# Former Fed chair warns of new financial crisis

**By Nick Beams**
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In the midst of increasing volatility on global financial markets, the former chair of the US Federal Reserve, Janet Yellen, has pointed to a potential source of major instability with "systemic risks."

In an interview with the *Financial Times* to be published today, Yellen said there had been a "huge deterioration" in the standards of bank lending to corporations as a result of moves to lessen regulation.

Her focus of concern is so-called leveraged loans which are provided to companies with weaker credit ratings—a market which amounts to $1.3 trillion in the US.

"I am worried about the systemic risks associated with these loans," she said. "There has been a huge deterioration in standards; covenants have been loosened in leveraged lending."

In remarks unprecedented for a former central banker, Yellen told the newspaper that the lessons of the financial crash of 2008 were being forgotten as banks were pushing to water down regulations that had been put in place since then.

"There are a lot of weaknesses in the system, and instead of looking to remedy those weaknesses I feel things have turned in a very deregulatory direction."

Yellen's remarks echo views expressed during the meeting of the Fed's Open Market Committee at its last meeting in September. According to the minutes published earlier this month: "Some participants commented about the continued growth in leveraged loans, the loosening of terms and standards on these loans, or the growth of this activity in the nonbank sector as reasons to be mindful of vulnerabilities and possible risks to financial stability."

The Fed had pointed to the rise of leveraged loans to highly indebted companies in previous meetings. But the September meeting was the first time such loans had been mentioned as a possible risk to financial stability.

These warnings were underscored in remarks made by Todd Vermilyea, the Fed's head of risk and surveillance, at a finance industry conference in New York on Wednesday. He said there could be "weaknesses in risk management."

While the conference was closed to the press, the *Wall Street Journal* reported that "Vermilyea's remarks were spurred by emerging trends that he said would threaten the safety and soundness of the biggest banks." The article cited Morgan Stanley, Goldman Sachs and Credit Suisse as being among firms "that have recently participated in deals that exceeded what the Fed previously deemed appropriate."

One of the key risks associated with leveraged loans is that they are repackaged into collateralised loan obligations (CLOs) that are bought and sold by investors—a similar process to that which occurred in the sub-prime mortgage market which set off the financial meltdown ten years ago when a crisis in one, relatively small area of the market, spread throughout the system.

In September, the Bank for International Settlements pointed to the possible consequences of a similar downturn in the leveraged loans sector.

It said that because mutual funds are a major buyer of CLOs, "mark-to-market losses could spur fund redemptions, induce fire sales and further depress prices. These dynamics may affect not only investors holding these loans but also the broader economy by blocking the flow of funds to the leveraged credit market."

In other words, because of the interconnected nature of the operations of the banks, corporations and investment funds, a major loss or downturn in one area could rapidly spread throughout the global financial system.

Yellen also drew attention to the fact that much of the debt held by the banks is repackaged and then sold on to other investors.

"You are supposed to realise from the crisis, it is not just a question of what banks do that imperils themselves, it is what they do that can create risks to the entire financial system. That lesson to me seems to have been lost."

Yellen warned that if there was a "downturn in the economy, there are a lot of firms that will go bankrupt, I think, because of this debt. It would probably worsen a downturn."

Since the coming to power of the Trump administration, even the limited regulations introduced after the financial crash have been wound back together with the appointment of what the *Financial Times* called a "phalanx of regulators with softer-touch agendas."

"When I see what is happening politically with lobbying and the pushback on the regulators and the priorities of some of the regulators, I am really concerned we are on the verge of forgetting about the financial crisis and the need for stronger regulation," Yellen said.

The Bank of England (BoE) has also warned of the rise of leveraged loans, which it defines as those made to a company whose debt is more than four times its earnings before interest and tax deductions. In the US, the ratio is more than five and a half times the loans, with the proportion even higher in Europe.

Moreover, according to the BoE, some 80 percent of these loans are "covenant-lite," that is, they do not have the protections that were previously demanded for lending to riskier companies. Before the financial crisis only a quarter of such loans fell into the "covenant-lite" category.

One of the main driving forces behind the rise of leveraged loans has been their use by private equity investors, which use their already indebted companies to raise even more money to fund mergers and acquisitions. That is, the money is not used to finance productive activity but for speculation.

The latest Financial Policy Committee report of the BoE said that the global leveraged market was growing at a faster rate than the US subprime market in 2006. It said that, as with the subprime market, underwriting standards had been weakened and because of the "significant uncertainty" surrounding the ultimate investors in the collateralised loan obligations it was not clear who would bear the costs of any losses or whether they would have the capacity to absorb them.

The ratings agency Moody's has also warned of the dangers posed by the rise of leveraged loans. Last August, Moody's senior vice-president Christina Padgett warned that a combination of "aggressive financial policies"—the willingness of investors to take greater risks as they searched for profits—"deteriorating debt cushions," and a greater number of "less credit worthy firms" seeking loans was "creating credit risks that foreshadow an extended and meaningful default cycle once the current expansion ends."

In other words, an economic downturn would see a string of bankruptcies. When that warning was issued, just two months ago, it appeared that the US economy was still powering ahead. But the outlook has significantly changed since then, with warnings that the so-called "synchronised" upturn in the global economy is moving in the opposite direction—fears of which are a significant factor in the gyrations on the US stock market since it reached its high earlier this month.

The warnings by Yellen and major financial institutions point to the undeniable fact that ten years after the global financial crisis, none of the contradictions of the global economy and financial system have been resolved. Indeed the very measures enacted by the Fed and other central banks in propping the system through the injection of trillions of dollars have only created the conditions for an even bigger disaster.

The bitter experiences of the past decade have already revealed what the response of the ruling elites will be. There will be no reforms but rather a stepped up assault on the social position of the working class enforced by the development of ever more authoritarian forms of rule.

The urgent task facing the working masses in the US and all over the world is to develop its own independent class response through the political struggle for an international socialist program.