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The Honorable Janet Yellen
Secretary
U.S. Department of Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Dear Secretary Yellen:

I am writing to you as Chair of the Financial Stability Oversight Council (FSOC) seeking information about how FSOC is evaluating and responding to three potential risks to the banking system caused in part by the Federal Reserve's (Fed's) rapid increase in interest rates over the past year and a half and its ongoing threat to raise rates even higher: the decline in value of banks' bond portfolios, losses in commercial real estate, and losses in the leveraged lending market.

While FSOC and individual financial regulators have indicated that they are monitoring some of these threats,[1] the credit rating agency Moody's recent downgrade of ten regional banks – and its warning of potential downgrades for nearly a dozen other banks, including some of the largest financial institutions – on grounds that they are "vulnerable to nervous depositors and investors, risks from higher interest rates, and a weakening commercial real estate market"[2] lends new urgency to FSOC's role. I urge you to take strong action to address the alarming fallout from high interest rates and protect the safety of our financial system.

The Fed raised interest rates in ten straight meetings beginning in March 2022, a 15-month streak that constituted the most extreme series of hikes in 40 years.[3] After a short pause in rate hikes in June,[4] another increase in July 2023 raised the rates to their highest levels in 22 years,

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[1] U.S. Department of the Treasury, "READOUT: Financial Stability Oversight Council Meeting on June 16, 2023," press release, June 16, 2023, https://home.treasury.gov/news/press-releases/jy1547; Board of Governors of the Federal Reserve System, "Agencies finalize policy statement on commercial real estate loan accommodations and workouts," press release, June 29, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230629a.htm.
[2] Washington Post, "Moody's downgrades 10 regional banks as crisis pressures persist," Tory Newmyer, August 8, 2023, https://www.washingtonpost.com/business/2023/08/08/moodys-banks-downgrade/.
[3] USA Today, "Fed pauses interest rate hikes, signals two more increases likely in 2023 to fight inflation," Paul Davidson, Charisse Jones, and Jessica Guynn, June 14, 2023, https://www.usatoday.com/story/money/2023/06/14/fed-interest-rate-hike-live-updates/70313232007/.
[4] NPR, "The Federal Reserve finally hits pause on raising interest rates," David Gura and Don Gonyea, June 17, 2023, https://www.npr.org/2023/06/17/1182941206/the-federal-reserve-finally-hits-pause-on-raising-interest-rates.

with Fed officials indicating they still expect one more rate hike this year.[5] These hikes have raised concerns among experts that the Fed's actions "helped trigger instability in the banking sector" with "each jump in interest rates deal[ing] a shock to the economy."[6] The Office of Financial Research (OFR) also found that the rate hikes have led to rapidly tightening financial conditions and bond fund outflows straining fixed income markets.[7] The collapse of Silicon Valley, Signature, and First Republic Banks in March 2023 further demonstrated the risks that the Fed's rate hikes posed to banks' balance sheets, and banks' failures to adequately manage that risk.[8] In light of these developments, I seek information about the steps FSOC is taking to respond to three potential threats to the financial system:

1. **Risks to banks from unrealized losses on bonds.**

In response to a long period of low interest rates, the banking industry in recent years heavily invested in longer-term Treasuries and bonds in order to boost their returns and profits.[9] As the Fed has raised interest rates, however, bond prices have fallen, leaving banks with assets that have significantly declined in value.[10] Silicon Valley Bank, which invested 55% of its assets in fixed-income securities such as bonds,[11] suffered huge losses as it tried to sell off its securities portfolio when faced with a deposit run in March 2023.[12] According to the Fed's analysis of SVB's collapse, the bank's epic failure to "assess and manage the interest rate risk (IRR) in its rapidly growing securities portfolio" – the result of SVB executives' decision to "maintain short-term profits rather than effectively manage the underlying balance sheet risks" – was a key cause of the bank's demise.[13] As the Fed's report notes, "While interest rate risk is a core risk of banking that is not new to banks or supervisors, SVB did not

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[5] CNN, "The Fed hikes interest rates by a quarter point and hints at another increase this year," Bryan Mena, July 26, 2023, https://www.cnn.com/2023/07/26/economy/fed-july-interest-rate-decision-final/index.html.
[6] Washington Post, "Seven charts explain the current banking turmoil," Abha Bhattarai, May 4, 2023,https://www.washingtonpost.com/business/2023/03/19/inflation-interest-rates-bonds-svb/.
[7] Office of Financial Research, "Annual Report to Congress," March 7, 2023, p. 6, https://www.financialresearch.gov/annual-reports/files/OFR-Annual-Report-2022.pdf.
[8] Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," April 28, 2023, p. 1, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.
[9] CNN, "US banks sitting on unrealized losses of $620 billion," Nicole Goodkind, March 12, 2023, https://www.cnn.com/2023/03/12/investing/stocks-week-ahead/index.html.
[10] U.S. Securities and Exchange Commission, "Interest Rate Risk – When Interest Rates Go Up, Prices of Fixed Rates Bonds Fall," https://www.sec.gov/files/ib_interestraterisk.pdf; Investopedia, "Inverse Relation Between Interest Rates and Bond Prices," Nick Lioudis, March 28, 2023, https://www.investopedia.com/ask/answers/why-interest-rates-have-inverse-relationship-bond-prices/.
[11] Fortune, "Why the failures of SVB and Signature were such outliers—and why the banking crisis is far from over, former central banker says," Vidhura S. Tennekoon, March 14, 2023, https://fortune.com/2023/03/14/silicon-valley-bank-svb-signature-why-banking-crisis-far-from-over-former-central-banker/.
[12] Reuters, "Morning Bid: Bond blows batter banks as SVB cracks," March 10, 2023, https://www.reuters.com/markets/us/global-markets-view-usa-2023-03-10/.
[13] Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," April 28, 2023, p. 3, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

appropriately manage its interest rate risk, and supervisors did not force the bank to fix these issues quickly enough."[14]

Although quick action by regulators mitigated the panic in the banking system earlier this spring, reports indicate that banks may still be vulnerable to their unrealized losses. According to the latest quarterly report from the Federal Deposit Insurance Corporation, banks have an estimated $515 billion in unrealized losses in their investment securities.[15] Bank of America, for example, has racked up over $100 billion of losses from money it poured into bonds three years ago.[16] JPMorgan Chase and Wells Fargo each have about $40 billion in unrealized bond market losses, while Citigroup has about $25 billion in unrealized losses.[17]

These troubles may not be limited to the largest banks. One analysis found that dozens of smaller banks, including community banks with just a few branches, "are deeply underwater on their bond investments."[18] Another study estimated that 10 percent of banks could have larger unrecognized losses than Silicon Valley Bank.[19] The prevalence of this risk across the banking system threatens to spell more deposit runs and bank failures that could catalyze another crisis.[20]

2. Risks to the commercial real estate sector.

I also urge FSOC to closely examine the mounting stresses on commercial real estate, which "is navigating steeper debt costs, reduced access to credit, and big declines in the value of … properties,"[21] and the potential impact these stresses could have on the financial system. The streak of interest rate hikes and the largescale shift to remote work after the COVID-19 pandemic – which resulted in less office usage and reduced revenues from leases that have yet to return to pre-pandemic levels – have slashed commercial real estate values.[22] Pension funds, real estate investment trusts, and especially regional banks that have heavily invested in

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[14] *Id.*
[15] Forbes, "Banks' $515 Billion Of Quarterly Paper Losses Is Actually An Improvement," Brandon Kochodin, May 31, 2023, https://www.forbes.com/sites/brandonkochkodin/2023/05/31/banks-515-billion-of-quarterly-paper-losses-is-actually-an-improvement/?sh=72b42bead8c8.
[16] Financial Times, "Bank of America nurses $100bn paper loss after big bet in bond market," Stephen Gandel, June 29, 2023, https://www.ft.com/content/df4f343c-5666-43a2-ba01-ef315bfb119a.
[17] *Id.*
[18] American Banker, "How interest rate risk sneaked up on dozens of community banks," Polo Rocha, March 27, 2023, https://www.americanbanker.com/news/how-interest-rate-risk-sneaked-up-on-dozens-of-community-banks.
[19] National Bureau of Economic Research, "Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?" Erica Xuewei Jiang, Gregor Matvos, Tomasz Piskorski, and Amit Seru, March 20, 2023, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4393389#.
[20] Wall Street Journal, "Rebound in Rates Puts Pressure on Banks," Jonathan Weil, July 5, 2023, https://www.wsj.com/articles/rebound-in-rates-puts-pressure-on-banks-afff0c00?st=6t8fq4tjtkqq2i5.
[21] Markets Insider, "WeWork just warned it might fail, signaling commercial real estate is in serious trouble," Theron Mohamed, August 9, 2023, https://markets.businessinsider.com/news/stocks/wework-doubt-warning-commercial-real-estate-offices-economy-credit-rates-2023-8.
[22] Markets Insider, "The pain is just starting for commercial real estate – and plunging prices could reignite the banking crisis and choke the US economy, Columbia professor says," Theron Mohamed, July 4, 2023, https://markets.businessinsider.com/news/stocks/commercial-real-estate-prices-offices-banking-crisis-economy-credit-crunch-2023-7.

commercial real estate are finding themselves with loans and securities with much less value.[23] Analysts are concerned that commercial real estate prices have yet to face the worst of the drop in value.[24]

At an FSOC meeting in June, you acknowledged the potential risks in the commercial real estate market and that "regulators are taking steps to emphasize risk management and examine exposures to [commercial real estate] loans at their regulated institutions."[25] U.S. bank regulators have also asked lenders to work "prudently and constructively" with borrowers facing financial stress in the commercial real estate market.[26] Reports indicate that distressed commercial property assets rose to over $60 billion earlier this year, underscoring the extent to which office owners are struggling with higher borrowing costs and the rise of remote work.[27] WeWork, for example, a shared-workspace giant, has warned it may fail, signaling that a potential collapse in commercial real estate sector could be imminent.[28]

The impact of rising interest rates has also spread to other areas of the real estate investment market, most notably apartments. Investors that bid up the prices of multifamily buildings, initially attracted by rising rents in years prior, took on too much debt. Now, despite low apartment vacancy rates, high interest rates combined with slowing rent growth and increasing building expenses have been causing a "sudden surge in debt" that "now threatens to wipe out many multifamily owners across the country."[29]

3. Risks emerging from the leveraged lending market.

Rising interest rates have also put pressure on the $1.4 trillion leveraged lending market, with significant potential consequences for the financial system.[30] Leveraged loans are loans made

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[23] U.S. Government Accountability Office, "Empty Offices Increase Risks for Banks Lending to Commercial Real Estate," June 8, 2023, https://www.gao.gov/blog/empty-offices-increase-risks-banks-lending-commercial-real-estate; The New York Times, "In an Unsteady Banking Industry, First Republic's Problems Stood Out," Stacy Cowley, May 1, 2023, https://www.nytimes.com/2023/05/01/business/first-republics-regional-banks-crisis.html.
[24] MarketWatch, "Commercial real estate prices are still expected to crater, Morgan Stanley warns," Joy Wiltermuth, July 17, 2023, https://www.marketwatch.com/story/commercial-real-estate-prices-are-still-expected-to-crater-morgan-stanley-warns-117ad1d7.
[25] U.S. Department of the Treasury, "READOUT: Financial Stability Oversight Council Meeting on June 16, 2023," press release, June 16, 2023, https://home.treasury.gov/news/press-releases/jy1547.
[26] Board of Governors of the Federal Reserve System, "Agencies finalize policy statement on commercial real estate loan accommodations and workouts," press release, June 29, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230629a.htm.
[27] Bloomberg, "US Regulators Asks Lenders to Help Firms With Commercial Real Estate Stress," Benjamin Bain, June 29, 2023, https://www.bloomberg.com/news/articles/2023-06-29/us-asks-lenders-to-help-firms-with-commercial-real-estate-stress.
[28] Markets Insider, "WeWork just warned it might fail, signaling commercial real estate is in serious trouble," Theron Mohamed, August 9, 2023, https://markets.businessinsider.com/news/stocks/wework-doubt-warning-commercial-real-estate-offices-economy-credit-rates-2023-8.
[29] Wall Street Journal, "A Real-Estate Haven Turns Perilous With Roughly $1 Trillion Coming Due," Konrad Putzier and Will Parker, August 7, 2023, https://www.wsj.com/articles/a-real-estate-haven-turns-perilous-with-roughly-1-trillion-coming-due-74d20528.
[30] Politico, "Credit markets are tightening. Private equity will feel the squeeze." Sam Sutton, August 1, 2023, https://www.politico.com/newsletters/morning-money/2023/08/01/credit-markets-are-tightening-private-equity-

to companies that are already highly indebted or have low credit ratings.[31] While banks, insurance companies, pension funds, hedge funds, and other private investments funds that originate leveraged loans may hold them directly, the vast majority of leveraged loans are sold off to investors, allowing exposure to these loans to spread throughout the economy[32] – risk that is compounded by poor underwriting standards and few protections for lenders and investors.[33] According to a recent analysis, over two-thirds of the leveraged loan market "wasn't hedged to protect against possible losses from higher interest before rates started climbing."[34]
Another analysis found that "[s]ince the Fed started raising interest rates, we have seen an increase in downgrades of [leveraged] loans and a rise in the share of [leveraged] loans trading at distressed levels."[35] If leveraged loan borrowers are unable to repay their loans, these companies and the loans could fail, spreading risk to all the entities that are exposed to them. This is particularly true for private equity-backed companies, which have long relied on leveraged loans to fund their predatory business models.[36]

Deteriorating conditions in the bond market, declines in commercial real estate, and losses in the leveraged lending market pose significant risks to the financial system. I am concerned that financial institutions may not be adequately managing these risks particularly in light of reports that banks are planning huge shareholder payouts. Wells Fargo, for example, just approved a new $30 billion share buyback program.[37] These payouts would deplete capital and raises significant concerns that the banks will be even less resilient to these threats.[38] I urge FSOC to carefully assess these risks and work swiftly to mitigate them. I also request a response to these questions no later than September 30, 2023:

1. What actions has FSOC taken to monitor the risks associated with the Fed's interest rate hikes? If no action has been taken, how does FSOC plan to take action?

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will-feel-the-squeeze-00109129; Wall Street Journal, "Private Equity Turns To Direct Lenders s Leveraged Loans Dry Up," Chris Cumming, June 8, 2022, https://www.wsj.com/articles/private-equity-turns-to-direct-lenders-as-leveraged-loans-dry-up-11654682400.
[31] Congressional Research Service, "Leveraged Lending and Collateralized Loan Obligations: Frequently Asked Questions," December 4, 2019, p. 1, https://crsreports.congress.gov/product/pdf/R/R46096.
[32] *Id.*, p. 2.
[33] *Id.*, pp. 9-10.
[34] Politico, "Credit markets are tightening. Private equity will feel the squeeze." Sam Sutton, August 1, 2023, https://www.politico.com/newsletters/morning-money/2023/08/01/credit-markets-are-tightening-private-equity-will-feel-the-squeeze-00109129.
[35] Apollo Academy, "The Impact of Fed Hikes on Loans," Torsten Sløk, July 26, 2023, https://apolloacademy.com/the-impact-of-fed-hikes-on-loans/.
[36] Politico, "Credit markets are tightening. Private equity will feel the squeeze." Sam Sutton, August 1, 2023, https://www.politico.com/newsletters/morning-money/2023/08/01/credit-markets-are-tightening-private-equity-will-feel-the-squeeze-00109129; Wall Street Journal, "Private Equity Turns To Direct Lenders s Leveraged Loans Dry Up," Chris Cumming, June 8, 2022, https://www.wsj.com/articles/private-equity-turns-to-direct-lenders-as-leveraged-loans-dry-up-11654682400.
[37] Reuters, "Wells Fargo approves new $30 billion share buyback program," July 25, 2023, https://www.reuters.com/business/finance/wells-fargo-approves-new-30-billion-share-buyback-program-2023-07-25/.
[38] Financial Times, "Largest US banks boost dividends after passing stress tests," Joshua Franklin and Stephen Gandel, June 30, 2023, https://www.ft.com/content/c6e4f2c1-6760-44d0-a96f-4790896e57e8.

2. What is FSOC's assessment of the state of these risks to the financial system and the economy as a whole? If no assessment has been made, when does FSOC plan to make and release an assessment?

3. What challenges does FSOC foresee that regulators will have in mitigating these risks associated with high interest rates?

Sincerely,

Elizabeth Warren
United States Senator