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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

Bank Regulators Eye Leveraged Lending

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Historically low interest rates in the United States have helped to fuel tremendous growth in leveraged loans. Leveraged loan volume in 2013 surpassed record levels set just prior to the global financial crisis, as banks and other institutional investors sought opportunities with potentially higher returns from more highly leveraged borrowers. In response to the substantial growth and significant participation of unregulated non-bank entities, U.S. bank regulators appear to be paying closer attention to the leveraged lending activities of their regulated banks. We expect this attention to continue in 2014, and banks will need to consider how new guidelines will affect their leveraged lending activities.

The Interagency Guidance on Leveraged Lending

On March 21, 2013, the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation issued updated guidance outlining principles related to safe and sound leveraged lending activities for banks operating in the United States. The Interagency Guidance on Leveraged Lending (the Guidance) replaces interagency guidance on this topic from 2001 and takes a more detailed and prescriptive approach than its pre-economic crisis predecessor. Nevertheless, the Guidance remains vague, and many institutions have expressed concern, if not confusion, about how they should implement it. Of note, the Guidance includes the following:

- **Call for clear underwriting and risk rating standards.** Emphasizing the importance of sound lending practices following the financial crisis, the Guidance stressed the need for clear, written and measurable underwriting standards regardless of whether the loan is underwritten to hold or distribute. Banks must closely analyze the ability of the borrower to de-lever to a sustainable level over a reasonable period of time; the Guidance generally suggests that institutions look at whether base case cash-flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. Similarly, with regard to a bank's internal risk rating of loans, the Guidance notes that supervisors assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five- to seven-year period provides evidence of adequate repayment capacity.

  Institutions also must scrutinize covenant protections in credit agreements, including the lack of meaningful financial maintenance covenants that require a borrower to maintain certain financial metrics. The Guidance notes that a leverage level after asset sales in excess of 6X Total Debt/EBITDA raises concerns for most industries, and thus the loan may be criticized.

- **Standards that differ from certain market practices.** The Guidance articulates certain standards that conflict with those of many market participants, particularly unregulated nonbank entities, that accept (i) projected levels of amortization significantly lower than that referenced in the Guidance and rely on refinancing capacity in the market for repayment, (ii) "covenant-lite" term loans or (iii) in certain cases, higher leverage levels.

- **Detailed board and senior management reporting.** The Guidance includes detailed requirements for the level and type of reporting and monitoring, as well as board and senior management involvement, and suggests at least 14 metrics for leveraged lending reports. Banks likely will need to invest substantial organizational and financial resources to update management information systems to generate accurate and timely reports.
- **Stress testing the portfolio.** The Guidance directs a bank to develop and implement periodic portfolio stress tests of leveraged loans originated to hold and loans originated to distribute. The stress tests are meant to assess how economic changes will impact asset quality, earnings, liquidity and capital.

The *SNC Review*

The Guidance became effective in May 2013. In September, the bank regulators issued the *Shared National Credit (SNC) Review*, an annual interagency review of large, complex credits shared by multiple banks. The *SNC Review* highlighted the significant volume of leveraged loans both as a whole and as a percentage of total criticized SNC assets (although the volume of criticized assets generally has decreased since 2009). Leveraged loans in the SNC portfolio totaled $545 billion. Forty-two percent of the leveraged loans in the SNC portfolio were criticized by examiners. By contrast, 10 percent of the loans in the total SNC portfolio were criticized. Criticized assets include all assets rated by examiners as either "special mention," "substandard," "doubtful" and "loss," as defined by the agencies' uniform loan classification standards and examination manuals.

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The *SNC Review* also cited material weaknesses in underwriting practices, a high volume of leveraged loans to borrowers without a capacity to de-lever over a reasonable period of time and a lack of meaningful financial covenants. The *SNC Review* specifically cited in this regard the reduced number of financial maintenance covenants, the use of net debt in many leverage covenants and various provisions that allow increased debt above starting leverage and the dilution of senior secured positions. According to the report, 34 percent of recently originated transaction structures were cited as weak due to a combination of high leverage and absence of financial covenants.

Additional Observations

The regulators have made clear they intend to scrutinize leveraged lending practices closely. Following the *SNC Review*'s release, several news reports indicated that the regulators sent individual letters to several banks. The regulators reportedly told the banks they had 30 days to come up with a plan for tighter procedures. Additionally, at least one high-ranking OCC official has said publicly that the regulators are looking to deter the origination of criticized or below-standard loans and alluded to the supervisory tools regulators have available, including enforcement orders and lower supervisory ratings. Both tools can have a significant impact on a bank's ability to receive required approvals from regulators or otherwise operate consistent with their intended business plans.

The annual stress-test scenarios are another indication that the bank regulators are focusing increased attention on leveraged lending. On November 1, 2013, the Federal Reserve released the scenarios for the 2014 capital planning and stress tests. The adverse and severely adverse scenarios include factors that will test a bank's response to changes in economic conditions that may affect the performance of leveraged and

other high-risk loans, such as the widening of U.S. corporate borrowing spreads. A bank's negative performance in the annual stress test could impact its ability to make capital distributions, such as dividend payments or stock repurchases.

Other recent final rules suggest banks will need to pay more as they increase the volume of the leveraged loans they hold. For example, in 2011 and 2012, the FDIC revised its deposit insurance assessment scheme so that banks will pay higher deposit insurance premiums if they have higher-risk assets, including leveraged loans. The FDIC's scorecard for highly complex banks considers the ratio of a bank's higher-risk assets to its tier 1 capital and reserves.

The traditional bank regulators' focus on credit and its impact on the health and performance of individual banks may explain the attention on leveraged lending only in part. Since the economic crisis, regulators also have focused on macroprudential risk. The regulators' view that banks should treat equally loans they intend to hold and distribute may be specific evidence of this concern. A large number of the loans subject to the Guidance are originated by the banks to be held by unregulated nonbank entities that are the primary buyers of riskier loans. The Guidance articulates a concern that the risks associated with poorly underwritten transactions can impact a wide array of investments and exacerbate systemic risks within the general economy.

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It remains to be seen to what degree the Guidance will restrain terms for leveraged loans in a robust credit market or increase the cost of credit for borrowers of leveraged loans. In the meantime — and regardless of a regulator's motive — banks will need to pay close attention to leveraged lending or face unwelcome consequences. Although the Guidance technically is nonbinding, banks that do not implement strong risk management processes consistent with the Guidance may be criticized by examiners and found to be engaging in unsafe and unsound banking practices warranting enforcement actions.