Bloomberg Law

Insights

INSIGHT: Banks Could Remain Cautiously Optimistic After Leverage Guidance Clarification

Posted Nov. 28, 2018, 11:30 AM
By Ronan Wicks

On September 11, 2018, the Federal Reserve Board (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of the Controller of the Currency (OCC) and the Bureau of Consumer Financial Protection issued a joint statement clarifying the role of supervisory guidance generally (the Joint Statement). The Joint Statement may have been issued in part as a response to the Government Accountability Office's October 2017 determination that the 2013 Interagency Guidance on Leveraged Lending (the Guidance) is a rule rather than guidance.

Although the Federal Reserve, OCC and FDIC have clarified in the past that the Guidance should not be viewed as establishing bright-line rules or tests, banks have been criticized, both formally and informally, for lending to borrowers that could not meet its leverage and amortization parameters. The Joint Statement and recent announcements by agency heads have some commentators suggesting, perhaps prematurely, that we can expect an end to this practice. As a result, some market observers worry that the banking industry is headed back towards to an era of irrational exuberance. Evidence could instead suggest that regulators have not significantly changed their approach to monitoring and reviewing the leveraged lending activities of regulated financial institutions.

Introduction of the 2013 Leveraged Lending Guidance

The Guidance defined "leveraged lending" based on a multi-factor test, with the most important factor being whether a borrower's total debt to earnings before interest, tax, depreciation and amortization (EBITDA) or Senior Debt to EBITDA exceed 4x or 3x, respectively. Through the Guidance, regulators sought to limit leveraged lending activities they deemed too risky. This included loans to borrowers with leverage of 6x total debt to EBITDA, which they viewed as raising "concerns for most industries", and loans to borrowers that lacked the ability to fully amortize their senior secured debt or to repay at least 50% of their total debt over a five-to-seven year period. As stated in a Federal Reserve Staff Report published in May 2017, the goal was "to ensure that federally regulated financial institutions conduct leveraged lending activities in a safe and sound manner so that these activities do not heighten risk in the banking system or the broader financial system." The Fed, OCC and FDIC viewed issuance and enforcement of the Guidance as within the scope of powers granted to them by the Code of Federal Regulations to ensure the macro-prudential safety and soundness of the banking industry.

Following the introduction of the 2013 Guidance, many, but not all banks shied away from highly-levered transactions. Those that did worried about receiving scrutiny from regulators. Some banks that continued to participate in highly levered loans deemed problematic by regulators were sent "matters requiring attention" (MRAs) and "matters requiring immediate attention" (MRIAs). MRAs and MRIAs require a bank to correct a deficiency identified by regulators. MRIAs are issued for more serious violations that banks must attend to immediately. These enforcement actions, together with a lack of clear rules or metrics, may have had a chilling effect on the market. Staffers at the Federal Reserve note that "even for regulated entities, the guidance was complicated and potentially subject to different interpretations".

Nevertheless, a number of highly leveraged deals still made it to the finish line during the post-Guidance period. Among them was the $8.7 billion leveraged buyout of PetSmart which represented, based on some metrics, a 9.1x multiple of the specialty pet retailer's adjusted EBITDA. That deal closed in March 2015.

Shifting Market Shares

Although most leveraged lending is still done by banks, nonbanks have increased their market share since the Guidance was issued. Prior to the Guidance, nonbank entities extended 7.4% of the number of leveraged loans extended by banks. As of May 2017, this number had risen to 10.4%. The volume of nonbank leveraged loans increased from 4.3% to 8.3% during this same period.

Nonbanks have now carved out a niche for themselves in middle-market private equity-backed buyouts. According to data from PitchBook, the top five lenders to private equity-backed middle market companies in the first quarter of 2018 were all nonbanks: Antares Capital, NXT Capital, Madison Capital Funding, NewStar Financial and Twin Brook Capital Partners.

This increased market share cannot be attributed solely to the restrictions placed on banks by the Guidance. Irrespective of the Guidance, nonbanks have a number of competitive advantages over banks that could have spurred this growth. Nonbanks, by virtue of their organizational structure, can be more flexible on terms and have greater risk appetite. Borrowers are able to obtain funds more quickly from them, with lighter conditionality and no market flex.

Pendulum Swings Back in Banks' Favor…but Not Fully

President Trump's appointees to the Federal Reserve and OCC have signaled a more relaxed approach to enforcing the Guidance. Chairman Jerome Powell has stated that the Guidance is nonbinding, and examiners are being advised to treat is as such. On February 27, 2018, Comptroller of the OCC Joseph Otting stated that “as long as banks have the capital, I am supportive of banks doing leveraged lending. When the guidance came out — it was like people were afraid to jump over the line without feeling the wrath of Khan from the regulators. But you [the banks] have the right to do what you want as long as it does not impair safety and soundness. It is not our position to challenge that.” In the same speech, Otting predicted that leverage ratios were likely to increase over the following 12-18 months. His prediction has materialized.

According to S&P’s Leveraged Commentary & Data, the share of U.S. leveraged buyouts (LBOs) levered at 6.0x or higher reached its highest point since the financial crisis this year. Loan Pricing Corporation data shows that in the first nine months of 2018, 73.1% of private equity LBOs exceeded 6.0x total leverage, up from 64.2% in 2017.

Despite recent developments, regulators can be expected to keep a watchful eye on banks’ leveraged lending activities. Career regulators remain in place, and regulations that existed prior to the issuance of the Guidance endure. The Bank of England issued a warning in October over the rapid growth of highly-leveraged lending, even drawing parallels to the boom in U.S. subprime mortgages prior to the 2008 financial crisis.

Some suggest that banks may now feel more comfortable originating leveraged loans that exceed the parameters set in the Guidance, but the following quote from the September Joint Statement should give them at least some pause – “in some situations, examiners may reference (including in writing) supervisory guidance to provide examples of safe and sound conduct, appropriate consumer protection and risk management practices, and other actions for addressing compliance with laws or regulations.”

Notwithstanding recent clarifications in publications and speeches, confusion may persist. Comptroller Otting’s declarations of relaxation should be viewed in conjunction with messages from other regulators like Todd Vermilyea, a Senior Associate Director at the Fed who highlighted risk management concerns at an LSTA conference on October 24th, 2018. In his speech, Vermilyea noted that safety and soundness concerns may arise if there are no appropriate controls for risks posed by various contractual provisions such as covenant-lite loans, incremental facilities and EBITDA add-backs.

Even under the new administration, OCC’s own empirical data suggest that regulators continue to keep a close eye on banks, with the number of outstanding MRA concerns related to commercial credit underwriting increasing 24 percent from the first quarter of 2017 through the first quarter of 2018.

Ultimately, perhaps the more things change, the more they stay the same.

****

Ronan Wicks is the Global Bank Finance Practice Group Leader at Shearman & Sterling LLP. He focuses on advising financial institutions in connection with leveraged and investment grade acquisition financings, asset-based facilities, workouts, general financings and special situations, including in the middle market. Ronan has deep experience across various industries

and has advised on important transactions for a wide range of financial institutions, including Canada Pension Plan Investment Board, Citibank, Goldman Sachs, Barclays, GlobalFoundries, Bridgepoint and Morgan Stanley.

Arman Naraghi-Pour contributed to this article.