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US Bank Regulators Publish FAQs and 2014 SNC Review of Leveraged Lending

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On November 7, 2014, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Federal Reserve") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "agencies") released the widely anticipated answers to Frequently Asked Questions (the "FAQs") relating to the March 2013 interagency guidance on leveraged lending (the "2013 Guidance"). The agencies simultaneously released the Shared National Credit ("SNC") Program 2014 Review, which includes a supplement relating exclusively to leveraged loans (the "SNC Leveraged Loan Supplement" and, together with the FAQs, collectively, the "Additional Guidance").[1]

The Additional Guidance provides insight into how the agencies are interpreting and implementing the criteria set forth in the 2013 Guidance, and is designed to assist in the development of a shared understanding among the industry and examiners of supervisory expectations for safe and sound underwriting of leveraged loans. The Additional Guidance also sends a direct warning to originators of leveraged loans, either to ensure that their leveraged loan businesses are conducted in line with the 2013 Guidance or to shut them down.

[1] The agencies' Joint Press Release announcing the Additional Guidance is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20141107a.htm.

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"[B]anks must not heighten risk by originating and distributing poorly underwritten and low-quality loans. A poorly underwritten or low-quality loan that is pooled with other loans or is participated with other institutions can generate excessive risk to the financial system. The 2013 Guidance addresses the agencies' supervisory focus and risk management expectations for supervised financial institutions involved in leveraged lending activities. Institutions that participate in this lending activity without implementing strong risk management processes consistent with the guidance will be criticized by the appropriate agency. Underwriting standards for loans originated to hold, distribute, or purchased [sic] should be similar and consistent with board approved risk criteria and lending policies. *The 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.*"[2]

How did we get here? And where are we?

The SNC Program was jointly established in 1977 by the agencies to provide an efficient and consistent review and classification system for large syndicated loans by financial institutions supervised by the agencies. The SNC review provides a qualitative assessment of those institutions' syndicated loans and promotes consistency among loan origination standards irrespective of how the originator is chartered or by whom it is supervised. The SNC review is conducted annually; however, the SNC Leveraged Loan Supplement states that, because of the agencies' findings, "supervisors will increase the frequency of their reviews around this business line to ensure risks are well understood and well controlled."

The agencies issued the 2013 Guidance on leveraged lending on March 21, 2013. In the final release, the agencies stated that it "is not a rulemaking action,"[3] but rather a set of standards that institutions should use to assess their risk management frameworks for leveraged lending. "A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices."[4]

As low-interest rates (encouraged in significant measure by the Federal Reserve's bond-buying program) and highly liquid loan market conditions prevailing in recent years have contributed to a competitive environment among originators of leveraged loans – evidenced by "covenant lite" terms, flexible capital structures and historically higher

[2] *SNC Leveraged Loan Supplement* at 7 (emphasis added).

[3] 78 Fed. Reg. 17,766, 17,770 (March 22, 2013).

[4] *Id.* At 17,771.

leverage – regulators have become increasingly focused on compliance with the 2013 Guidance. A series of public announcements and confidential supervisory criticism of institutions' origination standards, widely covered in the press, have made the 2013 Guidance a leading topic on the agenda in deal committees, industry conferences and board rooms. Sharpening the tone of the discussion, institutions subject to the 2013 Guidance have wryly observed that as they have pulled back from the origination of market deals, many have been done by unregulated funds and other institutions to which the 2013 Guidance does not apply.[5]

2014 SNC Leveraged Loan Supplement

The SNC Leveraged Loan Supplement states that the 2014 Review found "serious deficiencies" in underwriting standards and risk management of leveraged loans. Thirty-one percent of the leveraged loans originated since the 2013 review (of approximately $623 billion in commitments reviewed) are cited as weak, because of high leverage, an absence of financial maintenance covenants, "nominal" equity and minimal de-leveraging capacity, among other factors cited. The agencies criticize covenant deterioration in particular, including the use of net debt in leverage covenants and features that permit debt to be increased above opening leverage , as well as provisions that permit dilution of senior secured positions. The 2014 Review also identified risk management flaws, including inadequate support for enterprise valuations, general weakness in credit analysis and overreliance on sponsors' projections.

The agencies acknowledge the importance of leveraged lending for the US and global economies, and that the US banking system plays a key role in making credit available by syndicating credit to investors. However, the SNC Leveraged Loan Supplement warns repeatedly that "banks must not heighten risk by originating and distributing poorly underwritten and low-quality loans."

Given the supervisory concern the agencies note with leveraged lending, they announce in the SNC Leveraged Loan Supplement that they expect that all firms with leveraged loan exposure will:

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

[5] The Guidance applies to all Federal Reserve-supervised, FDIC-supervised or OCC-supervised financial institutions, including insured depository institutions, financial holding companies, bank holding companies and their non-bank subsidiaries, and the US branches and agencies of foreign banks that are "substantially engaged in leveraged lending activities." For purposes of the Guidance, "Financial institutions" means national banks, federal savings associations, and Federal branches and agencies supervised by OCC; state member banks, bank holding companies, savings and loan holding companies and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor, including such institutions' non-banking subsidiaries. The Guidance does not apply to unregulated entities like hedge funds, private equity sponsors and their affiliates, mezzanine funds and unregulated commercial lenders, nor to entities that are regulated but not by the agencies, like independent broker dealers and foreign financial institutions operating in the United States other than through a branch, agency or banking subsidary. *See* 78 Fed. Reg. 17,767 at FN 2.

The 2013 Guidance stated that poor underwriting could be unsafe and unsound regardless of whether a loan is fully distributed or held on the books of the originating institution. Going beyond the "pipeline risk" of a large unsyndicated commitment, the agencies cautioned institutions in the 2013 Guidance to be wary even of fully distributed loans that are poorly underwritten, because they "may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." The SNC Leveraged Loan Supplement reemphasizes this point: "the origination of leveraged transactions, whether for investment or distribution, should have a sound business premise, an appropriate capital structure, and reasonable cash flows that support the borrower's ability to repay and to de-lever to a sustainable level over a reasonable period."

FAQs

Simultaneously with release of the SNC Leveraged Loan Supplement, the agencies released answers to 26 "frequently asked questions" relating to the 2013 Guidance. The FAQs are briefly considered below.

Applicability of the 2013 Guidance (FAQ Nos. 1-4, 15, 16 and 19-24)

The 2013 Guidance required institutions to maintain a definition of leveraged lending that is "sufficiently detailed to ensure consistent application across all business lines." The agencies identified four common characteristics of a leveraged loan:

- it is used for buyouts, acquisitions or capital distributions,
- it may involve a borrower whose Total Debt-to-EBITDA ratio or Senior Debt-to-EBITDA Ratio exceeds 4:1 or 3:1, respectively, or other defined levels as appropriate to the industry or sector,
- the borrower is recognized in the market as highly leveraged, characterized by its debt-to-net-worth ratio, and
- the borrower's post-financing leverage exceeds industry norms or historical levels based on debt ratios or industry standards.

Several of the FAQs probe the applicability of the 2013 Guidance in certain situations or to certain types of financings.

Question 1 asks how institutions should consider the above characteristics when defining leveraged loans. The agencies caution that such characteristics are a "starting point" for developing an institution-specific definition of leveraged loans. At a minimum, such a definition should include borrower characteristics recognized in the debt markets as leveraged for each industry in which the institution lends.

Question 2 asks whether the above characteristics could be used to fashion a safe harbor exclusion, i.e., if a loan does not satisfy one of the above characteristics can it definitively be excluded as a leveraged loan? The agencies' answer is no. An institution's management should establish underwriting and risk management processes covering a range of credits, and excluding loans from the definition because it does not satisfy a purpose test would be inconsistent with a comprehensive risk management framework.

Question 3 approaches the same issue from the opposite direction, asking if any one characteristic (e.g., exceeding 3x senior debt or 4x total debt) automatically results in the applicable loan being treated as a leveraged loan. The agencies answer in the negative, stating that while leverage is an "important indicator," it should be considered in relation to other loan characteristics. For instance, some loans secured by tangible collateral such as A/R, inventory, PP&E or real estate might exceed 3x senior debt or 4x total debt without necessarily meeting an institution's definition of a leveraged loan. As a result, the agencies "would not expect most loans secured by commercial real estate and small business loans to be

included in an institution's definition of a leveraged loan." Significantly, in responding to Question 3, the agencies observe that "Examiners will criticize situations in which EBITDA is defined in loan documents in ways that allow enhancements to EBITDA without reasonable support."[6]

Question 4 asks how institutions should determine if they may exclude ABL facilities from their definition of leveraged loans. The agencies answer that ABL facilities must be the "dominant source" of funding for a borrower to be excluded. If an ABL is part of a "larger debt structure," it should not be excluded from the definition (even if it is the only tranche of such structure that an institution holds) and captured within the institution's leveraged lending risk management framework. Similarly, loans referred to as ABLs that lack other indicia of asset-based lending, including borrowing base advances, field audits, enhanced reporting and similar monitoring should be captured within an institution's leveraged lending and risk management framework.

Question 15 asks if assets held on an institution's trading book are subject to the 2013 Guidance. The answer is yes, because institutions are expected to be able to identify and aggregate their exposure to a leveraged borrower, regardless of the loan's accounting classification.

Question 16 asks if an institution can trade in loans that would not receive a pass rating in a SNC review. The answer is that institutions are permitted to trade in preexisting non-pass leveraged loans (subject to their applicable rules and guidance governing investments and securities), because such activity does not constitute origination or refinancing subject to the 2013 Guidance. On the other hand, leveraged loans acquired by an institution for the available-for-sale or held-to-maturity portfolios are subject to the 2013 Guidance.

Inquiring as to the applicability of the 2013 Guidance from the perspective of the originator rather than the borrower or loan type, Question 19 asks if so-called "best efforts"[7] transactions fall within the scope of the 2013 Guidance. The agencies confirm that the origination and distribution of all leveraged loans are covered by the 2013 Guidance, whether or not fully committed.

Question 20 asks if lenders outside of the largest underwriters are held to the same standards for leveraged lending. The answer is yes. Question 21 asks if the 2013 Guidance applies to the lending activities of nonbank subsidiaries of regulated institutions. It does.

Question 22 asks about leveraged lending activities outside of the United States. The agencies answer that, for US banking organizations, the 2013 Guidance applies on an enterprise-wide basis, irrespective of where a loan is booked. For foreign institutions with a US charter, the 2013 Guidance applies to leveraged loans that are both originated and distributed in the United States. The agencies remark in connection with this question that they will "closely scrutinize attempts to bypass supervisory expectations."

Question 23 asks if the 2013 Guidance must be applied the same for loans originated to hold versus loans originated for distribution. Consistent with the position taken in the 2013 Guidance itself and in the SNC Leveraged Loan Supplement,

[6] This point is also reflected in the SNC Leveraged Loan Supplement at 5-6. "[E]xaminers noted an overreliance on borrower/sponsor base case projections when evaluating borrower performance. For some credits, [EBITDA] calculations … included difficult-to-support adjustments, such as unrealized cost savings from mergers and acquisitions."

[7] A misnomer. In the United States, virtually all lead arrangers of uncommitted financing agree to use "commercially reasonable efforts" rather than "best efforts."

the agencies confirm that an institution's board-approved leveraged lending policies and underwriting standards should apply to all leveraged lending activity, whether intended for distribution or to be held on the books of the institution. The entire transaction "should reflect a sound business premise and borrower capital structure, consistent with the intent of the guidance."

Question 24 asks how the 2013 Guidance applies to indirect exposure to leveraged loans, such as investments in CLOs and direct loans to BDCs. In addition to reciting that the 2013 Guidance applies to the origination of the underlying loans themselves, the agencies break such exposure into three categories. First, for indirect exposure that is part of an institution's distribution channels, i.e., where an institution markets its own loans through a BDC or funds a CLO through a warehouse line and the CLO markets the institution's own loans, the 2013 Guidance applies. Second, for indirect exposure arising solely from an investment, e.g., in a CLO, the 2013 Guidance does not apply. Rather, the institution should look to existing regulations and guidance for investing in securities. Finally, where an institution provides funding to a CLO or BDC that itself holds leveraged loans, the institution should treat such funding as a leveraged loan.

Origination of Loans that Receive a Non-Pass Risk Rating (FAQ Nos. 5-14, 17 and 18)

Question 5 asks how the agencies have viewed institutions that originate[8] loans with a non-pass risk rating.[9] Read together with the SNC Leveraged Loan Supplement, the answer is that the agencies view leveraged loans originated with a non-pass risk rating as inconsistent with safe and sound lending standards. They expect financial institutions to put in place underwriting standards to "prevent" the origination of such loans, unless the origination is part of a refinancing pursuant to a risk mitigation strategy intended to improve an existing non-pass loan.

Inquiring as to leveraged loans that are downgraded to a non-pass rating after the inception date, Question 8 asks whether this results in an origination that is inconsistent with the intent of the 2013 Guidance to originate loans in a safe and sound manner. While the agencies acknowledge that changing conditions may warrant a change in a loan's risk over time, they emphasize that they expect institutions to work with their borrowers to restore such transactions to a pass rating. Citing prevalent weaknesses in underwriting in leveraged lending over the last year in the SNC Leveraged Loan Supplement, the agencies caution that if a downgrade occurs within a short period after origination (typically, six months), the agencies expect institutions to re-evaluate their decision-making and risk-rating processes.

Questions 9 and 10 address the refinancing, modification or renewal of loans with special mention risk ratings. The agencies assure that they have no intent of precluding lenders from refinancing, modifying or renewing an existing credit facility, or discouraging institutions from providing financing to borrowers engaged in workout negotiations. However, their answers, together with the SNC Leveraged Loan Supplement, clarifies that they expect lenders to demonstrate, and be able to clearly document, that they are actively pursuing and executing meaningful improvements in structure or

[8] What constitutes "origination" is the subject of Question 6, and who is an "originator" is the subject of Question 7. "Origination" means any new extension of credit, refinancing or modification of an existing loan, or renewal of a matured or maturity loan (whereas a "refinancing" or "modification" means any type of restructuring or change to an existing unmatured loan). "Originator" for purposes of supervisory expectations under the 2013 Guidance is any institution that arranges, underwrites, or distributes a leveraged loan. On the other hand, any institution that only purchases participations in leveraged loans in the secondary market is not considered to be an "originator," but is nevertheless expected to have practices consistent with the 2013 Guidance with respect to participations purchased.

[9] The SNC review process ranks non-pass leveraged loans as loss, doubtful, substandard, or special mention. *See SNC Program 2014 Review* at 3, available at: http://www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-153a.pdf.

controls during the refinancing of a non-pass borrower. Such improvements can include, among other things, new or stricter covenants, equity injections, or the addition of collateral. Generally, lowering the pricing structure or interest rate, or extending maturity, are not on their own deemed effective means of mitigating the agencies' credit-related concerns. Additionally, the agencies caution that a refinancing, modification or renewal of a special mention loan that involves the extension of additional funds to the borrower is considered a new origination, and therefore comes with a duty on the lender to clearly show how the extension of new funds mitigates existing risks in order to avoid a non-pass risk rating.

Question 11 asks whether "covenant-lite" leveraged loans are automatically assigned a non-pass risk rating. The short answer is no.

The agencies respond that the designation of a loan as a "covenant-lite" does not automatically result in a non-pass rating, and that analysis of a loan under the risk-rating system evaluates a range of factors, including repayment capacity, structure of the debt, and covenants. The centerpiece of the 2013 Guidance was the requirement that each institution's underwriting standards should consider, at a minimum, the following factors:

- whether there is a sound business premise for each transaction, and whether the borrower's capital structure is sustainable without regard to whether the transaction is underwritten for the institution's portfolio with the intent to distribute,
- the borrower's ability to repay the debt, with the most realistic cash flow projections showing the ability to fully amortize senior secured debt or repay at least 50 percent of total debt over a five to seven year period,
- due diligence expectations, with collateral evaluation standards and clearly defined credit risk management roles in the diligence process,
- reliance on enterprise value and other intangible factors as a predicate for repayment assumptions,
- whether lender approval is required for material dilution or disposition of collateral or other cash-flow producing assets, and
- financial covenants and ongoing monitoring requirements, including debt-to-cash flow ratios, interest or fixed charge coverage ratios, reporting requirements and compliance monitoring. The agencies noted in the 2013 Guidance that a Total Debt-to-EBITDA ratio in excess of 6:1 "raises concerns for most industries."

Evaluation of a "covenant-lite" loan should take the same considerations into account. The agencies will assess potential weaknesses in one aspect of a transaction structure, such as covenants, maturity or repayment structure, together with the financial aspects of the borrower in determining the final risk rating, instead of automatically assigning a non-pass rating.

Question 12 asks whether, in a leveraged finance transaction with multiple loan tranches, all such tranches should be rated pass at inception. The answer is yes, as the main objective for financial institutions should be to develop underwriting standards that prevent the origination of new non-pass credit. Question 13 asks whether low ratio of debt-to-enterprise value offsets other underwriting weaknesses, such as weak cash flow or high balance sheet debt ratios. The answer, similar to the answer to Question 11, is that no one factor is decisive. Strong enterprise value alone is insufficient to offset other underwriting weaknesses in a given leveraged loan transaction.

Question 14 asks how classified loans (rated substandard, doubtful or loss) are considered in relation to the 2013 Guidance. The answer, like the answers to Questions 9 and 10 above, is that the 2013 Guidance is not intended to

discourage workouts, as long as lenders document their efforts to strengthen the credits as part of a loss-mitigation strategy. The agencies' review focuses on management's actions designed to strengthen a classified credit.

Question 17 inquires what the 2013 Guidance means when it states that a leverage level exceeding 6x EBITDA raises concerns for most industries. The agencies respond that, while no particular leverage level is viewed as a bright line when evaluating risk in a transaction, loans to borrowers that exceed this leverage level may "raise supervisory concerns" and receive additional scrutiny to assess the capital structure and the borrower's repayment ability. The agencies specifically note that management information systems are expected to include risk management reports that "stratify the leveraged-lending portfolio into meaningful segments based on risk."

The answer to Question 18 follows a similar approach. When asked whether a borrower's inability to fully amortize senior secured debt or to repay at least 50 percent of total debt over five to seven years automatically results in a non-pass rating, the agencies respond that they consider all aspects of credit risk when they evaluate the risk rating of a loan, and will not automatically assign a non-pass rating in these cases, but rather weigh the weaknesses of the transactions against compensating means of financial support the borrower may possess. Considerations such as quality and accessibility of liquid assets, demonstrated guarantor or sponsor support, strength and stability of cash flow sources and the borrower's ability to curtail discretionary expenses or dividends without negatively affecting business operations and growth prospects are some factors that may support a pass rating.

Monitoring of Compliance with the 2013 Guidance

Question 25 asks how an institution's implementation of the 2013 Guidance is assessed and monitored. The agencies respond that examiners will (1) assess policies, procedures, limit structures, management information systems, and other risk management processes related to leveraged lending activities, and (2) conduct transaction testing of leveraged loan transactions. Supervisory reviews usually occur during the SNC examination, as part of other targeted supervisory examinations of leveraged lending activities, and through continuous monitoring by the agencies. The agencies reserve the right to evaluate the underwriting standards financial institutions have put in place during the SNC examinations.

In Question 26, the agencies establish that the 2013 Guidance does not contain the same requirements for financial institutions as the FDIC deposit insurance assessment rules, in particular with respect to the definitions. The agencies caution that compliance with the 2013 Guidance and the deposit insurance rules is assessed separately.

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