Reprinted from *JIBFL*, Vol. 28 – No. 6, 2013

Feature

KEY POINTS

- To comply with the Guidance, Financial Institutions may have to allocate additional compliance resources and broaden the scope of their existing compliance monitoring resources.
- Potential bright-line criteria in the Guidance may cause discrepancies between Financial Institutions and the Agencies in their assessments of risk levels in leveraged loan portfolios.
- The Guidance will likely have considerable influence on the operation of the leveraged loan market due to the regulatory power wielded by the Agencies; however, it is unclear how Agencies will enforce the Guidance and what forms of disciplinary action they may take. Financial Institutions were required to begin to comply with the Guidance on 21 May 2013.

Authors Douglas Landy, Andrew Sagor and Spencer Pepper

US bank regulatory agencies issue final guidance on leveraged lending practices: high-level considerations for financial institutions

In this article, the authors raise several high-level issues that US financial institutions and certain US offices of foreign banking organisations may have to consider in determining how best to comply with the final Guidance recently issued by US bank regulatory agencies.

BACKGROUND

In an effort to reduce systemic risk in the US financial system and to address the potential for deteriorating underwriting practices by US financial institutions and certain US offices of foreign banking organisations (collectively, "Financial Institutions"), the US federal bank regulatory agencies have issued final joint guidance (the "Guidance"; see 78 Fed. Reg 17776 (Mar. 22, 2013)) for the Financial Institutions that they supervise and which engage in leveraged lending activities. In this article we raise several high-level issues that Financial Institutions may have to consider in determining how best to comply with the Guidance.

The Guidance was issued on 21 March 2013 by the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC, Federal Reserve and OCC, collectively, the Agencies). The Guidance replaces the leveraged lending guidance that was last jointly issued by the Agencies in April 2001 (the "2001 Guidance") and finalises the Agencies' proposed guidance from March 2012 (the "Proposed Guidance") which had been subject to significant comment by the US banking industry. The Agencies addressed some of the commenters' concerns with the Proposed Guidance while also arguably maintaining bright-line criteria that could result in Financial Institutions needing to adopt high-level reforms within their leveraged lending practices.

Similar to many other regulations and guidances issued by the Agencies in recent years, the Guidance should be viewed as part of the Agencies' broader effort to identify and to reduce systemic risk while keeping pace with changes in market practices. In the aftermath of the 2001 Guidance, the Agencies observed periods of "*tremendous growth in the volume of leveraged credit and in the participation of unregulated investors,*" inadequate lender protections in debt agreements, and aggressive capital structures, all of which could have negative ramifications for the financial system as a whole.

According to the Agencies, the financial crises underscore the need for Financial Institutions to employ sound underwriting, ensure strong risk management, adequately monitor borrowers, and engage in stress-testing in order to be able to withstand adverse events in the future. The Agencies assert that Financial Institutions that fail to adhere to these practices may not only "*suffer acute threats to their financial condition and viability*" but may also "*generate risks for the financial system.*"

In contrast to a rulemaking action, the Agencies leave implementation and application of the Guidance up to each individual Financial Institution. The applicability of the Guidance, however, is also subject to the discretion of Agency examiners who will take into account institution-appropriate criteria. Financial Institutions were required to begin to comply with the Guidance on 21 May 2013. In reaction to this compliance date, the Loan Syndications and Trading Association (LSTA) and the American Banking Association (ABA) have sent the Agencies a joint letter in which they have requested a one-year extension of the 21 May 2013 deadline for Financial Institutions to be in compliance. Financial Institutions that originate or sponsor leveraged finance transactions may have several significant high-level considerations to weigh in implementing the Guidance.

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Douglas Landy is a partner in the New York office of Milbank, Tweed, Hadley & McCloy LLP. He is an acknowledged expert in US financial services regulation and has been at the forefront of the financial services practice during the recent credit crisis.

Email: dlandy@milbank.com

Website: http://www.milbank.com/attorneys/douglas-landy.html

DEFINITION OF "LEVERAGED LENDING" AND THE POTENTIAL BROAD SCOPE OF THE GUIDANCE

The Guidance applies to leveraged loans, which begs the question of how the Agencies define "leveraged lending". The Agencies simultaneously require Financial Institutions to adopt a definition for "leveraged lending" across their business practices that is appropriate to each individual institution while also setting forth several potential bright-line criteria common to leveraged loans. Such potential bright-line criteria include transactions where a borrower's total debt-to-EBITDA ratio is in excess of 4.0x or senior debt-to-EBITDA ratio is in excess of 3x, respectively. Financial Institutions may raise objections to such bright-line rules because such rules may, in some circumstances, be contrary to prevailing transactional practices. For instance, the aforementioned leverage test does not appear to address the concept of net debt that is used in numerous contemporary credit facilities whereby a borrower's unencumbered cash is netted against its indebtedness in order to calculate the borrower's leverage. Therefore, a potential consequence of this aspect of the Guidance could be that Financial Institutions underestimate the risk in their leveraged loan portfolios in comparison to how the Agencies would assess such risk.

The Agencies appear to include coverage of leveraged loans held in trading portfolios by stating that Financial Institutions "should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates." The potential broad applicability of the Guidance in this area could raise high-level concerns within some Financial Institutions to the extent such institutions do not have the same type of robust in-house monitoring and analytic functions set up for their trading portfolios as they do for their origination teams. Therefore, there may be potential for increased compliance costs as Financial Institutions may ultimately decide to allocate additional resources toward their trading portfolios in order to comply with the Guidance.

There is further potential for Financial Institutions to incur compliance costs even in areas where the Agencies sought to address issues raised in comments to the Proposed Guidance. For instance, both the LSTA and several individual banks commented on the Proposed Guidance that so-called "fallen angels" – credits that deteriorate post-inception and become highly leveraged – should not be included in the final Guidance. The Agencies accepted this argument to a point: "fallen angels" are not included within the scope of the Guidance unless the credit at issue is modified, extended or refinanced. Given the high volume of loans that are expected to be modified, extended or refinanced in anticipation of what remains of the "refinancing cliff," it appears at least possible that many refinanced credits could be constituted as being part of a bank's leveraged lending portfolio and be subject to Agency examiner criticism. Financial Institutions could potentially be compelled to shift monitoring and compliance resources to cover such loans, leaving their leveraged lending monitoring teams stretched thin.

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UNDERWRITING STANDARDS

The Agencies emphasise in the Guidance that Financial Institutions should have clear, written and measurable underwriting standards. While the generic language of the Guidance in this area may not appear to conflict with the existing best practices of US banks in the leveraged loan market, the Agencies did not accept previous comments from various firms (including from Milbank, Tweed, Hadley McCloy LLP) that the Agencies abandon or clarify a proposed test that total debt-to-EBITDA levels in excess of 6x would "*raise concerns for most industries*." While the Agencies frame their Guidance in this area as a useful metric for consideration, the Guidance suggests that such loans may be flagged for criticism by Agency examiners and by credit rating agencies. It remains to be seen how the Agencies' references in the Guidance to this specific matter will impact the availability of credit for more highly leveraged companies.

VALUATION STANDARDS

Recognising the role that enterprise value plays in the underwriting and assessment of leveraged loans, the Agencies state in their Guidance that enterprise valuations should be performed by qualified persons independent of the origination function within Financial Institutions.

The Guidance specifically states that capitalised cash flow and discounted cash flow analyses are the most reliable methods for calculating enterprise value. Moreover, if a Financial Institution relies upon enterprise value or illiquid collateral in its credit decisions, internal policies ought to provide loan-to-value ratios, discount rates and collateral margins.

Although the Agencies explicitly state that a Financial Institution should perform its own valuation analysis, it will also be interesting to observe whether the Guidance in this area will result in Financial Institutions separating their valuation teams from the teams heavily involved in originating leveraged loans. It is also possible that Financial Institutions may seek to outsource these functions to specialised valuation firms, potentially increasing the costs of originating leveraged loans for both Financial Institutions and for borrowers.

PIPELINE MANAGEMENT

The Guidance emphasises that a Financial Institution should have strong risk management controls over leveraged loan

Biog box

Andrew Sagor is an associate in the New York office of Milbank Tweed, Hadley & McCloy LLP. His practice focuses on representing and counseling banks, other financial institutions and borrowers in various domestic and cross-border financing transactions.
Email: asagor@milbank.com
Website: http://www.milbank.com/attorneys/andrew-sagor.html

transactions in its pipeline, including loans to be held and distributed, in order to avoid incurring material losses in a market environment where selling down such loans is difficult. The Guidance underscores that such controls ought to be able to differentiate leveraged loan transactions by tenor, investor class, structure and key borrower characteristics.

Notably, borrowers do not appear to be considered investment-grade by virtue of the ratings assigned to them by credit rating agencies. Rather, the metrics contained in the Guidance, such as the amortisation and leverage tests discussed elsewhere in this article, appear to control. Therefore, it is possible that investment-grade ratings issued to borrowers by credit rating agencies are overridden by such tests in the Guidance, which would be consistent with the requirement in the Dodd-Frank Act that the Agencies develop alternative standards of creditworthiness that do not rely on external credit ratings. Given this possibility, it will be worthwhile to monitor how Agency examiners assess investment-grade borrowers as well as the impact on Financial Institutions' assessments of such borrowers, in their mutual interpretation and implementation of the Guidance.

RISK RATING LEVERAGED LOANS

The Guidance describes the Agencies' expectations for sound risk management of leveraged financing activities, including, among other things, the development and maintenance of transactional structures that reflect a borrower's ability to repay and "*de-lever to a sustainable level within a reasonable period of time*," whether underwritten to hold or distribute, and well-defined underwriting standards that identify "acceptable" leverage levels and amortisation expectations. However, Financial Institutions may be concerned with the Agencies' attention to examples of specific tests or standards that may not be as simply or broadly applicable to leveraged credits as suggested in the Guidance. And because the Guidance will be given great attention by leveraged loan market participants (Financial Institutions, sponsors and corporate borrowers alike), the Agencies' broad application of such specific tests or standards could have unintended consequences and lead to increased volatility in leveraged financing markets.

In this regard, we note the Agencies' highlighting of a test presented as generally applicable to leveraged credits as perhaps particularly noteworthy: that Agency examiners consider adequate repayment capacity to be evidenced by a borrower's "ability to fully amortise senior secured debt or the ability to repay at least 50% of total debt over a five-to-seven year period" (the Amortisation Test) and that, in the absence of such evidence, a credit will receive an adverse, substandard rating from Agency examiners.

The general applicability of the Amortisation Test poses a number of issues. This test may not be well-suited to earlier stage companies or companies in industries with higher relative levels of capital investment, such as telecommunications, healthcare and certain technology and manufacturing companies. Such companies are likely to be unable to generate cash-flow projections demonstrating their ability to comply with the Amortisation Test even though their ability to service and ultimately repay their debt is not compromised.

It is also possible that the Amortisation Test will make it more difficult to structure specific loans or other instruments for the tailored demands of lenders. Institutional lenders and investors have significant demand for loans that possess particular characteristics, such as security and tenor, and care less about other characteristics, such as maintenance covenant protections and amortisation. The leveraged loan market is sufficiently stratified in its demands that the Amortisation Test could affect negatively the ability of arrangers to structure loans for distribution, which also enables Financial Institutions to better manage balance sheet risk. An additional possibility is that various "amend-and-extend mechanics," whereby certain existing lenders agree to amend a credit agreement in order to extend the maturity date of some or all of their leveraged loans, could be swept up within the Amortisation Test and be subject to greater scrutiny by Agency examiners because the loan maturity has been pushed past the five-to-seven year time period embedded in the Guidance.

In addition, incremental facilities or "accordions" that allow borrowers to choose to increase lenders' commitments or to add an additional tranche of indebtedness up to a certain amount and/or subject to pro forma leverage ratios, could also run afoul of the Amortisation Test because the incremental facility has increased the quantum of debt on the borrower's balance sheet such that the credit no longer satisfies the requirements of the Amortisation Test.

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DEAL SPONSORS

The Guidance addresses the support of financial sponsors (typically private equity firms) that hold equity interests in companies borrowing in the leveraged loan market. The Agencies make clear that Financial Institutions should evaluate the qualifications of sponsors and, where sponsors are relied upon as a secondary source of repayment, implement processes to consistently monitor a sponsor's financial condition. Factors for consideration include the sponsor's historical performance in supporting its investments, the sponsor's economic incentive to financially support the credit (such as equity contributions), the sponsor's dividend and capital contribution practices and the likelihood of the sponsor supporting a particular borrower compared to other companies in the sponsor's portfolio. The Agencies clarified in the Guidance that they

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Spencer Pepper is an associate in the New York office of Milbank, Tweed, Hadley & McCloy LLP. He represents banks and other financial institutions in a variety of domestic and international financing transactions.
Email: spepper@milbank.com
Website: http://www.milbank.com/attorneys/spencer-pepper.html

agreed with a previously submitted comment that "the ability of Financial Institutions to obtain financial reports on sponsors may be limited in the absence of a formal guaranty." Therefore, the Guidance appears responsive to the concerns of Financial Institutions in this context. Nevertheless, since leveraged finance transactions differ in the level of support expected of a sponsor with respect to a borrower (for example, whether there is a guarantee, comfort letter, or verbal assurance), it remains to be seen how Agency examiners will assess the approach taken by Financial Institutions to evaluate sponsors as well as any secondary support by sponsors (including any documentary support received by Financial Institutions from such sponsors).

The Guidance does not specify whether, to the extent such sponsor evaluations are undertaken, Financial Institutions will be expected to evaluate an individual private equity fund, its investment manager or management company. Should additional inquiries need to be made of a sponsor's investment manager or management company, it may create administrative and relationship hurdles for Financial Institutions, particularly when an investment manager or management company is unwilling or unable to disclose financial information about itself.

> Of particular interest to market participants, Financial Institutions and borrowers, is whether any formal enforcement action could be taken against loan parties under certain circumstances ...

COMPLIANCE, APPLICATION AND ENFORCEMENT

The Guidance outlines for Financial Institutions high-level principles relating to safe and sound leveraged lending activities that are important for institutions to develop and to maintain. The Agencies do not, however, offer clarity regarding the manner in which the Guidance will be expected to be practically applied to, and affect the availability of, credit provided to borrowers by Financial Institutions.

Of particular interest to market participants, Financial Institutions and borrowers, is whether any formal enforcement action could be taken against loan parties under certain circumstances or whether the Guidance will, instead, be used only informally by the Agencies to guide its examiners. For example, the Agencies do not state whether examinations will emphasise particular statements in the Guidance more than others.

The Guidance will likely have considerable influence on the operation of the leveraged loan market due to the regulatory power wielded by the Agencies and its examiners. While the Guidance does state that adverse, substandard or nonaccrual ratings may be applied to leveraged loans that fail the Amortisation Test, to the extent disciplinary or adverse regulatory consequences flow to Financial Institutions and borrowers from entering into leveraged loan transactions that are not aligned with some or all of the Guidance, those adverse consequences may not be clearly known at this point to all current and future market participants. ■

The author's views are his own.

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