US Leveraged Lending Guidelines

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There has been much written about the 'US Leveraged Lending Guidelines' and, with increasing speculation that European bank regulators will look to control leveraged lending in some form or another in the near future, this article takes a closer look at the guidelines, who they apply to and their impact so far. The spotlight then falls onto whether the ECB or any other European regulator will follow suit by implementing similar guidelines.

What are they?

On March 22, 2013 the "Interagency Guidance on Leveraged Lending" (guidance) (the Guidelines) were published by the Federal Reserve Board (the FRB), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (the OCC, and collectively the Agencies). The Guidelines are not new and replace guidelines last updated in April 2001. The April 2001 guidelines themselves were not effective in hindering or curbing the lending boom of the mid noughties which came to an abrupt halt during the financial crisis. During that time, the Agencies reviewed banking organisation adherence to the April 2001 guidelines and were not satisfied with the levels of adherence and as a result the April 2001 guidelines were revised (with a view to bolstering them) as leveraged lending activity picked up from 2009. The Agencies noted, when issuing the revised guidelines, that "[w]hile leveraged lending declined during the crisis, volumes have since increased and prudent underwriting practices have deteriorated."

The Guidelines identify a number of key areas for attention by bank management centering around leveraged lending practices but do not establish monetary limitations based on a percentage of capital or similar criteria applicable to all banking organisations pursuant to which they must limit their leveraged lending. Cognizant of the differences between banking organisations, the Guidelines leave it to each banking organisation to determine individually what its credit policies and procedures for leveraged lending should be. However, a set of general policy expectations is laid out to which banking organisations are expected to adhere. These include the need for a banking organisation to identify its risk appetite by, for example, defining amounts around how much it is willing to underwrite and hold on an individual credit and aggregate basis taking into account industry and geographic spread of the borrower base. Further, a banking organisation must define which transactions will be subject to its leveraged lending regime. While the requirement to define leveraged lending was also set out in the April 2001 guidelines, the Guidelines give explicit examples. The Agencies have also clarified that a purpose test (such as loans for acquisitions, buyouts or capital distributions) for determining whether a transaction falls within leveraged lending would, on its own, be insufficient.

What is leveraged lending?

Purpose	Where proceeds of the loans are used for buyouts, acquisitions, or capital distributions.
Borrower profile	Where a borrower is recognised in the debt markets as being highly leveraged.
EBITDA multiplier	Where Total Debt to EBITDA is greater than 4 x or Senior Debt to EBITDA is greater than 3 x.
Industry	Generally where a credit's post financing ratios significantly exceeds industry norms or historic levels.

By reference to its pre-determined appetite for leveraged lending, a banking organisation will be expected to manage its pipeline more effectively to ensure it (i) does not exceed its committee approved appetite and (ii) is not left with a large number of hung deals should the market cool. Written policies for identifying the reasons for a hung deal (one where there has been a failed distribution 90 days from a transaction closing) should be in place. Generally a banking organisation should have guidelines around how long it will permit for distribution of loans taking into account any take-and-hold limits.

When looking at a particular credit, a banking organisation should consider whether the borrower's capital structure is sustainable, including whether it has the ability to repay and de-lever over a reasonable period. The Agencies' examiners will look at the covenants provided for in the loan agreement including the financial covenants, reporting requirements and compliance monitoring. The item which has received the most press (and banking organisations' attention) is the Agencies' concern with any transaction where leverage levels would be in excess of 6 x Total Debt/EBITDA after planned assets sales.

What loans do they apply to?

The Guidelines apply to any leveraged lending at the origination stage and to all levels of a loan structure whether provided on a committed or best efforts basis. Origination is very broad and covers 'a new extension of credit, refinancing, or modification of an existing loan agreement, or a renewal of a matured or maturing loan transaction'. This eases initial concerns of some banking organisations that so called 'fallen angels' could be picked up by the Guidelines, i.e., credits that would not have fallen within the definition of leveraged lending at origination or participation, but for which the market or credit conditions have deteriorated so badly it could fall within the definition at a later stage. Although this gives some comfort, it does create refinancing risk for such fallen angels as well as leveraged deals done at much higher multiples before the Guidelines were issued.

The Agencies will look at the leveraged finance transaction and the entire debt structure as a whole including senior and subordinated bonds. The Guidelines, however, apply to all of the debt in the leveraged structure with the exception of bonds and high-yield debt. The Agencies have also noted that the Guidelines are not intended to capture any asset-based lending unless part of a leveraged lending structure. Therefore, any asset-based lending which is the 'dominant source of ongoing funding for a borrower' is unlikely to fall within the ambit of the Guidelines.

Loan characteristic	Guidelines apply	
Proceeds of loan used for buyouts, acquisitions or capital distributions	✓	(if combined with one or more other characteristic(s))
Loans resulting in Total Debt/EBITDA exceeding 4x	✓	(possibly on this characteristic alone or if combined with one or more other characteristic(s))
Loans resulting in Senior Debt/EBITDA exceeding 3x	✓	(possibly on this characteristic alone or if combined with one or more other characteristic(s))
To a borrower with a reputation for being highly leveraged with a high debt-to-net-worth ratio	✓	(possibly on this characteristic alone or if combined with one or more other characteristic(s))
To a borrower where post-financing leverage exceeds industry norms or historical levels	✓	(possibly on this characteristic alone or if combined with one or more other characteristic(s))
Asset-based loans	✕	(unless not the predominant loan and provided was part of a leveraged lending structure)
Loans to fallen angels (loans to borrowers that were not considered leveraged at the time of origination or distribution, but have since become so)	✕	(unless the loan is modified, extended or refinanced)
Refinancing of loans to an existing borrower	✓	(possibly if combined with one or more other characteristic(s))
Add-on loans to an existing borrower	✓	(possibly if combined with one or more other characteristic(s))
Extensions of loans to an existing borrower	✓	(possibly if combined with one or more other characteristic(s))
Modification of loans to an existing borrower	✓	(possibly if combined with one or more other characteristic(s))

What types of loans are likely to be criticised by the Agencies?

Overall, the Agencies want to ensure that any loan determined by the banking organisation to be a leveraged loan has been through the banking organisation's leveraged lending process including all appropriate internal approvals. A banking organisation would be criticised in the banking organisation's annual examination report if the examiner concluded that the banking organisation has too high a level of leveraged loans. An examiner may also classify a loan as special mention. A loan that might be identified as special mention by the Agencies may have one or more characteristics that act as red flags. A transaction with one red flag is not necessarily critical. For example, a leveraged deal above 6 x Total Debt/EBITDA may not be identified as special mention if there was clear evidence that the debt could be amortised over a 5 to 7 year period.

The loan structure should support a borrower's ability to repay and de-lever over a reasonable period. The sponsor/borrower's base case cash flow projections used to determine this should be the most realistic (i.e., not the conservative base case, but also not the more aggressive/upside base case). A bank may make adjustments to the base case financial projections to assist with determining this. Otherwise the transaction may become a refinancing risk that will put a strain on the financial system at a later date. It is also clear that the level of diligence and stress testing of base case models, valuations and synergies will have to be shown to be thorough and of a high standard.

Examples of red flags
Leverage at more than 6 x Total Debt/EBITDA: Total Debt should include any unused permitted debt baskets and accordion facilities.
No or limited amortisation requirement: no requirement to amortise at least 50% of loans over the life of the loan agreement (or, if earlier, within a 5 to 7 year period).
Over reliance on enterprise value and other intangible assets for repayment: for example, relying on IPO or sale proceeds based on projected enterprise values, unless such values are well supported.
Loan agreements which allow for material dilution, sale or exchange of collateral or cash flow producing assets without lender approval.
Poor covenant protections, reporting requirements and compliance monitoring.
Limited requirements to provide ongoing financial and other credit information to all participants and investors.
Overly optimistic or unsubstantiated projections including sales projections, margins and merger and acquisition synergies.
EBITDA definitions and adjustments which are not supported by third-party diligence.
Insufficient protection from interest rate and foreign exchange risk.

Who do they apply to?

The Guidelines apply to any banking organisation regulated by the Agencies. The types of banking organisations which are regulated by the Agencies is outside the scope of this article, but as a general rule, the guidelines do not apply to alternative credit providers and similar funds.

A US incorporated and regulated banking organisation includes all of its subsidiaries, branches and agencies including any non-bank subsidiaries wherever they may be situated in the world and, as such, are also subject to the jurisdiction of one or more of the Agencies. Therefore, all leveraged lending originated, distributed or participated in by such US banking organisations, either directly or through one of its subsidiaries, branches or agencies, would be subject to the Guidelines. This would also apply irrespective of the country in which the leveraged lending is originated, distributed or participated in. In short, the remit of the Guidelines goes well beyond leveraged loans in the US.

For non-US banks regulated by one of the Agencies, the OCC, FRB or FDIC, as appropriate, will have supervisory and regulatory jurisdiction over any of its direct operations in the US whether through a US branch, agency or a "non-bank" subsidiary. Note that any US bank subsidiary of a non-US bank would fall within the paragraph above. Therefore any leveraged lending originated, distributed or participated in by such US branch, agency, or non-bank subsidiary of a non-US bank would be captured by the Guidelines and the Guidelines would apply to all leveraged lending irrespective of which country it is originated, distributed or participated in. Any leveraged lending originated or intended to be distributed in the European market by a non-US bank or any of its non-US subsidiaries, branches or agencies would not be captured by the Guidelines unless that entity is a non-US subsidiary, branch or agency of a US regulated subsidiary, branch or agency of the non-US bank.

Type of banking organisation	Guidelines apply to leverage loans underwritten/ participated in the US	Guidelines apply to leverage loans underwritten/ participated in Europe
US regulated bank	✓	✓
Non-US subsidiary or branch of a US regulated bank	✓	✓
US regulated non-bank subsidiary or branch of a non-US bank	✓	✓
Non-US subsidiary or branch of a non-US bank (provided they are not a subsidiary of a regulated US non-bank subsidiary or branch of a non-US bank)	✕	✕
US entity not regulated by any Agency	✕	✕

The Guidelines apply not only to such banking organisations originating transactions but also those participating in leveraged loans.

The Guidelines do not apply to unregulated investors or entities, (the so-called "shadow banking system"). Some companies are turning to unregulated entities for what would be leveraged loans under the Guidelines. The Guidelines potentially provide them with a competitive edge and a window of opportunity to entice borrowers away from traditional lenders and arrangers. This applies to take-and-hold deals by alternative credit providers as well as deals arranged by them with a view to syndicate as there remains a large pool of investors that are not subject to the participation restrictions set out in the Guidelines. Many commentators are of the view that the majority of larger deals are likely to still require the distribution network and the expertise of the syndicate desks and deal teams of the larger regulated banking organisations.

How often are they monitored?

One should not forget that the Agencies' staff read the newspapers and would follow up on a transaction that seems to well exceed the Guidelines. In addition, US banking organisations and branches are examined annually by the Agencies. Credits which are syndicated, underwritten, or participated would be addressed in the Shared National Credit (SNC) program. The SNC program, governed by an interagency agreement among the FRB, the FDIC and the OCC, is designed to review and assess risk in the largest and most complex credits shared by multiple financial institutions. The program provides uniform treatment of, and increased efficiency in, the risk analysis and classification of shared credits. These credits are typically reviewed by the Agency responsible for the lead banking organisation on a transaction. The results of that examination are distributed by the Agencies to other regulated banking organisations in the syndicate or who purchased participations in such credits.

It has been reported that the Agencies have started to examine the books of some banking organisations on a monthly basis to increase the pressure on the granting of leveraged loans. A monthly visit allows the Agencies to assess the types of deals which are going through at any one time and illustrates that the Agencies mean business in their attempt to curtail the riskier aspects of leveraged lending. The last SNC survey published in November 2014 observed that 33.2 percent of leveraged loans were criticised by the Agencies. A criticised or classified credit in this case means that the examiners evaluated the credit as special mention, requiring management and directors to pay particular attention to such loans. Banking organisations are expected to charge off (i.e., assume that a debt is unlikely to be collected) a portion or all of a credit receiving a harsher criticism.

Do they have legal effect?

The Guidelines are not issued pursuant to a specific statute. The Agencies have cease and desist remedial authority and under this authority can issue guidance. Those not following the guidance could become the subject of a remedial action. This leaves both formal and informal measures available to the Agencies should the Guidelines be flouted or ignored. An examiner might note criticism of a banking organisation's failure to adhere to the Guidelines in the annual examination report which is delivered to members of the organisation's board of directors. Measures can include changing a banking organisation's compliance and management risk rating, delivery of a 'matters requiring immediate attention letter,' or a formal remedial action. To date no written agreement with, or cease and desist order has been issued in respect of, a banking organisation. A public action by one of the Agencies would result in negative press attention and, as has been seen, even private actions can be the subject of speculation by the financial press and the financial markets in general.

Impact on the US market

Initially there was some confusion as to how the Guidelines should be applied. US banks were reported to have ceded their role in high profile transactions where leverage was above 6 x. There was also the feeling that US banks were subject to a more stringent application of the Guidelines by the OCC, whereas US branches or agencies of non-US banking organisations subject to the FRB were getting a lighter touch. The Agencies appeared to make it clear that this was not the case as in September 2014 The Wall Street Journal reported that the FRB had issued a 'matters requiring immediate attention letter' to a major foreign bank with a US regulated presence noting that it was failing to adhere to the Guidelines. As a result of demand for more guidance as to how the Guidelines should be interpreted, the Agencies published a set of Frequently Asked Questions in November 2014.

S&P, Leveraged Commentary & Data had total debt levels for US leveraged financings at 6.62 x during the third quarter of 2014, more than a year after the Guidelines had been issued but the market has retracted somewhat since and there has not been any publicly reported deal with leverage above 6x arranged by a US bank in the US market in 2015.

One key aspect of the Guidelines is to hold banking organisations to a degree of greater accountability for following risky lending practices. It will no longer be sufficient to adopt a policy of agreeing to any terms to win a mandate which a syndicate desk has determined it can sell to the market or to meet the competition. The Agencies are well aware of the competition to make such leveraged loans and its impact on credit standards and terms. The question remains whether it is only a matter of time before a remedial action will be taken or whether the Guidelines have begun to bite. It is a disruption of the supply and demand model but some investors may welcome the reins being pulled on banks agreeing to terms which are not attractive but which they feel they have no choice but to participate in due to lack of alternative investment opportunities in a low return environment.

Impact on the European market

European banks (but not their US regulated subsidiaries, branches or agencies) are free to arrange deals without reference or concern for the Guidelines. This should give them a competitive edge in Europe for European deals particularly at a time when it is hard to compete on pricing alone. However, European banks cannot afford to overlook the Guidelines. The US banks are big players in the European market, and some deals will require them and their syndications desks to be involved in a deal whether as arranger, underwriter or participant. In fact, as reported in Financial News (8-14 June 2015 issue 952), European banks have lost market share to their US rivals. This is the case notwithstanding a number of 2015 European deals having EBITDA multiples above 6 x.

Even though the Guidelines do not apply to them, the thought on any European bank's mind has to have been whether European regulators would propose or implement similar guidelines or regulations. Any concerns European banks had would have been compounded when in May the ECB requested detailed information from Eurozone banks about their leveraged lending practices. This information, it has been reported, had to be provided by mid-June. The ECB's findings may determine whether or not we see some form of regulation in Europe of leveraged lending. Any such regulation or guidelines may end up impacting some European banks more than others depending on

each participating states interpretation of any directive, regulation or guideline issued. The UK falls outside of the Eurozone and the ECB's current information request. The Bank of England made a request for information from UK banks in 2014 and later intimated in March 2015 that it will not be establishing its own guidelines for UK banks to adhere to as "the UK banking system currently appeared resilient to stress in the leveraged loan market." It may be that the ECB comes to the same conclusion.

Conclusion

Overall, it seems likely that leverage multiples will need to come down across the board for the larger leveraged financing deals. Smaller and mid-market will continue to be the pick of alternative credit providers and unregulated entities.

The Guidelines are not just impacting on the banks but on sponsors looking to refinance existing leveraged credits, add bolt-on financing or for new acquisitions where a lower EBITDA requires a greater equity cheque or a reduction in purchase prices across the board. As M&A activity has picked up and sponsors face competition from corporate acquirers, we have seen, unsurprisingly, a lower supply of deal flow in the leveraged financing market. The result is to add to the already existing and ever increasing demand for investments. This increasing demand may not work for the sponsors' benefit in obtaining better terms such as increased leveraged where this risks intensified scrutiny from the Agencies. It remains to be seen whether deals which do need to be refinanced will end up in the restructuring space, or borrowers will look towards alternative credit providers or the high yield market.

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