Client update
Regulators Clarify Leveraged Lending Guidance

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As we discussed in our April 2013 Client Alert, in the spring of 2013, the U.S. 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 supervisory Interagency Guidance on Leveraged Lending (the "Guidance").[1] The Guidance applies to banks and other financial institutions that are regulated by the Agencies and engage in leveraged financing activities. The Agencies expressed their view in the Guidance that "the origination of leveraged finance 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."

The imprecise nature of the Guidance created some uncertainty in the leveraged lending market as different market players came to different working understandings of its meaning and implications. Some market participants perceived differing interpretation and application of the Guidance by the Federal Reserve Board and the Office of the Comptroller of the Currency, which supervise different segments of the market. Market participants have expressed concern that any differing regulatory oversight could lead to an uneven competitive landscape in the leveraged lending market.

The Agencies clearly intend to address some of this uncertainty in their annual Shared National Credits review (the "SNC Review") and Frequently Asked Questions for Implementing March 2013 Interagency Guidance on Leveraged Lending (the "FAQ"), which were released jointly by the Agencies last week. The Agencies also clearly intend to use the SNC Review to convey their displeasure with the progress that regulated institutions have made thus far in adopting and implementing the Guidance and to capture the attention of these institutions and trigger further meaningful change in the "safety and soundness

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

of bank underwriting and risk management practices relative to the expectations articulated" in the Guidance.

We outline below some of the most significant findings and clarifications in the SNC Review and the FAQ. The Guidance now appears even more likely than when it was originally issued to cause a tightening in underwriting policies at regulated institutions. As we anticipated in our April 2013 Client Alert, such a development may well ultimately lead to a relatively smaller role in the leveraged finance market for loans arranged by regulated institutions (such as both US and non-US banks) and a larger role for less regulated providers and products. We have already seen this trend in the market to some extent, and we would expect this trend to continue and potentially to accelerate.

GENERAL FINDINGS

The Agencies found that the credit quality of syndicated loans remained broadly unchanged from last year's review, noting that 33.2% of leveraged loans were "criticized" by the Agencies, notwithstanding the issuance of the Guidance. Further, the Agencies found "serious deficiencies in underwriting standards and risk management of leveraged loans" and "an increased frequency of weak underwriting during the past year."

The Agencies emphasize the seriousness with which they wish market participants to take the Guidance by stating that they "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," and that, as a result of the findings, "supervisors will increase the frequency of reviews around this business line to ensure risks are well understood and well controlled." This language is clearly intended to signal to regulated institutions that the Agencies will be watching the leveraged loan market closely and that failure to comply with the Guidance will have meaningful consequences.

The SNC Review also provides additional clarity as to the Agencies' views of some specific market developments and some of the likely implications of the Guidance.

REFINANCINGS

One significant question that we and other market participants have raised focused on how the Agencies would apply the Guidance to refinancings of existing credits that do not meet the Guidance ("Non-Pass Credits"). The SNC Review makes clear that the Agencies will indeed be reviewing refinanced credits in light of the Guidance. While the Agencies note that the Guidance was not

intended to discourage institutions from providing financing to Non-Pass Credits engaged in refinancings, they also stated that they expect to see refinanced credits strengthened. Mere reductions in interest rate, extensions of maturity or decreases in bank exposure will not suffice. Rather the Agencies will expect to see evidence of "meaningful improvements in structure or controls," which could include the addition of new covenants or the tightening of existing covenants, additional equity injections, line reductions, increased amortization, addition of collateral or restrictions on new acquisitions or issuance of additional debt.

Non-Pass Credits seeking to refinance debt in transactions arranged by regulated institutions thus might have to accept tighter terms, including financial covenants, even if the market would not otherwise require them. This constraint (among other elements of the Guidance) may result in more refinancing business going to unregulated arrangers and high yield bond underwriters.

LEVERAGE AND DEBT AMORTIZATION METRICS

As highlighted in our April 2013 Client Alert, the Guidance requires that a lender 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."

In the SNC Review and FAQ, the Agencies have now made clear that neither of these metrics is a bright line test, but that any credit not meeting one or both of these metrics will receive increased scrutiny.

FINANCIAL PROJECTIONS

The Agencies remain very focused on the projections supporting the debt amortization metric. The SNC Review highlighted a perceived overreliance by regulated institutions on borrower/sponsor projections, the use of overly optimistic growth rates and the inclusion in EBITDA calculations of "difficult-to-support adjustments, such as unrealized cost savings from mergers and acquisitions." The Agencies also noted the use of unrealistic stress scenarios and a lack of documentation around stress testing. The Agencies emphasized that all regulated institutions should evaluate transactions in the context of internally generated base case scenarios that are stressed to sufficiently measure borrower sensitivities to economic downturns, and to more fully document these

processes and the related assumptions and models.

This increased focus on projections and the need for documented internal models may place pressure on base case models presented by sponsors and other leveraged borrowers. In addition, as a matter of process, it may be advisable in some circumstances to involve lenders and arrangers and provide a financial model to them earlier in the deal process, to give them time to do their own modeling and stress testing.

COVENANTS AND OTHER TERMS

The Agencies gave additional focus to the specific terms of leveraged loans that the Agencies might consider in rating such loans, noting in particular some of the more borrower-favorable features that have become increasingly common in the market in recent years. The Agencies identified a number of "weak characteristics," evidencing the deterioration of covenant protection: the presence of equity cures, "the reduced number of financial maintenance covenants, the use of net debt in leverage covenants, excessive headroom, springing features, and various accordion features that allow increased debt above starting leverage and the dilution of senior secured positions."

Terms such as these, and perhaps covenant-lite structures more generally, accordingly may receive more attention from arrangers in future financings with high leverage multiples or inconclusive evidence of de-leveraging capacity.

ASSET-BASED LOANS

While the Agencies state that all loans in a financing structure with multiple tranches should be compliant with the Guidance, they also note that an asset-based loan ("ABL") in a structure in which that loan is the dominant source of funding for a borrower could be excluded from the Guidance's requirements in many circumstances. This statement may leave open the possibility that a capital structure using an ABL revolver in combination with an unregulated financing product such as high yield bonds, whether secured or unsecured, would not have to comply with the Guidance. We expect that this and other questions about the implications of the Guidance for differing capital structures will be a major focus of analysis in the future.

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Please do not hesitate to contact us if you have any questions.