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CLIENT UPDATE

NEW BANKING GUIDANCE MAY IMPACT LEVERAGED LENDING

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Recently, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the "Agencies") issued the final version of their new supervisory Interagency Guidance on Leveraged Lending (the "Guidance")[1]. To the extent that the Guidance causes a tightening in underwriting policies at regulated banks, it could ultimately lead to a relatively smaller role in the leveraged finance market for loans by regulated banks and a larger role for less regulated products and providers, including private funds.

TO WHOM DOES THE GUIDANCE APPLY?

The Guidance is applicable to banks and other financial institutions that are regulated by the Agencies and engage in leveraged financing activities, and it is intended to update the Agencies' standards in light of the financial crisis and the many changes in the leveraged loan market in recent years. The Guidance replaces the Agencies' prior guidance in this area, which had been issued in 2001, and is the final version of proposed guidance first released a year ago, having been revised in response to numerous comments submitted by industry participants.

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1 *See* 78 Federal Register 17766 (2013).

While obviously relevant for banking institutions (which will need to review and update their risk management policies, underwriting standards established in the Guidance), the Guidance also is likely to have broader implications for the leveraged lending market, and for financial sponsors and their portfolio companies, which should note a few elements of the Guidance in particular.

WHAT DOES THE GUIDANCE REQUIRE?

Notably, the Guidance requires lenders to consider a borrower's de-leveraging capacity as part of the lender's risk rating analysis, including whether the borrower has the ability to fully amortize its senior secured debt, or repay a significant portion (e.g., 50%) of its total debt, over the medium term (i.e., 5-7 years) using free cash flow. The Guidance also indicates an acceptable leverage level of 6x total debt to EBITDA, saying that a higher level "raises concerns" for borrowers in "most industries." Loans that do not meet these criteria would be subject to additional scrutiny and potential criticism by the applicable regulating Agency and, thus, lending banks are apt to treat these standards as bright line rules going forward.

In contrast to the Agencies' proposal, the Guidance clarifies that diligence and evaluation of financial sponsors is not mandated in all instances but only when sponsors provide financial support for a transaction. In this regard, the Guidance requires lending banks to analyze and monitor the financial condition and historical performance of financial sponsors in transactions where the sponsor provides a guarantee of a leveraged loan that is relied on as a secondary source of payment.

CONCLUSION

The Guidance has a compliance date of May 21, 2013, although banking industry participants are seeking more time to make the necessary changes to internal processes, such as revising credit and underwriting standards. While the full implications of the Guidance and the resulting changes that will be made by regulated lending banks in response remain to be seen, it is possible that the Guidance could lead to an increased role in the leveraged lending market for unregulated (or less regulated) providers of financing, such as private funds, as well as for less regulated financing products, such as high yield bonds. Such providers and products may become a relatively more attractive alternative to bank-provided leveraged loans in future leveraged financing transactions, both in new transactions, and in refinancings of existing transactions, particularly those existing transactions that do not meet the financial criteria outlined in the Guidance.

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Please do not hesitate to contact us with any questions.

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