should amend the Investment Advisers Act of 1940 so the Securities & Exchange Commission (SEC) can require hedge funds and private equity firms to report more detailed data on their individual holdings and companies, which should be shared with the FSOC

- Modernize financial disclosures across bonds and corporate loans. Given the magnitude and economic importance of highly leveraged corporate borrowers, the SEC should look into ending Rule 144A exemptions to ensure that regulators and investors have uniform access to important financial data across subprime corporate debt markets, especially pertaining to assessing risk concentration.

3. Require better lending practices and closing regulatory arbitrage opportunities

- Address deceptive underwriting practices. To address such flagrant and persistently misleading earnings projections based on EBITDA, the SEC should more rigorously utilize the anti-fraud provisions under Section 17(a)(2) under the Securities Act of 1933.

- Limit large and active debt issuers from relying on outdated disclosure exemptions. The SEC should consider changes to the investor disclosure and registration exemptions under Rule 144A and Rule 506 which were passed decades earlier when the subprime corporate debt markets were a fraction of the size they are today.

- Restrict brokers from providing quotations on opaque debt without conducting due diligence or providing the public with more information. Investors and policymakers would also be better served by requiring brokers to conduct their own due diligence and having the issuers of debt offerings relying on the reporting exemptions under Rule 144A provide more information to the public.

- End the favorable capital treatment for securitized subprime corporate debt. The National Association of Insurance Commissioners (NAIC) has found that insurance companies can save 6% in capital charges when subprime corporate debt is instead packaged into CLOs. The NAIC should end the disparate treatment between the two forms of subprime corporate debt and require insurance companies to hold more capital against CLOs.

- Follow through on credit rating agency reform. Credit rating agencies are currently not considered financial experts, despite the fact that billions of dollars of financial assets (including subprime corporate debt) are sensitive to their ratings. The SEC should continue to repeal Rule 436(g) in the original spirit of Dodd-Frank, subjecting rating agencies to expert liability and requiring them to contend on credit rating accuracy.

4. End the exemptions that allow non-bank financial institutions to avoid regulatory oversight

- End exemptions for private funds under the Investment Company Act. Congress should amend the Investment Company Act of 1940 that allows both hedge funds and private equity firms to avoid more direct supervision by the SEC. Private funds were fractions of the size when they were given such exemptions in 1996 under the National Securities Markets Improvement Act.

- Pass the Stop Wall Street Looting Act. Private equity funds have benefitted unfairly for decades from a system that allows them and their partners to acquire firms using debt that the acquired company has to repay. Congress should end this inequity by passing the Stop Wall Street Looting Act, which requires joint responsibility for debt used in a buyout and limits when new debt can be issued for things like dividend payments.

- Amend securities laws to cover leveraged lending and enhance disclosures and protections. Despite its massive size and growth, the leveraged loan and direct lending markets are not subject to securities laws – meaning their institutional investors do not have basic investor protections. Congress should pass new legislation to amend the Securities Act of 1933 to address this fundamental shortcoming.

- Prevent the largest companies from intentionally dodging oversight by being taken or staying private. Congress should pass the Private Markets Transparency and Accountability Act proposed by Senators Jack Reed, Elizabeth Warren, and Catherine Cortez Masto that would require private companies valued at over $700 million or with greater than $5 billion in revenue and 5,000 employees to file important disclosures and financial statements as public companies do with the SEC.

- Pass legislation giving the Federal Reserve systemic risk oversight over insurance companies. Insurance companies play a major role in financing subprime corporate lending yet no regulator at the federal level has oversight into the risks the largest insurance companies may pose to the rest of the financial system. New legislation should therefore be passed subjecting insurance companies over a certain size to direct oversight and supervision by the Federal Reserve's Board of Governors.

As the Federal Reserve raises interest rates to address rising inflation, subprime corporate borrowers are quickly seeing their borrowing costs rise, making it more challenging for them to service their debt that was issued during the earlier boom.

Rather than address this rapid growth in subprime corporate debt after the fact policymakers should proactively take these steps to modernize the financial and regulatory system so that regulators can finally gain clearer insight into non-bank financial institutions and private markets and be able to proactively address warning signs before it’s too late.

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