Paul|Weiss

Private Equity Digest

February 2015, Issue 11

Federal Leveraged Lending Guidance

In recent months, leveraged lending guidelines issued by U.S. federal banking regulators in the Spring of 2013 have been grabbing headlines and making waves in the syndicated loan market and the LBO arena in particular. This edition of the Digest examines issues raised by the federal guidance and the impact it is having on the marketplace, in particular on the availability of credit for sponsor M&A transactions.

Background

On March 22, 2013, the three U.S. federal banking regulatory agencies—the Office of the Comptroller of the Currency (the OCC), the Board of Governors of the Federal Reserve System (the Board) and the Federal Deposit Insurance Corporation (the FDIC)—jointly issued "Interagency Guidance on Leveraged Lending" (the Guidance) (for a link to the full text of the Guidance, please click here). The Guidance, which updated and replaced previous interagency guidance last issued in April 2001, outlined "high-level principles related to safe-and-sound leveraged lending activities." The regulators have stated that the Guidance was issued in response to concerns that deteriorating underwriting practices in the loan market contributed to the financial crisis and could pose systematic risks to the financial system.

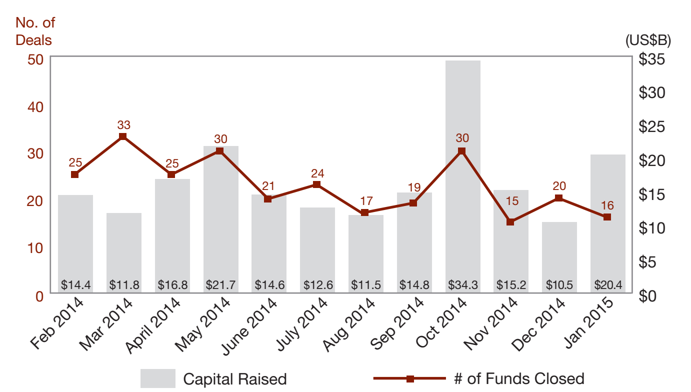
The Guidance was structured as "guidance" rather than a formal rule or regulation, and since its inception has created confusion in the marketplace (initially including as to whether compliance was even mandatory). On November 7, 2014, the regulators simultaneously issued (i) an FAQ intending to address frequently asked questions relating to implementation of the guidance (for a link to the full text of the FAQ, please click here) and (ii) the results of the 2014 Shared National Credit (SNC) review of covered financial institutions (including a supplement focused specifically on leveraged lending), in which the regulators criticized banks for failing to adhere to the safe-and-sound lending practices outlined in the Guidance (for a link to the full text of the SNC review and the leveraged loan supplement, please click here and here, respectively).

Who and What does the Guidance Cover?

The Guidance applies to financial institutions supervised by the applicable regulatory agencies, which generally includes all U.S. banks and the U.S. branches of foreign banks. The institutions covered include the lenders that traditionally act as lead arrangers in high-profile syndicated loan transactions but do not include other lenders (such as hedge funds) that make up the so-called "shadow banking" system.

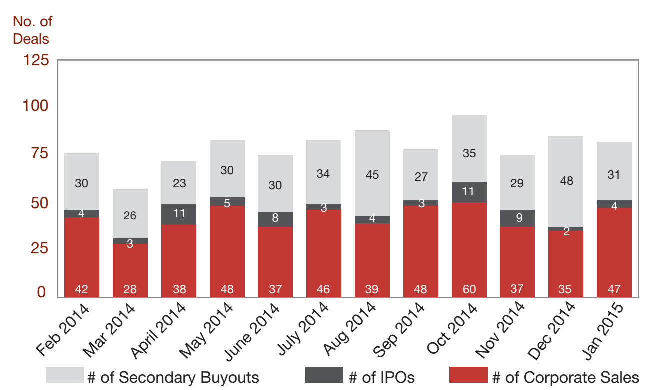
The Guidance applies to the activity of "leveraged lending," but does not define that term. Instead, recognizing that numerous competing definitions exist in the financial services industry, the Guidance leaves it up to each financial institution to adopt its own appropriate definition. Several examples of potential definitions are offered (including, for example, transactions where the ratio of the borrower's total debt or senior debt to EBITDA exceeds 4.0x or 3.0x, respectively, in each case without netting cash against debt).

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

The Guidance applies to "origination" of leveraged loans, and the FAQ clarifies that origination includes not only new extensions of credit but also refinancings and even "modifications" of existing loans (including "any type of restructuring or change to an existing nonmatured loan"). Presumably, this means even simple amendments have the potential to fall under the Guidance's scope. Because its application extends to all originations, the Guidance applies to loans that the financial institution does not intend to hold and has no obligation to hold.

Underwriting Standards

Underwriting standards are a primary focus of the Guidance. Most of the Guidance's text on this topic consists of general, overarching recommendations. For example, "A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions."

However, the following more specific statement in the Guidance has been the cause of much of the consternation surrounding it:

> *Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6x Total Debt/EBITDA raises concerns for most industries.*

Initially, this statement led to concerns that it could be interpreted as establishing a bright-line test that operates as a de facto restriction against leveraged loans having a leverage ratio in excess of 6.0x. In the FAQ, the regulators stated that they do not view a 6.0x leverage ratio as a bright line when evaluating the risk in a transaction, but instead stated that such loans are more likely to receive heighted scrutiny. In spite of this (or perhaps because of this), there have been growing reports in the press and mounting anecdotal evidence that regulated banks are increasingly reluctant to participate in leveraged financing transactions where the debt-to-EBITDA multiple is expected to exceed 6.0x.

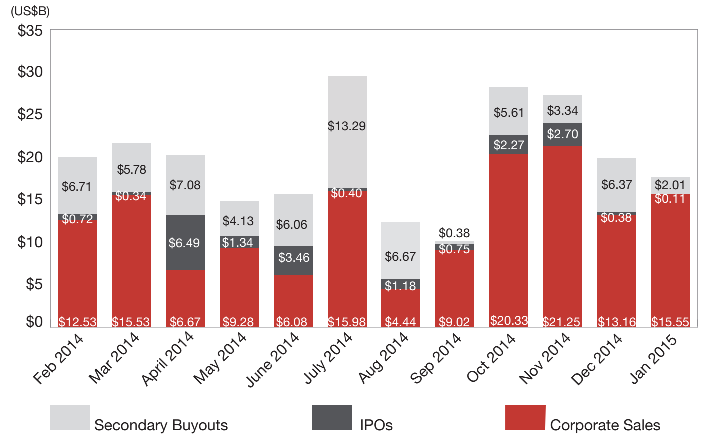
Risk Management Practices

The Guidance also directs financial institutions to adopt prudent risk management practices, including the use of "realistic assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time." In another widely scrutinized statement, the Guidance advises that:

> *[Regulatory banking] supervisors commonly assume that the [borrower's] 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.*

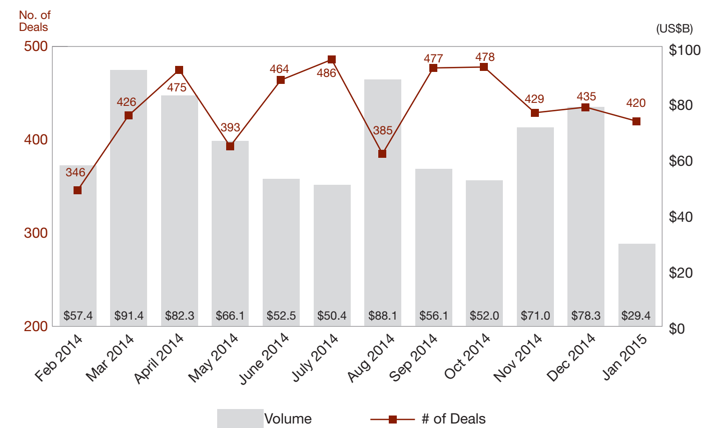
Some market participants observed that this statement may suggest that the absence of such evidence may be taken by the regulators as an indication of inadequate repayment capacity. The FAQ clarifies that a borrower's inability to meet such standards does not automatically result in a non-pass rating by the agencies, but it is considered as one relevant factor in the overall mix of relevant information for evaluating credit risk.

U.S. Sponsor-Backed Exits By Dollar Volume



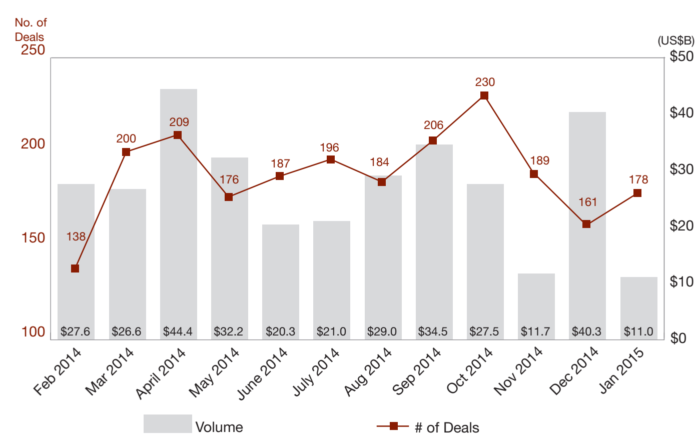
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Loan Covenants

The Guidance generally advises lenders to take covenant protections into account when ascertaining risk but provides no specific guidance relating to loan covenants. However, the introductory statement accompanying the Guidance states that:

> *The agencies believe…[covenant-lite]structures may have a place in the overall leveraged lending product set; however, the agencies recognize the additional risk in these structures. Accordingly, although the final guidance does not have a different treatment for such arrangements, the agencies will closely review such loans as part of the overall credit evaluation of an institution.*

In the FAQ, the regulators reiterated this viewpoint, indicating that covenant-lite features do not automatically result in a non-pass risk rating but noted that potential weaknesses in the transaction structure (such as the absence of financial maintenance covenants) are assessed along with the financial aspects of the borrower itself as part of the regulatory review process. The FAQ states that "[l]oans with relatively few or weak loan covenants should have other mitigating factors to ensure appropriate credit quality."

Deal Sponsors

The Guidance specifically addresses leveraged loans in the context of private equity sponsored borrowers. When a lender "relies on sponsor support as a secondary source of repayment," the Guidance directs the lender to develop guidelines for evaluating the qualifications of the sponsor and to implement processes to regularly monitor the sponsor's financial condition. This is not limited to situations where the sponsor provides a formal guaranty or comfort letter; it could also apply if the lender has reason to expect sponsor support on the basis of "[t]he sponsor's historical performance in supporting its investments, financially and otherwise," "[t]he sponsor's economic incentive to support, including the nature and amount of capital contributed at inception" and "[t]he likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio."

Compliance and Enforcement

When the Guidance was first released, commentators in the industry observed that the agencies left it unclear whether or not compliance was mandatory. On the one hand, the Guidance stated that "this final guidance is not being adopted as a rule" and used language suggesting that it was espousing recommendations and agency expectations rather than compulsory edicts (the Guidance tells banks what they "should" do, not what they "shall" do). On the other hand, the Guidance professed to require a "compliance date" of May 21, 2013, indicating that the agencies viewed compliance as mandatory.

In any event, it has become clear that the agencies are adopting an aggressive enforcement position. The SNC leveraged lending supplement released on November 7, 2014 chastises banks for serious deficiencies in underwriting standards and risk management of leveraged loans, and warns that "banks must not heighten risk by originating and distributing poorly underwritten and low-quality loans" and "[t]he agencies believe that an institution unwilling or unable to implement strong risk management processes will incur significant risks and should cease their participation in this type of lending until their processes improve sufficiently."

In addition, there have been widespread news reports describing regulatory actions to privately admonish banks for failing to comply with the standards set forth in the Guidance. With growing frequency, there have also been reports of lenders sitting out deals specifically over concerns surrounding the Guidance (particularly in transactions with expected leverage multiples in excess of 6.0x). The overall impact on the loan market remains to be seen, but the financial press has also reported that unregulated lenders have started stepping in to fill the void left by covered financial institutions seeking to avoid regulatory scrutiny.

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