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EXPERT ANALYSIS

Regulators Continue Focus On Leveraged Lending

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New interagency guidelines addressing leveraged lending became final in March 2013.[1] Since the adoption of the guidelines, the banking regulators have targeted leveraged lending in their reviews of commercial banks, including the 2013 shared national credit examination[2] and the Office of the Comptroller of the Currency's National Risk Committee's assessment of leveraged lending in 2014.[3] The findings contained in each of these reports emphasized that the regulators continue to be concerned about banks not effectively managing risks associated with leveraged lending. The challenge for bankers is how to implement a risk management framework that satisfies both the new guidelines and the regulators' subjective expectations that aren't spelled out, while remaining competitive in this market considering the significant presence of non-regulated lenders.

DEFINITION OF 'LEVERAGED LENDING'

The guidelines do not define the term "leveraged lending" and require banks to adopt their own definition. The guidelines state that leveraged lending commonly contains a combination of the following criteria:

- Proceeds of the loan are used for acquisitions and distributions; the borrower's total debt is more than four times its earnings or, alternatively, the borrower's senior debt (debt that is entitled to be repaid before other debt in the event the borrower goes out of business) is more than three times its earnings.
- The borrower is known as a highly leveraged firm.
- The borrower's post-financing leverage significantly exceeds industry norms or historical levels.

Although stated as an example in the guidelines, banks should expect the regulators to look to this language as the basis for whether credit meets the definition of a leveraged loan.

RISK LIMITS

The guidelines require banks to establish limits for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The regulatory findings from the recent reviews do not cite overall exposure levels to leverage lending as a concern, and the guidelines do not establish any numerical limits. However, banks that intend to significantly expand their activity in this area of lending will have to quantify the potential impact on earnings and capital and the adequacy of the allowance for loan and lease losses. Banks that adopt risk limits significantly in excess of historical lending in this area should expect to receive additional regulatory scrutiny and be prepared to justify how they intend to closely monitor the risk from growth in leveraged lending.

UNDERWRITING STANDARDS

During the past year, the banking regulators have criticized banks for failing to underwrite leveraged lending credits prudently, citing as two key weaknesses excessive leverage and the inability to amortize debt over a reasonable period. The guidelines do not mandate limits on leverage or establish bright-line rules regarding what is considered a reasonable period for debt amortization. However, the guidelines provide that "supervisors commonly 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," and "if the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten."

As a result of the language in the guidelines, banks that elect to originate credits that cannot support a cash-flow analysis evidencing repayment within the five-to-seven-year period based upon financial performance assumptions that are reasonably likely to occur need to be prepared to justify why the credit should not automatically be subject to an adverse classification.

Regulators continue to be concerned about banks not effectively managing risks associated with leveraged lending.

'COVENANT-LITE' LOANS

The regulators have expressed concerns that banks are originating leveraged loans without "meaningful financial covenants." These are commonly referred to as "covenant-lite" loans, and the challenge for bankers is how to meet regulators' expectations that leveraged loans contain covenants typical of more traditional commercial loans while remaining competitive with non-banks that can offer borrowers terms with more relaxed covenants.

The guidelines do not mandate that a bank require specific covenants in loan agreements and only provide that banks should adopt underwriting standards that address covenant protections and consider whether credit agreement terms should allow for the sale of collateral or cash-flow-producing assets without lender approval.

However, given the regulators' continued focus regarding covenant-lite loans, it is inevitable that banks that originate such credits will be subject to increased regulatory scrutiny. Banks that adopt policies requiring traditional covenants for all loans in an effort to fully appease regulators run the risk of losing the best-quality borrowers who have other alternatives, and thus effectively increase the risk in the leveraged lending portfolio. The key is for banks that permit covenant-lite loans to establish specific criteria to justify when such loan terms are acceptable based upon the overall quality of the credit or other mitigating factors.

CONCLUSION

Taken on their face, the new guidelines are relatively benign and appear to provide banks with flexibility in determining the types of loans that qualify as leveraged, as well as the specific underwriting standards for such loans. However, in light of the regulatory findings during the past year, it is evident that the regulators are holding banks to a higher standard than simply adopting a general framework in response to the guidelines. Banks must focus on their overall risk management systems, as well as on documenting specific credit decisions in light of such enhanced scrutiny. In response to the January 2014 senior loan officer opinion survey on bank lending practices conducted by the Federal Reserve, a number of banks indicated that they had tightened standards on leveraged loans.[4] The ability to originate credits given the level of competition from non-banks on terms that satisfy regulators will continue to be a challenge for bankers who want to maintain or expand their leveraged lending portfolios.

NOTES

[1] Board of Governors of the Federal Reserve System, Supervision & Regulation Letter 13-3; Interagency Guidance on Leveraged Lending, *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1303.htm.

[2] Shared National Credits Program 2013 Review, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131010a1.pdf.

[3] Office of the Comptroller of the Currency, Semiannual Risk Perspective from the National Risk Committee, Spring 2014, *available at* http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2014.pdf.

[4] The January 2014 Senior Loan Officer Opinion survey on Bank Lending Practices, *available at* http://www.federalreserve.gov/boarddocs/snloansurvey/201402/default.htm.

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