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Interagency Guidance on Leveraged Lending (March 2013)—A Summary of the 2014 Interagency Shared National Credit Review and Answers to the Most Frequently Asked Questions

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I. Background

On March 22, 2013, the Board of Governors of the Federal Reserve Board (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") published the "Interagency Guidance on Leveraged Financing"[1] (the "Guidance"). The Guidance focused on the leverage lending activities of banks and other financial institutions that are supervised by the Board, the FDIC and/or the OCC (collectively, the "Agencies") and revamped the previous guidance issued by the Agencies' in 2001.

In November 2014, the interagency Shared National Credits Program (the "SNC") (which is governed by an interagency agreement among the Agencies) issued the "Shared National Credits Program 2014 Review"[2] (the "SNC Review") and the "Shared National Credits Program 2014 Leveraged Loan Supplement" (the "2014 Supplement"), which examined a portfolio of leveraged loans and identified areas of weaknesses and risks in the leveraged lending arena. On November 7, 2014, the Agencies published answers to frequently asked questions to address the numerous inquiries received following the publication of the Guidance.[3]

This client alert will focus on the 2014 Supplement and the Guidance FAQ.

II. 2014 Supplement

The SNC Review examined the credit quality of syndicated loans held by U.S. banking organizations, foreign banking organizations and non-banks based on an examination of $975 billion in credit commitments (which comprised 29% of the SNC loan portfolio), using data collected between December 31, 2013 and March 31, 2014. Of this total, the 2014 "leveraged" SNC loan portfolio consisted of $767 billion in commitments across 24 industry segments, of which the SNC examined 782 leveraged loan obligors consisting of $623 billion of commitments in the 2014 Supplement, representing 81% of the 2014 "leveraged" SNC loan portfolio by dollar commitment.

As set forth in the SNC Review, leveraged loans represented 72.9% of all SNC loans that rated special mention (i.e., such loans exhibit potential weaknesses that could result in further deterioration if uncorrected), 75.3% of all substandard loans, 81.6% of all doubtful loans and 83.9% of all nonaccrual loans.[4] Further, according to the SNC Review, financial institutions continue to originate large volumes of non-pass risk rated leveraged loans (i.e., loans that are not in good standing or are criticized on some way (such as special mention or worse)) at inception to either hold or distribute. As such, given the concern of these findings as they relate to the capacity of the borrower to repay the loan, the expectation of the Agencies is that all firms with leveraged loan exposure will:

- "Establish underwriting standards to prevent the origination[5] of new non-pass credit;
- Establish policies to enhance the credit position of non-pass borrowers seeking refinance of current credit structures;
- Set prudent limits for leveraged transactions to highly cyclical industries that would struggle to meet obligations during a down cycle; and
- Set prudent limits for leveraged transactions that do not result in increased cash flow for the borrower, such as dividend recapitalizations."

With respect to the underwriting of leveraged loans, the SNC Review found that 31% of leveraged loans originated within the past year were "weak" due to being highly leveraged, lacking in financial covenants, having minimal de-leveraging capacity and/or nominal equity. In addition, the SNC discovered that some of the refinancings of non-pass loans did not result in any meaningful improvement in structure or controls as a result of such refinancing. As such, the Agencies are expecting to see future strategies that would actively seek to effect meaningful improvements in structure and controls during the refinancing of non-pass loans. Suggestions for such strategies include "implementation of new covenants or tightening of existing covenants; equity injections; line reduction; step-ups to a term loan A structure with increased amortization; the addition of collateral; restrictions on new acquisitions; or issuance of additional debt." The 2014 Supplement notes that the Agencies do not consider reductions in pricing, extension of maturities or a decrease in bank exposure to be strategies for the achievement of successful pass ratings.

Lastly, the 2014 Supplement also focused on enterprise valuation and noted a reliance on dated valuations, weaknesses in credit analyses (including the inclusion of difficult-to-support adjustments in EBITDA calculations used to determine leverage and repayment capacity), and an overreliance on borrower/sponsor base case projections.

III. Guidance FAQ

The Guidance FAQ focused primarily on Guidance clarifications, Scope of the Guidance and the Agencies' expectations.

A. Expectations and Guidance Clarifications

1. <u>Defining and Identifying Leveraged Loans</u>

It is expected that financial institutions will use the four common characteristics outlined in the Guidance[6] as a starting point for defining and identifying leveraged loans across the various industries. The Agencies clarified that such definition should not require that the loan meet any type of "purpose test" (e.g. buyout, acquisition or capital distribution) and that loans that meet any one of the four common characteristics (e.g. leverage level) are not automatically considered to be leverage loans based on that one characteristic.

2. *Exclusion of ABL Loans*

The Agencies also addressed the exclusion of asset-based facilities from the Guidance, clarifying that such facilities are to be excluded if they are the "dominant source of ongoing funding for a borrower" and included if they are "part of a larger debt structure of a company . . . (even if they are the only tranche of the debt structure an institution holds)."

3. *Refinancings, etc.; Extension of New Funds*

It is expected that in the event a leverage loan origination is downgraded to a non-pass rating after the inception date, the relevant financial institution will work with the borrower to institute a strategy aimed at restoring the pass rating. Further, financial institutions may refinance, modify or renew loans with special mention risk ratings as it is not the intent of the Agencies to interfere with or preclude such acts. However, the financial institution should demonstrate that action is being taken to mitigate the structural/credit concerns that resulted in such a rating and should recognize that the extension of new funds in connection with such refinancing, modification or renewal of leverage loans with special mention risk ratings will be considered to be a new origination and will be subject to an adverse risk rating unless it is demonstrated that the new extension of funds mitigates existing risks.

4. *Covenant-lite Loans*

With respect to covenant-lite loans, the Agencies clarified that such loans are not automatically assigned a non-risk rating and that a weakness in one aspect of a transaction structure (such as covenants, maturity or repayment structure) will be assessed in totality with the financial aspects of the borrower and other mitigating factors.

5. *Multiple Loan Tranches*

The Agencies also addressed the issue of multiple loan tranches, clarifying that all of the loan tranches should be rated pass at inception and that each institution should implement policies that deter the origination of non-pass leveraged loans in each loan tranche.

6. *6.0x Total Debt divided by EBITDA Underwriting Benchmark*

According to the underwriting standards section of the Guidance, a leverage level exceeding 6.0x Total Debt divided by EBITDA raises concern for most industries. The Agencies clarified that the 6.0x Total Debt divided by EBITDA level is not a bright line test and that management and examiners should consider all underwriting factors when reviewing credits.

7. *Inability to Amortize*

The Agencies clarified that a borrower's inability to fully amortize senior secured debt or to repay at least 50% of total debt over five to seven years will not automatically result in a non-pass rating.

B. Classified Loans

Classified loans are loans that have been rated substandard, doubtful or loss. The Agencies clarified that the Guidance is not meant to prevent workouts, which generally include a transaction that is rated substandard or below.

C. *Scope; Implementation and Monitoring*

1. Scope

Both "best efforts" and fully committed transactions are intended to fall under the Guidance. Further, all federally regulated institutions that originate or purchase leveraged loans as well as non-bank subsidiaries of a bank or savings and loan holding company are subject to the Guidance. In addition, the Guidance applies to foreign institutions with U.S. charters that originate and distribute loans in the United States.

With respect to loans originated to be held by a financial institution as opposed to loans originated only for distribution to other lenders, the expectation of the Agencies is that the Guidance will be consistently applied to all leveraged based activities, regardless of the foregoing distinction.

As for investments in collateralized loan obligations, direct loans to business development corporations or investments in similarly structured transactions, the Agencies are of the view that the risk management and reporting aspects of the Guidance should be applied to the underlying loan in structured transactions if an institution originates or retains credit risk in the individual loans.

2. Implementation and Monitoring

It is expected that examiners will "evaluate an institution's implementation of the guidance by (1) assessing policies, procedures, limit structures, management information systems, and other risk management processes related to leveraged lending activities, and (2) conducting transaction testing of leveraged loan transactions."

Supervisory reviews will occur during the SNC general examinations of leveraged financing transactions and through continuous monitoring by the Agencies. If a financial institution is not a part of the SNC process, examiners will assess that institution's conformance with the Guidance during that institution's regular examinations.

D. *Trading Assets*

Trading assets are also subject to the Guidance. Further, it is consistent with the Guidance for trading desks to buy and sell non-pass credits in an institution's trading account. The Agencies "do not consider the purchase of a trading asset that is a preexisting leveraged loan or portion thereof to be an origination or refinancing" under the Guidance. Loans held or purchased for the available-for-sale or held-to-maturity portfolios are subject to the guidance.

E. *Distinction between the Guidance and the FDIC's deposit insurance assessment rule*

The requirements in the Guidance are not intended to be the same as those required by the FDIC's deposit insurance assessment rule. The FDIC's definitions differ from those in the Guidance (e.g., the FDIC's deposit insurance assessment rule includes specific tests to determine whether a commercial and industrial loan is a high-risk loan whereas the Guidance does not establish a uniform definition for leverage lending). Compliance with the Guidance and the FDIC's deposit insurance assessment rule are to be assessed separately.

Given the importance of guidance and benchmarks to minimize origination and distribution of improperly underwritten and weak leveraged loans and the need to mitigate the risk such loans present to the financial system, the Guidance FAQ may provide helpful clarifications to financial institutions as they navigate the leverage markets. However, given the complexity of the leverage markets and the ever-evolving nature of the financial system, unanswered questions will likely necessitate further clarifications from the Agencies.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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[1] See 78 Fed. Reg. 17766 (March 22, 2013).

[2] As revised by the Agencies on November 10, 2014 to correct certain 2014 year figures in Appendix B to the report.

[3] See "Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance for Leverage Lending (November 7, 2014) (the "Guidance FAQ").

[4] See the SNC Review for further discussion.

[5] The Guidance FAQ clarified that "origination" for the purposes of the Guidance refers to an origination that occurs on the date of a new extension of credit, refinancing or renewal. Financial institutions that arrange, underwrite or distribute leveraged loans are considered to be originators of loans, whereas participants would not be considered to be originators.

[6] I.e., loan proceeds used for buyouts, acquisitions, or capital distributions; transactions where the borrower's Total Debt is divided by EBITDA or Senior Debt divided by EBITDA exceeds 4.0x EBITDA or 3.0X EBITDA, respectively, or another level appropriate to the industry; a borrower is recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net worth ratio; and/or transactions where the borrower's post-financing leverage significantly exceeds industry norms or historical levels.