Fed Flags Risky Business Debt as Vulnerability for U.S. Financial System

In second financial stability report, officials warn of growth in leveraged loans and elevated asset prices

By Andrew Ackerman Updated May 6, 2019 4:22 p.m. ET

WASHINGTON—The Federal Reserve identified rising sales of risky corporate debt as a top vulnerability facing the U.S. financial system, according to a report released Monday.

Officials for the second time in six months cited potential risks tied to nonfinancial corporate borrowing, particularly leveraged loans—a $1.1 trillion market that the Fed said grew by 20% last year amid declining credit standards. They also flagged possible concerns in elevated asset prices and historically high debt owned by U.S. businesses.

“Borrowing by businesses is historically high … with the most rapid increases in debt concentrated among the riskiest firms amid signs of deteriorating credit standards,” the Fed said in the second iteration of its financial stability report.

Monday’s report also identified potential economic shocks that could test the stability of the U.S. financial system, including trade tensions, potential spillover effects to the U.S. from a messy exit of Britain from the European Union and slowing economic growth globally.

Specifically, the Fed warned a downturn could expose vulnerabilities in U.S. corporate debt markets, “including the rapid growth of less-regulated private credit and a weakening of underwriting standards for leveraged loans.”

Monday's report is the latest evolution in the Fed's efforts to spotlight financial stability monitoring and follows years of more intense in-house research. It comes as financial markets have generally reacted positively to a string of positive economic news showing strength for the U.S. economy after a rocky start to the year.

A separate report released Monday showed some banks eased certain terms, such as credit-line costs and loan covenants, on business loans to medium and large companies in the first quarter. At the same time, banks tightened lending standards for commercial real-estate lending. Banks reported weaker demand for both types of loans in the first quarter, according to the Fed's senior loan officer opinion survey.

The Labor Department reported on Friday that the U.S. economy added 263,000 jobs in April and the unemployment rate fell to 3.6%, the lowest level since December 1969. The data are unlikely to move Fed policy makers from their wait-and-see stance that the economy isn't cooling but is still far from overheating.

Financial stability has remained a central focus at the Fed because of the easy-money policies employed to nurse the economy back to health in the years following the financial crisis. Critics have warned that the Fed's large bond-buying campaigns and years of near-zero interest rates risked new bubbles.

Credit standards for certain classes of business debt appeared to have deteriorated during the past six months, Monday's report said. For example, the share of newly issued large loans to corporations with high leverage—defined as those with ratios of debt to their earnings before interest, taxes, depreciation and amortization above six—have risen above the prior peaks seen in 2007 and 2014.

The stability report signaled less concern about borrowing by households and by risks in the banking sector, which is regulated by the Fed, among others. It described funding risks in the financial system as low, meaning the chance that mispricing of one asset—housing in 2007, for example—triggers a run by investors that puts the solvency of U.S. banks at risk.

The largest U.S. banks remain strongly capitalized, the Fed added, while the leverage of broker-dealers is substantially below precrisis levels. Insurance companies appear to be in relatively strong financial positions, and hedge-fund leverage appears to have declined over the past six months, the report said.