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Banking Regulators Signal Movement Away from Leveraged Lending Guidance

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Recent remarks by the new Chairman of the Board of Governors of the Federal Reserve System ("FRB") and Comptroller at the Office of the Comptroller of the Currency ("OCC") signal that the federal banking agencies ("Agencies") may be backing away from the relatively prescriptive approach to assessing the leveraged lending activities of regulated banks set forth in the Agencies' 2013 Leveraged Lending Guidance ("LLG") in favor of a more risk-based safety and soundness approach.[1]

Background

The status of the LLG has been in limbo since the General Accountability Office ("GAO") determined in October 2017 that the LLG is a "rule" under the Congressional Review Act ("CRA").[2] The CRA requires federal agencies to submit new rulemakings to Congress and gives Congress the right to review a rulemaking and, by joint resolution, disapprove a rule prior to its effectiveness.[3] The GAO finding left the Agencies with the choice of submitting the LLG to Congress, issuing similar new guidance as a rule that would be submitted to Congress for CRA review, or abandoning the LLG altogether in favor of an alternative approach. Recent remarks by the new Chairman of the FRB and the OCC Comptroller indicate that the Agencies are considering the latter approach.

For a discussion of the GAO determination, please see our Alert available *here*.

Recent Remarks of the Agencies

On February 27, 2018, FRB Chairman Jerome Powell and OCC Comptroller Joseph Otting each made separate public remarks regarding the status and future prospects of the LLG.

In his testimony before the House Financial Services Committee ("HFSC") on February 27, FRB Chairman Powell stated that, "in the case of the leveraged lending guidance we do accept and understand that that's non-binding guidance."[4]

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The Chairman's statement came in response to a question from the Chairman of the House Financial Institutions and Consumer Credit Subcommittee, Blaine Luetkemeyer, who asked: "[W]ould you agree that rules are rules and guidance is guidance and guidance is not binding."[5] Chairman Luetkemeyer indicated that his question was based on reports from banks that examiners are continuing to treat the existing guidance as binding in respect of outstanding matters requiring attention ("MRAs") despite no one disputing the GAO finding that the LLG is a rule that requires submission to Congress before being treated as effective. The FRB Chairman noted that the FRB has "made it a point to go out and make sure that that message [of the LLG's non-binding status] is getting out to supervisors of banks." He referenced the "good intentions" of new leadership of the agency, including the FRB's new vice chairman in charge of bank supervision, Randal Quarles, to communicate to the entire agency that "an understanding needs to take place by everybody that this is a new way of doing business—that guidance is guidance, rules are rules, and there's a big difference between how they're adjudicated and administered and enforced."[6]

On the same day, OCC Comptroller Joseph Otting told attendees at a Structured Finance Industry Group conference that "[i]nstitutions should have the right to do the leveraged lending they want, as long as they have the capital and personnel to manage that and it doesn't impact their safety and soundness."[7] He went on to specify that safety and soundness concerns would be raised by "a ton" of leveraged lending, highly concentrated lending or deterioration in a leveraged lending portfolio. In an interview later that day, he clarified that "[w]hat we are telling banks is you have capital and expected loss models and so if you are reserving sufficient capital against expected losses, then you should be able to make that decision."[8] The Comptroller voiced support for banks having the right to "do what you want as long as it does not impair safety and soundness."[9] He noted that the LLG has created an atmosphere where jumping over the "line" set by the LLG would result in "feeling the wrath of Khan from the regulators" and specified that his approach would permit banks to transgress guidelines so long as they have sufficient capital.[10]

Potential Actions by the Regulatory Agencies

As noted by FRB Chairman Powell in his HFSC testimony, the FRB is advising its examiners not to treat the LLG as a rule. His point that there is a "big difference" between how rules and guidance are adjudicated, administered and enforced would seem to indicate that, to the extent the Agencies intend to retain the LLG as "non-binding" guidance, its prescriptive limits—such as borrower leverage in excess of six times total debt-to-EBITDA – should not be used as the basis for MRAs or other adverse supervisory action by examiners.

The FRB Chairman also noted that the Agencies are considering alternatives to the LLG that include putting out new guidance for comment. The OCC Comptroller's comments, on the other hand, suggest the Agencies may not pursue issuance of new guidance or a proposed rulemaking and seek, instead, to monitor the leveraged lending activities of banks under the Agencies' statutory "safety and soundness" authority. That authority permits the Agencies to take action against a bank deemed to be engaged in unsafe or unsound activities. In general terms, that requires a finding that a bank lacks adequate internal controls and other operational and managerial standards and/or adequate capital to ensure that its leveraged lending activities are conducted in a manner that does not jeopardize the bank's safety and soundness or, alternatively, that the quantity or quality of leveraged loans held poses such a risk. Such determinations are generally based on an assessment of the risks of an activity or asset to the particular bank being examined, rather than attributing the risks of the bank's loans based on the size, purpose or borrower's leverage ratio of the loans held. Generally, this approach would provide more flexibility, require greater examiner judgement and, in this regard, provide less certainty and, presumably, less uniformity than a bright-line benchmark such as a 6.0 times leverage limit of the LLG. Therein lays the tradeoff.

Earlier leveraged lending guidance replaced by the LLG adopted the approach articulated by the Comptroller, establishing an expectation of reasonable amortization of loans, but not specific quantified limits for determining reasonableness. If the Agencies decide to limit new guidance to these types of "reasonable" standards, reviews by Agency examiners could become more subjective, with assessments of the proper classification of syndicated loans determined based on the adequacy of a bank's operational and managerial standards and capital position, rather than the borrower's leverage and financial projections. Again, this tradeoff, sacrificing certainty and predictability in favor of judgement and flexibility, was largely the catalyst for the bright line standard articulated in the LLG by the Agencies in 2013—which is now the subject of significant criticism.

Agencies Tailor Loans Subject to SNC Program

If there is any doubt that the Agencies are serious about addressing the concerns and criticism regarding the constrictiveness of the LLG, we need to look no further than recent actions to modify the Shared National Credit Program ("SNC Program"). In December, the Agencies raised the threshold for syndicated loans subject to reporting and review under the SNC Program, signaling what appears to be a clear change in approach to monitoring bank-leveraged lending activities. In this regard, the Agencies raised the threshold for the aggregate commitment amount of loans covered by the SNC Program to $100 million from the $20 million threshold that had been in place since the SNC Program was established in 1977.[11]

Potential Implications for Banks

The recent remarks by the new heads of the FRB and OCC indicate that, going forward, the LLG's prescriptive limits should not be used by examiners as the basis for MRAs requiring banks to classify participations in syndicated loans as special mention, sub-standard or doubtful and, as appropriate, banks can adjust their regulatory capital treatment accordingly. While outstanding MRAs should not be ignored, the remarks pave the way for a dialogue with examiners on the resolution of such issues.

The remarks suggest that, from the Agencies' perspective, the LLG prescriptive limits are "non-binding" and, perhaps, no longer being applied at all. In this regard, however, the remarks do not offer a clear indication of how the Agencies will look to assess bank-leveraged lending activities going forward. Thus, banks should be prepared to continue to defend their leveraged lending activities, understanding that the bright lines of the LLG are now being supplanted by examiner judgment and discretion regarding safety and soundness in the context of a bank's leveraged lending program and activities. The remarks create an expectation that examinations may focus less on the amount of leverage and other quantifiable criteria of borrowers and more on the reasonableness of the amortization and other terms of a leveraged loan, the adequacy of a bank's management procedures and internal controls to assess the potential safety and soundness risks presented by such lending activities, and the adequacy of regulatory capital levels to withstand classification or default of leveraged loan assets.

Global banks subject to supervision by the European Central Bank ("ECB") should also be aware that a move away from the existing LLG approach by the Agencies may not relieve banks of the need to maintain adequate policies and procedures and systems to monitor their leveraged lending based on LLG-type criteria applied by the ECB. Existing ECB guidance for how EU banks should treat leveraged loans is modeled, in part, after the LLG prescriptive limits, including the use of borrower leverage ratio limits to determine whether a loan is a leveraged transaction.[12]

Issues for Further Consideration

At this juncture, banks subject to the LLG and actively engaged in leveraged lending activities should seek to obtain as much clarity as possible from their regulators regarding examination and review of their leveraged lending activities and program. In particular, banks should inquire regarding examiners' expectations of what they view as a reasonable level of amortization, the reasonableness of other terms of a leveraged loan, the adequacy of a bank's internal controls and management procedures to assess safety and soundness risks with leveraged lending activities, and the adequacy of regulatory capital levels to withstand classification or default of leveraged loan assets.

It remains unclear exactly how and to what degree we will see palpable, rather than incremental, movement in the supervisory and examination response to leveraged lending going forward. The extent to which, how, and how quickly, reforms will be carried out are issues of keen interest to regulated institutions in the leveraged lending space. It often takes considerable time and effort not only to implement the type of programmatic supervisory reforms suggested by FRB Chairman Powell and Comptroller Otting, but also for regulated institutions to understand, adopt and adjust to the new approach(es) embraced by the regulators.

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[1] Interagency Guidance on Leveraged Lending (March 21, 2013), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf.

[2] GAO Letter to Sen. Pat Toomey, 163 Cong. Rec. S6636 (Oct. 19, 2017).

[3] 5 U.S.C. § 801(a)(1)(A).

[4] "Monetary Policy and the State of the Economy," hearing before the US House Financial Services Committee, remarks of FRB Chairman Jerome Powell (Feb. 27, 2018).

[5] *Id.*

[6] *Id.*

[7] "OCC Head Says Banks Not Bound by Lending Guidelines, Expects Leverage to Increase," *Debtwire* (Feb. 27, 2018), available at https://www.debtwire.com/info/occ-head-says-banks-not-bound-lending-guidelines-expects-leverage-increase

[8] *Id.*

[9] "Banks Can 'Do What They Want' in Leveraged Lending: Otting," *Reuters* (Feb. 27, 2018), available at https://www.reuters.com/article/us-usa-banks-lending-otting/banks-can-do-what-they-want-in-leveraged-lending-otting-idUSKCN1GC0B5.

[10] *Id.*

[11] Agencies Joint Press Release, "Agencies Announce Shared National Credit Definition Change; Aggregate Loan Commitment Threshold Increased to Adjust for Inflation, and Changes in Average Loan Size" (Dec. 21, 2017), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171221c.htm.

[12] "ECB Publishes Guidance to Banks on Leveraged Transactions" (May 16, 2017). We addressed the ECB Guidance in our client alert available *here*.