CLIENT MEMORANDUM

Leveraged Lending Guidelines – 2013 to 2015 Impact

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AUTHORS

Michael I. Zinder | David Tarr | Christopher E. Giorgione

- The 2013 Leveraged Lending guidelines were intended to address growth of the leveraged market since 2001 as well as the 2008 credit crisis, but provided no clear specifics.
- Additional clarity and publicity around regulator action followed in late 2014/early 2015, though regulations still do not provide specific bright-line rules today.
- While ongoing impact of the late 2015/early 2016 market volatility remains to be seen, market share of the largest leveraged lenders has diminished between 2013 and 2015.

2013 – Initial Guidance

The Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Federal Deposit Insurance Company (the "FDIC" and, together with the OCC and the Federal Reserve, the "Regulators") promulgated the March 21, 2013 Interagency Guidance on Leveraged Lending (the "2013 Guidance") to address the growth of leveraged lending post-2001 (especially in the run-up to the 2008 credit crisis) and the general movement of documentation terms in favor of the borrower. In order to "assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner," the 2013 Guidance provided general

points that banks should consider for internal risk management frameworks around "leveraged loans," such as underwriting standards, valuation standards, reporting and analytic practices and other similar items.

The Regulators did not provide a hard and fast definition for a "leveraged loan" in the 2013 Guidance, instead allowing each institution to set its own definition, but noted common characteristics seen in the market. Those characteristics included:

- **Use of Proceeds:** Proceeds used for buyouts, acquisitions or capital distributions.
- **Financial Metrics:** Total Debt to EBITDA in excess of 4:1 or Senior Debt to EBITDA in excess of 3:1 (calculated absent any cash netting), or other defined levels appropriate to the applicable industry or sector.
- **Borrower:** Borrower is recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- **Industry Comparisons:** On a pro forma basis, post-closing leverage significantly exceeds industry norms or historical levels.

Lacking an actual definition of the types of loans subject to oversight, and providing no clear answer as to what that oversight was, the 2013 Guidance did not create the clearest regulatory environment.

2014 – Adding Clarity

In November 2014, in an attempt to add substance to the 2013 Guidance, the Regulators issued a further supplemental report. The report was based off of the Shared National Credit's (the "SNC") annual review and highlighted certain "serious deficiencies in underwriting standards" in the leveraged lending market. The review found that the volume of criticized assets remained at approximately double pre-crisis levels, and that many banks were not in compliance with the 2013 Guidance in areas such as borrower repayment capacity, lack of adequate support for enterprise valuations and overreliance on sponsor's projections.

The SNC report was accompanied by a statement of Frequently Asked Questions addressing specific questions around interpretation and implementation of the 2013 Guidance. Of particular significance, the agencies provided additional guidance on questions relating to leverage, borrower repayment capacity and covenant structures:

- **Excessive Leverage:** Examiners consider all underwriting factors (including expected future cash flows) when reviewing credits and "excessive levels of leverage" raise supervisory concerns.
- **Repayment Capacity:** Inability to fully amortize senior secured debt or to repay at least 50% of total debt over five to seven years would not automatically result in a non-pass rating; consideration is given for other financial

support such as quality liquid assets, guarantees (including from sponsors), stable cash flows and growth prospects.

- **Covenants:** Covenant-lite structures are still permitted; Regulators can approve loans with few or weak covenant structures so long as other mitigating factors exist to improve the credit quality.

Roughly concurrent with the release of the November 2014 supplemental guidance, news reports indicated that the Regulators had summoned a number of the leading leveraged lenders to New York for a meeting discussing the state of leveraged guidance. Banks were told at the meeting that the Regulators expected tighter compliance with the 2013 Guidance as updated, and that the Regulators would be willing to use various tools at their disposal, including monetary penalties and cease-and-desist orders, to bring non-compliant banks in line.

2015 – "Red Flag" Clarity and Measuring Impact

While the supplemental guidance of 2014 and the accompanying news reports of bank meetings indicated that the Regulators were increasing their focus, uncertainty still existed around the precise limits of Regulator concern. Further attempts at clarity were made by the Regulators in the form of a widely attended and reported-upon conference call in February 2015. While not setting forth specific bright lines for what triggers an unfavorable review of a leveraged loan, Regulators touched upon several "red flags," including:

- Total Debt to EBITDA in excess of 6:1 – calculated including any incremental or "accordion" baskets that are likely to be drawn upon;
- "overly optimistic" cash flow projections used when modeling loan performance;
- "large percentage" EBITDA adjustments; and
- other EBITDA adjustments lacking third-party diligence, appropriate documentation or "credible justification."

The conference call also indicated that the Regulators would look unfavorably on loans if, based on past practice, a private equity sponsor backing an underlying borrower has a history of paying dividends to itself quickly after the buyout.

Followers of the leveraged market would be familiar with several high-profile news stories reported throughout 2015, describing the struggle of traditional banks to provide financing to private equity firms used to receiving higher leveraged multiples. While the current volatility in the finance markets started late in 2015, an analysis of the Thomson Reuters LPC U.S. Leveraged New Money Bookrunner year-end tables from 2013 through 2015 shows that the lower end of the table took the largest hit in terms of market share lost in 2014, while those highest on the table took a larger hit in 2015.

	Aggregate Market Share of Top 3 Lenders	Aggregate Market Share of Top 5 Lenders	Aggregate Market Share of Top 10 Lenders	Aggregate Market Share of Top 20 Lenders
2013 Year-End Table	33%	46%	71%	92%
2014 Year-End Table	32%	45%	67%	85%
2015 Year-End Table	28%	42%	67%	83%

The top 20 names listed in the league tables have largely remained the same, and many of the larger lending entities not subject to Regulator oversight have not seen significant movement in their overall share of the market or in their league table position; so this is not a case of an existing (unregulated) horse overtaking the lead in a race. Rather, this missing 9% of the market (translating in 2015 to around $45B of loans) that the top 20 no longer provide can potentially be traced to smaller and newer entities taking up the slack as more prominent lenders seek to avoid Regulator spotlights. Private equity debt funds, smaller direct investment vehicles, and newly formed business development companies are increasingly finding ways to take roles on financings of all sizes, not merely those that make the front page of business periodicals.

Thus, while the 2013 Guidance and subsequent supplements may still not contain the sort of bright-line distinctions that many would like, their impact on the largest leveraged lenders has become increasingly clear in the last three years. Borrowers are well-served to consider casting a wider net in seeking financing from less familiar lenders. Similarly, opportunities exist for well-positioned firms to create or develop new lending vehicles or structures to capitalize on the market share left behind by existing market participants seeking to downsize their current exposure, or otherwise not being in a position to meet the leverage hurdles requested by many of their customers.

If you have any questions regarding this memorandum, please contact Michael I. Zinder (212-728-8298; mzinder@willkie.com), David Tarr (212-728-8241; dtarr@willkie.com), Christopher E. Giorgione (212-728-8159; cgiorgione@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

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