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Altering The Leveraged Lending Landscape

Law360, New York (April 16, 2012, 4:10 PM ET) -- On March 26, 2012, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System jointly proposed comprehensive policy guidance on leveraged lending (the "proposed guidance"), applicable to all financial institutions supervised by the agencies.

If adopted, the proposed guidance would replace the current guidance originally issued in 2001. The agencies seek to curb certain practices, many of which developed during the period of substantial growth in the leveraged lending market after 2001, that they consider unsafe and unsound due to financial institutions' failure to implement effective risk management controls addressing the increasing exposures from leveraged lending.

To realign regulatory policy with the increased risk exposure to leveraged lending, the proposed guidance requires financial institutions to develop and adopt a considerable number of policies and guidelines.

Generally, financial institutions must (1) perform regular stress testing to assess potential risk exposure in adverse economic environments, (2) adopt policies and procedures to ensure effective management oversight, clear lines of reporting and credit authority, (3) implement and adhere to clear, written underwriting and credit standards (which will restrict certain types of lending that has become widespread), (4) streamline the flow of information across the financial institution's different areas to support sound risk management decision-making and pipeline management and (5) perform loan-level analyses with more granularity, frequency and detail to improve the financial institution's understanding of real-time risk exposures.

The impact on individual financial institutions resulting from the implementation of the proposed guidance will largely depend on the size, scope and effectiveness of a financial institution's leveraged lending activities and on its existing risk management framework.

A financial institution with significant leveraged finance activities should assess all aspects of its existing risk management platform to identify where it would not satisfy the agencies' minimum supervisory expectations set forth in the proposed guidance. If the need for corrective action is limited, the overall impact will be minimal since most issues can be easily resolved.

Financial institutions that deviate from the proposed guidance by engaging in specifically prohibited practices or rely on substantially deficient policies, procedures, written standards or risk controls, could face a substantially larger burden. A coordinated response from all levels of the institution may be required to reorganize or scale back certain business lines, to develop and implement underwriting criteria, credit standards and other policies and procedures that comply with the proposed guidance, establish new lines of reporting and credit authorities for effective senior management and/or board oversight, and design effective management information systems.

If adopted as proposed, the proposed guidance could impact the underlying business of financial institutions and potential borrowers. Financial institutions may be restricted from underwriting loans which typically pay higher interest rates, specifically “covenant-lite loans” or loans having creative or unique capital structures.

By effectively limiting banks to safer, lower yield loans, the proposed guidance could put banks with already weak net interest margins under additional pressure, especially in the current interest rate environment. The impact on potential borrowers will depend on their creditworthiness, risk profile and deal structure. Borrowers with attractive credit profiles may benefit from the effects of the proposed guidance on the leveraged lending market. As financial institutions shift toward safer, low yield loans and competition for lower-risk borrowers increases, those borrowers may be able to use the new competitive landscape as leverage to extract even lower rates from financial institutions.

Certain transactions where the lending decision is less easily supported applying traditional underwriting metrics may be most negatively affected by the proposed guidance. In their effort to require financial institutions to have a better handle on identification and management of their exposure to risk, the agencies target the types of borrowers they believe pose significant risk to financial institutions by curtailing the kinds of leveraged loans developed to make credit available to those borrowers.

The proposed guidance is specifically intended to restrict practices where financial institutions retain limited or no ability to evaluate and manage ongoing credit risk, approve loans with questionable repayment prospects, underwrite loans without clear, consistent or well-defined underwriting standards and maintain weak management oversight and ineffective management information systems.

To limit the disfavored practices, financial institutions would be forced to implement policies, including written underwriting guidelines, requiring them to avoid loans that (i) lack covenant protections requiring the borrower to maintain certain financial standards and provide financial reports, known as “covenant-lite loans,” (ii) allow leverage levels to exceed six times EBITDA for most industries and (iii) include features which limit financial institutions’ recourse, such as payment-in-kind toggles allowing the borrower to repay interest by issuing preferred stock or other forms of securities to the financial institution instead of paying cash.

Certain loans, including those in many private equity leveraged buyouts, have historically had significantly higher leverage and were unable to easily conform to loan agreements containing covenant protections and other traditional requirements. The conservative standards now proposed, particularly if expected to be adopted on a “one-size-fits-all” basis, may restrict financial institutions’ ability to underwrite loans using nontraditional structures, leaving those borrowers to seek financing from nonbank lenders or forcing them out of the market entirely.

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