

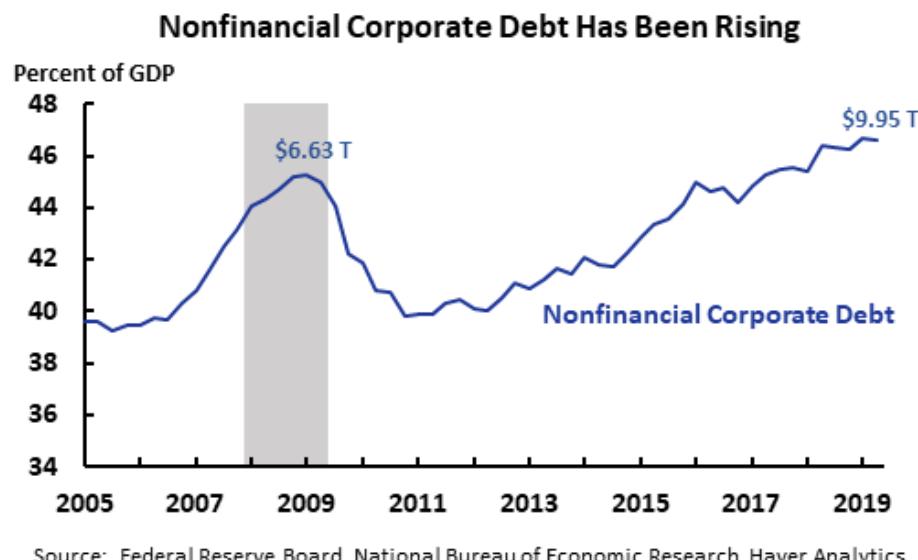


## The Risk of Rising Corporate Debt

Economists and financial analysts are concerned that rising levels of corporate debt—now at its highest level ever—could make the next recession more severe and recovery more difficult. The problem is compounded by the fact that the Federal Reserve likely will have less ability to fight an economic downturn because interest rates already are exceptionally low and therefore its ability to cut rates to stimulate the economy is limited.

In the second quarter of 2019, corporations held \$9.9 trillion in corporate debt, over \$3 trillion more than its peak of more than \$6.6 trillion during the Great Recession. Economists are concerned about the ratio of corporate debt to gross domestic product (GDP).

High levels of corporate debt likely won't cause an economic downturn, but they may accelerate one as highly leveraged companies fail, forcing layoffs, decreasing aggregate demand and creating a downward spiral of bankruptcies and further layoffs. According to Fed Chairman Jerome Powell, “[a] highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments.”<sup>1</sup>



### *Exceptionally low interest rates have been one driver of corporate borrowing*

In response to the financial collapse of 2008-2009, the Fed cut interest rates to almost zero (0-0.25 percent) and initiated “quantitative easing,” which were measures designed to encourage lending and business activity. It held rates at that level until raising them a quarter point more than seven years later. Rates peaked at only 2.25-2.5 percent in December 2018 before the Fed reversed course and lowered rates to the current level of 1.75-2 percent—still very low for a strong economy at full employment.<sup>2</sup>

## Corporate Debt

The historically low federal funds rates have made borrowing very cheap. This is one of the main reasons that corporations have taken on ever greater levels of debt. Even some nationally recognized, well-established companies have become highly leveraged.<sup>3</sup>

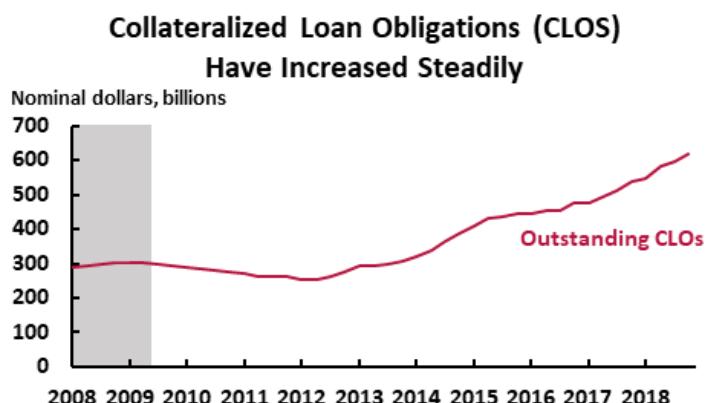
### *The declining quality of corporate debt makes default more likely*

Because interest rates have been so low, investors have been willing to buy higher risk bonds in order to get a higher return. Ratings agencies have found that the quality of the corporate debt has decreased and is of lesser quality than prior to previous recessions.<sup>4</sup>

Even though the fastest-growing category of debt is investment grade, this growth is driven by lower-rated debt within that category. BBB-rated debt, the lowest quality of investment-grade debt, has been growing the most quickly.<sup>5</sup> This is a signal of weakening corporate credit quality (and ultimately the threat of increased corporate credit stress). Most of this increase in debt has been used to fund stock buybacks, dividends and mergers.<sup>6</sup> The deteriorating debt quality and increasing borrower leverage have gained the attention of regulators and some members of Congress.<sup>7</sup>

### *Companies with poor credit that receive leveraged loans may be increasing risk*

A “leveraged loan” is a loan that is extended by a group of banks to a company that already has high levels of debt or a poor credit history. Bond issues from these borrowers are considered high risk, and as a result the leveraged loans are usually made at higher interest rates than those seen on investment-grade or even speculative-grade bonds. Typically, they get packaged into what are known as “collateralized loan obligations,” or CLOs. These CLOs are bought by private-equity firms, hedge funds, mutual funds, insurance companies, banks, pension funds and other companies.<sup>8</sup> They can be sliced and repackaged based on risk level and then resold. CLOs are a similar style of investment vehicle as the “collateralized debt obligations” (CDOs) composed of mortgages that froze the financial system in 2007-2008.



Source: Securities Industry and Financial Markets Association via the Federal Reserve Board, National Bureau of Economic Research, Haver Analytics

From 2016 to 2018, the total amount of collateralized loan obligations increased nearly 30 percent. In 2018 alone, \$736 billion of leveraged loans were issued, which was a market record.<sup>9</sup> Over one-third of leveraged loans refinance existing debt.<sup>10</sup>

***There are fewer protections for investors who purchase corporate bonds***

Leveraged loans are also riskier and less likely to include covenant provisions—terms if a borrower defaults—to protect lenders.<sup>11</sup> Indeed, as Fed Chairman Powell recently noted, “With leveraged loans, covenants intended to protect lenders may be an endangered species.”<sup>12</sup> For, example, the share of new loans from nonbank lenders with weak investor protections increased from 30 percent in 2007 to 80 percent in 2018.<sup>13</sup>

Fed policymakers have expressed concern about the risk to investors and the financial system, pointing to the growth of leveraged loans in particular. Some officials have proposed implementing a “countercyclical capital buffer”—requiring big banks to stow away more capital now, while economic times are good—in preparation for the next downturn.<sup>14</sup> The banking industry and some Fed officials oppose this move, arguing that capital levels are already high and that there is little immediate risk of financial instability.

***Corporations have high debt-to-earnings ratios, increasing the risk of default***

Companies also hold more debt relative to earnings than when the recovery began in 2009. For the top 1,000 companies, the debt-to-earnings ratio increased from 1.5 at the beginning of the recovery in 2010 to 2.0 in 2017, while their cash flow to interest expense ratio also fell.<sup>15</sup> If the economy enters recession, over-leveraged companies will be less able to pay back the money they have borrowed. Much of the existing corporate debt is subject to rates that will increase in step with the federal funds rate, so it is possible that once the federal funds rates return to higher levels, those holding more debt will also be under stress.

***Central bankers have raised concerns about current debt levels***

Federal Reserve Chairman Powell gave a speech in May detailing the rise in corporate debt.<sup>16</sup> He argued that rising debt is not currently putting the financial system at risk, but that if there were an economic downturn, levels of debt could become a stressor for borrowers.<sup>17</sup> He also stated that the Fed is carefully monitoring the buildup of CLOs to watch for systemic risk.<sup>18</sup>

Former Fed Chair Janet Yellen has said that “if the economy encounters a downturn, we could see a good deal of corporate distress. If corporations are in distress, they fire workers and cut back on investment spending. And I think that’s something that could make the next recession a deeper recession.”<sup>19</sup>

## Additional Resources

“Business Debt and Our Dynamic Financial System,” Chairman Jerome Powell, Federal Reserve, May 20, 2019,

<https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>.

“Federal Reserve Warns as Risky Corporate Debt Exceeds Peak Crisis Level,” *The New York Times*, May 6, 2019, <https://www.nytimes.com/2019/05/06/us/politics/federal-reserve-risky-corporate-loans.html>.

“Time to Worry about Corporate Debt Again,” *Wall Street Journal*, Sept. 22, 2019, <https://www.wsj.com/articles/time-to-worry-about-corporate-debt-again-11569160800>.

“When Blue Chip Companies Pile on Debt, It’s Time to Worry,” *The New York Times*, Nov. 26, 2018, <https://www.nytimes.com/2018/11/26/opinion/corporate-debt-bubble-att-ge.html>.

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<sup>1</sup> Powell, J. H. (2019). Business Debt and Our Dynamic Financial System. Board of Governors of the Federal Reserve System. Retrieved from <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>.

<sup>2</sup> Board of Governors of the Federal Reserve System. (2019). Open Market Operations. Retrieved from <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>.

<sup>3</sup> Cohan, W. D. (2018). When Blue Chip Companies Pile on Debt, It’s Time to Worry. *The New York Times*. Retrieved from <https://www.nytimes.com/2018/11/26/opinion/corporate-debt-bubble-att-ge.html>.

<sup>4</sup> Adrian, T., Natalucci, F., Piontek, T. (2018). Sounding the Alarm on Leveraged Lending. IMF Blog. Retrieved from <https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/?cid=sm-com-TW>.

<sup>5</sup> Kaplan, R.S. (2019). Corporate Debt as a Potential Amplifier in a Slowdown. Federal Reserve Bank of Dallas Research. Retrieved from <https://www.dallasfed.org/research/economics/2019/0305.aspx>.

<sup>6</sup> Ibid.

<sup>7</sup> Brown: Mnuchin Must Take Action to Address Emerging Threats to the Economy (2019). Sherrod Brown Sector for Ohio. Retrieved from <https://www.brown.senate.gov/newsroom/press/release/brown-mnuchin-must-take-action-to-address-emerging-threats-to-the-economy> and Vazza, D., Kraemer, N., Gunter, E. (2019). U.S. Corporate Debt Market: The State of Play in 2019. Retrieved from <https://www.spglobal.com/en/research-insights/articles/u-s-corporate-debt-market-the-state-of-play-in-2019>.

<sup>8</sup> Guse, M., Park, W., Saravay, Z., Yook, Y. (2019). Collateralized Loan Obligations in the Financial Accounts of the United States. Board of Governors of the Federal Reserve System. Retrieved from <https://www.federalreserve.gov/econres/notes/feds-notes/collateralized-loan-obligations-in-the-financial-accounts-of-the-united-states-20190920.htm>.

<sup>9</sup> What are leveraged loans? (2019). *The Economist*. Retrieved from <https://www.economist.com/the-economist-explains/2019/01/11/what-are-leveraged-loans>.

<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Powell, J. H. (2019). Business Debt and Our Dynamic Financial System. Board of Governors of the Federal Reserve System. Retrieved from <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>.

<sup>13</sup> Adrian, T., Natalucci, F., Piontek, T. (2018). Sounding the Alarm on Leveraged Lending. IMF Blog. Retrieved from <https://blogs.imf.org/2018/11/15/sounding-the-alarm-on-leveraged-lending/?cid=sm-com-TW>.

<sup>14</sup> Davidson, Kate and Timiraos, Nick. (2018) Federal Reserve Considers a New Tool to Avert Crisis. <https://www.wsj.com/articles/federal-reserve-consider-a-new-tool-to-avert-crisis-1536512283>

<sup>15</sup> Burua, A., Buckley, P. (2019). Rising corporate debt: Should we worry? Deloitte Insights. Retrieved from <https://www2.deloitte.com/us/en/insights/economy/issues-by-the-numbers/rising-corporate-debt-levels.html#endnote-sup-10>.

<sup>16</sup> Powell, J. H. (2019). Business Debt and Our Dynamic Financial System. Board of Governors of the Federal Reserve System. Retrieved from <https://www.federalreserve.gov/newsevents/speech/powell20190520a.htm>.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> Wiltermuth, J., Haunss, K. (2019). Yellen warns of corporate distress, economic fallout. *Reuters*. <https://www.reuters.com/article/us-yellen-distressed/yellen-warns-of-corporate-distress-economic-fallout-idUSKCN1QG2CZ>.