TAMMY BALDWIN
WISCONSIN

COMMITTEES:
APPROPRIATIONS
COMMERCE
HEALTH, EDUCATION, LABOR, AND PENSIONS

United States Senate

WASHINGTON, DC 20510

October 25, 2019

The Honorable Steven T. Mnuchin
Chairman
Financial Stability Oversight Council
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Request for FSOC Plan to Address Emerging Threat to U.S. Financial Stability From High Corporate Debt Caused by Stock Buybacks

Dear Secretary Mnuchin:

I write to you deeply concerned by the historic levels of debt held by U.S. corporations and the role that corporate stock buybacks have played in fueling this debt—which experts now believe could cause another crisis. High corporate debt increases the risk that businesses will lay off workers, cut wages and pensions, curtail investment, and file for bankruptcy—which would devastate working families, many of whom are still suffering from the $11 trillion in household wealth wiped out during the 2008 financial crisis.[1]

With three out of four economists predicting a U.S. recession before 2021, the time for you to act is now.[2] If you don't act soon, a minor downturn in the economy could tip us into a major recession, causing real suffering for millions of American families. As such, I ask that you provide to Congress a plan outlining how you will fulfill your statutory obligation to *respond* to the emerging threat posed by high corporate debt levels fueled by stock buybacks.

The 2018 Financial Stability Oversight Council (FSOC) Annual Report identified high corporate debt levels as an "emerging threat," and conditions have deteriorated significantly since the report's publication.[3] Last week, the International Monetary Fund (IMF) released its Financial Stability Report, which found that the outlook for firms has "weakened despite very low interest costs . . .[d]ebt has risen and is increasingly used for financial risk-taking—to fund corporate payouts to investors . . . especially in the United States."[4] The IMF report makes clear that share buybacks—especially those funded by risky debt—are a chief cause of the deterioration in U.S. corporate creditworthiness that "could exacerbate the next economic downturn."[5] Corporate stock buybacks have exploded in recent years and the trend accelerated following the passage of the Trump Administration's Tax Cuts and Jobs Act. In fact, S&P 500 companies are expected to surpass last year's record stock

[1] Financial Crisis Inquiry Commission. "The Financial Crisis Inquiry Report". January 2011. https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf
[2] National Association for Business Economics. "Economic Policy Survey". 19 August 2019.
[3] Financial Stability Oversight Council. "2018 Annual Report". 19 December 2018. https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf
[4] International Monetary Fund. "Global Financial Stability Report". 16 October 2019. https://www.imf.org/en/publications/gfsr
[5] Ibid.

repurchases, with Goldman Sachs projecting that $940 billion will be spent on share repurchases this year, up from $806 billion last year.[6]

The FSOC was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act and charged with both identifying risks to the financial stability of the United States and responding to these emerging threats.[7] In the last two FSOC meetings for which minutes are available, the risks posed by nonfinancial corporate credit were on the agenda.[8] According to the minutes of the March 6, 2019 meeting, the Council heard testimony from Ted Berg, senior financial analyst from the Office of Financial Research, indicating that the increased demand for corporate debt had led to decreased credit quality and that "over half of investment-grade corporate debt outstanding consisted of bonds rated BBB, the lowest-rated investment-grade category—a record high."[9] The minutes reflect that Mr. Berg made the Council aware of the significant risk this deterioration poses to the economy because "he estimated that during the next downturn, downgrades of investment-grade debt could range from roughly $300 billion to $1 trillion."[10] According to the minutes, Charles Press, senior financial institution and policy analyst at the Federal Reserve, noted that "vulnerabilities related to corporate debt had grown and leverage was at an all-time high, creating the potential for higher default rates and lower recovery rates in the next downturn compared to previous cycles."[11]

After the disturbing presentations of the March meeting, at the FSOC's second meeting of the year—on May 30, 2019—there appeared to be an effort to downplay the issue. Craig Phillips, Counselor to the Secretary of the Treasury, explained that banks' exposures to corporate debt were "relatively limited and there did not appear to be significant concentrations," before noting that further research was needed.[12] It is not clear if such research is underway as no mention of the corporate debt issue was made in the readout of the September 4, 2019 FSOC meeting.[13]

On September 27, 2019, in testimony before the House Financial Services Subcommittee on Consumer Protection and Financial Institutions, Federal Reserve Governor Lael Brainard raised concerns about the possibility that businesses will be more likely to lay off workers and decrease investment due to excessive debt in the event of a downturn because "historically, high leverage has been linked to elevated financial distress and retrenchment by businesses in economic downturns." She also raised concerns that the largest banks' capital buffers have "moved down somewhat as payouts have exceeded earnings over the last couple years." In other words, the biggest banks—who have lent to the overly indebted companies—are undercapitalized because they have also been excessive in their stock buybacks.

I am deeply disturbed by the Council's lack of action on what appears to be a dangerous emerging threat to the U.S financial system. The IMF report makes a clear connection between financial risk-taking—like the dramatic increase in stock buybacks—and financial instability: "Financial risk-taking by US companies in the form of payouts and M&A has increased—in contrast with subdued capital expenditures. Surges in financial risk-taking

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[6] CFO Magazine. "Buybacks on Pace to Hit Record Level in 2019". 1 August 2019. https://www.cfo.com/capital-markets/2019/08/buybacks-on-pace-to-hit-record-940m-in-2019/

[7] Public Law 111-203. "Dodd-Frank Wall Street Reform and Consumer Protection Act". 21 July 2010. https://www.govinfo.gov/app/details/PLAW-111publ203

[8] U.S. Department of the Treasury, Financial Stability Oversight Council. "Meeting Minutes". https://www.treasury.gov/initiatives/fsoc/council-meetings/Pages/meeting-minutes.aspx

[9] U.S. Department of the Treasury. "Minutes of the Financial Stability Oversight Council". 6 March 2019. https://home.treasury.gov/system/files/261/March062019_minutes.pdf

[10] Ibid.

[11] Ibid.

[12] U.S. Department of the Treasury. "Minutes of the Financial Stability Oversight Council". 30 May 2019. https://home.treasury.gov/system/files/261/May302019_minutes.pdf

[13] U.S. Department of the Treasury Office of Public Affairs. "Readout of Financial Stability Oversight Council Meeting". 4 September 2019. https://home.treasury.gov/system/files/261/September042019_readout.pdf

usually precede economic downturns. Payouts—dividends and share buybacks—at US large firms have grown to record high levels in recent quarters, whereas debt-funded payouts have increased since 2017 . . . debt funded payouts can considerably weaken a firm's credit quality." In addition to increased risk at corporations, businesses are increasingly seeking financing from nonbanks with lower credit standards, "[i]n the United States, nonbank lending has expanded faster than loans provided by banks and credit metrics in the leveraged loan market have continued to weaken."

FSOC has broad authority to recommend more stringent regulations to financial regulatory agencies. In order to address the emerging systemic threat posed by deteriorating lending standards to corporations from banks and nonbanks, FSOC could recommend that the Federal Reserve increase capital requirements. Additionally, limits on debt-funded shareholder payouts could be recommended by the Council to its member agencies, like the Securities and Exchange Commission.

FSOC was created in part to address what the Financial Crisis Inquiry Commission (FCIC) Report identified as the "widespread failure in financial regulation and supervision" that led to the 2008 crisis.[14] The FCIC's explanation of this failure provides a warning we should heed today:

> "In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee."[15]

There is ample evidence, much of which has been provided by members of FSOC itself, to show that corporate debt has been inflated by stock buybacks and now poses a threat to the stability of the U.S. financial system. I urge you to muster the political will to address this problem before it is too late. As the government organization charged with not just identifying, but most importantly *responding* to emerging threats to the U.S financial system, you must act. In closing, I again ask that you provide Congress a plan outlining how you will fulfill your statutory obligation to respond to the emerging threat posed by high corporate debt levels fueled by stock buybacks.

Sincerely,

Tammy Baldwin

Tammy Baldwin
U.S. Senator

[14] Financial Crisis Inquiry Commission. "The Financial Crisis Inquiry Report". January 2011. https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf
[15] Ibid.