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Leveraged Loan Scrutiny Brings Opportunities For Nonbanks

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The appetite of institutional investors for yield continues in the current low interest rate environment and has created renewed interest in increasing allocations to fixed-income portfolios, including additional allocations to private debt.[1] As a result of the heightened regulatory focus on banks and emphasis on enhanced underwriting standards for leveraged loans, investor interest has created an opportunity for nonbank institutions to provide investment opportunities to such institutional investors. Similarly, the gradual disintermediation of banking and exit from higher-risk areas of lending has created opportunities for various nonbank institutions to increase their market share in respect of highly leveraged loans.

Nonbank financial institutions such as Jefferies have increased their focus on leveraged loans.[2] Fund sponsors have sought to capitalize upon this opportunity through investments in private loans (either themselves making direct loans or acquiring existing loans of private companies). As of July 2015, $46 billion has been raised by funds investing in private debt, which is on track to surpass the 2014 total of $69 billion,[3] and senior loan structures have raised more than $32 billion in 2014 and $16 billion through August 2015.[4]

Background — Leveraged Lending Guidelines

As part of an ongoing effort to regulate financial institutions, the Office of Comptroller of the Currency, the Federal Deposit Insurance Corp. and the Board of Governors of the Federal Reserve have issued guidance to such financial institutions in respect of underwriting and risk management standards. The guidance has evolved since 2013[5] and has been aimed at achieving of a number of goals relating to systemic risk. These goals include:

(1) requiring institutions to create an internal definition of “leveraged lending” that is consistent across

business lines;

(2) more uniform credit and concentration policies with limits consistent with risks;

(3) well-defined underwriting standards that include a review of the capacity to de-lever;

(4) appropriately sound methodologies for determining “enterprise value”;

(5) sound practices for monitoring of exposures across business lines and pipeline management policies;

(6) setting guidelines for periodic stress testing;

(7) reliance on internal risk ratings; and

(8) criteria for evaluating financial sponsors (including willingness/ability to repay).

However, the guidance has not completely alleviated the need for additional clarity related to the lending practices of financial institutions.

In particular, the initial 2013 guidance, while applying to leveraged loans, did not itself define the criteria of what constitutes a “leveraged loan.” In theory, each institution would adopt an appropriate definition and criteria to define such loans consistently across its portfolio; however, the lack of specific criteria in the guidance led to significant uncertainty by institutions as to what types of loans would be subject to scrutiny. The guidance did specify certain “common characteristics” that the regulators regard as indicia of leveraged loans, which included: (1) purpose or use for buyouts, acquisitions or capital distributions; (2) total debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) ratios of greater than 4:1 (the total debt test) or senior debt to EBITDA ratios of greater than 3:1 (the senior debt test); (3) a high debt to net worth ratio; and (4) leverage permitted to exceed industry norms or historical levels.

In an effort to shed additional light on what would be considered leveraged loans subject to regulator scrutiny, the regulators issued supplemental guidance in November 2014 in the form of frequently asked questions. The FAQs noted that loans that are “identified as leveraged in the debt markets have all or many [such] characteristics” and that these common characteristics should only be used as a “starting point” by regulated institutions. The FAQs also clarified that having, or failing to have, some of the characteristics would not necessarily preclude a loan from being considered to be a leveraged loan.

For example, the regulators noted that a pure use of proceeds or purpose test would be inconsistent with developing a “comprehensive risk management framework” for leveraged loans. Moreover, loans secured by tangible collateral or real estate that do not rely upon enterprise valuations for repayment would not be considered leveraged loans. This would be true even if such loans would otherwise fail to meet the senior debt or total debt criteria on the basis that the lender may have additional sources of repayment other than cash flow.

One thing that was made clear by the supplemental guidance is that the regulators will levy particular scrutiny upon leveraged loans where the total debt test are in excess of 6:1. While the regulators acknowledged that this limit is not a “bright line,” it was made clear in a 2015 call hosted by the regulators[6] that ratios above that amount could be a “red flag.” Nonetheless, many leveraged buyout transactions have historically exceeded such levels and even as late as the fall of 2014, almost 50

percent of U.S. private equity deals had breached this threshold.[7] As the demand for such loans continued, the market was slow to react to the guidance. This changed in the fall of last year when Credit Suisse received a letter from the Federal Reserve requiring it to address its underwriting and sale of leveraged loans, raising concerns that the banks' adherence to the guidance had been too lax. This highly publicized letter captured the attention of the market, and banks have been increasingly concerned about the seriousness of regulators with respect to such guidelines.

Additionally, a number of banks were summoned to an in-person meeting in New York during November 2014 where the Fed and the OCC emphasized their stance on compliance with guidelines and the ability to criticize loans on such basis. The regulators raised the possibility that they could use cease-and-desist orders to force discontinuation of leveraged lending activities, which captured the market's attention.[8] This has naturally had a chilling effect, causing regulated lenders to become increasingly reluctant to participate in leveraged buyout and other similarly leveraged debt transactions. Moreover, there are a number of reports that banks have passed on financings for public buyouts due to the guidelines. In one highly publicized transaction, a leveraged buyout of PetSmart, it was reported that a number of well-known banks decided not to pursue the opportunity to arrange the financing of the transaction on the basis that the total debt test was in excess of 6:1.[9]

Loan Funds and Fundraising Activity

As a result of these regulatory concerns, opportunities have opened up for unregulated institutions to act as lead arranger for highly leveraged transactions that may also lack financial covenants or otherwise receive regulator criticism. As previously noted, institutions such as Jefferies have stepped in to fill the gap and have been noted in the press as aggressively pursuing highly levered loans, thereby replacing lenders such as Credit Suisse and Bank of America for add-on or refinancings of debt previously issued by such institutions that exceed the guideline ratios.[10]

While investment banks that are not subject to regulation by the Fed or the OCC have increased their participation in leveraged loans, private equity funds and their investors have also been staking out their claim on desirable returns from such products. Private equity fund investors, generally comprised of pension funds, insurance companies, foundations and endowments, have become concerned about the impact of potential rate increases on their fixed-income portfolios and, as a result, have sought to increase their interest in private debt just as lenders have become more cautious due to the regulatory requirements.[11] In particular, these private equity fund investors are attracted to the relatively high yields ranging from 10 to 12 percent,[12] and floating rates in reviewing their asset allocations, with such direct lending providing the benefit of a hedge against interest rate increases without the a diminution in investment value (as opposed to bond allocations).

Some pension funds have been so eager to enter this market that they have sought to purchase businesses that are already doing direct lending. For example, in June, it was announced that General Electric had agreed to sell its sponsor finance business as well as a $3 billion bank loan portfolio to the Canadian Pension Plan Investment Board.[13] The decision was viewed as part of GE's selloff of noncore businesses. Others argue, however, that this decision reflected the exit of another regulated lender from the commercial lending business due to regulatory concerns.[14]

As a response to these trends and investor desire, a number of fund sponsors, including Goldman Sachs, Ares Management, Morgan Stanley and KKR, have successfully closed large direct lending funds so far in 2015. The opportunities presented from bank exits from the market have meant that current fundraising for private debt funds has been concentrated on direct lending fund strategies (39 percent), rather than

more traditional special situations (11 percent) or mezzanine fund (29 percent) strategies.[15] Moreover, it is expected that investor interest in private debt funds will continue, as 57 percent of investors in private debt funds intend to commit more capital to the sector in 2015 than they had in 2014.[16]

While private debt funds have been focused primarily on the market in North America, another trend to look out for is penetration of European and Asian markets, which seems to have increased in activity with 66 funds currently fundraising in Europe and 21 focused on Asia.[17] The impact of direct lending in European markets has taken place even in the face of renewed interest by banks and a bifurcation of transactions whereby banks have taken on more "plain vanilla" transactions and direct lending funds have made inroads with borrowers attempting to execute more complicated transactions or those that require more favorable amortization terms.[18] While the retrenchment of banks, due to regulatory concerns, has been a greater trend within U.S. markets, it would not be surprising to see this bifurcation in the U.S. market as well, as comfort with nonbank sources of leverage continues and funds remain a flexible and unregulated source of capital.

Conclusion

Increasing regulatory pressures on banks have created the opportunity for nonbanks to stake a claim to loans that would otherwise face regulator criticism. Moreover, investor interest in chasing yield, while under the Damocles sword of interest rate hikes, has caused funds to become more interested in the market. We see this as a trend that will continue in the near future as borrowers become more comfortable with other sources of capital to suit their needs. Further, it would not be surprising to see the direct loan strategy of private funds to expand to include different types of direct loans that due to structure or complexity would require more flexibility from lenders.

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[1] "The Search For Yield Leads to Private Debt," Barrons April 25, 2015 and Arleen Jacobius, "Private Debt Ready for Takeoff," Pensions and Investments Apr. 20, 2015, available at http://www.pionline.com/article/20150420/ PRINT/304209981/private-debt-market-ready-for-takeoff.

[2] Lella Parker Deo, "LPC- Jefferies profiting from highly leveraged loans" Reuters, May 29, 2015 available at http://www.reuters.com/article/2015/05/29/ jefferies-loans-idUSL5N0YK4OV20150529.

[3] Prequin Special Report: Private Debt Fund Manager Outlook, August 2014 (the "Prequin Report") p. 1.

[4] See Prequin Report.

[5] What is generally referred to herein as "guidance" is comprised of a number of bulletins jointly issued by the OCC, the FDIC and the Fed including the following: "Leveraged Lending: Guidance on

Leveraged Lending," OCC 2013-9 issued on March 22, 2013, available at http://www.occ.gov/news-issuances/bulletins/2013/ bulletin-2013-9.html; OCC 2014 "Leveraged Lending: Frequently Asked Questions for implementing March 2013 Interagency Guidance on Leveraged Lending" issued Nov. 7, 2014, OCC 2014-55, available at http://www.occ.gov/news-issuances/bulletins/2014/ bulletin-2014-55.html.

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[7] Gillian Tan and Ryan Tracy, "Credit Suisse Loans Draw Fed Scrutiny" Wall Street Journal, Sept. 16, 2014, citing S&P Capital IQ LCD, available at http://www.wsj.com/articles/credit-suisse-loans-draw-fed-scrutiny-1410910272

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[11] Jacobius.

[12] Claire Ruckin, "Direct Lending Plays Bigger Role in European Loan Market," Reuters, Dec. 1, 2014, available at http://www.reuters.com/article/2014/12/01/ us-direct-lending-loans-idUSKCN0JF26K20141201.

[13] "GE to Sell Buyout Unit to Canada Pension Fund for $12 Billion," Ted Mann, Ben Dummett and Chelsey Dulaney June 9, 2015, available at http://www.wsj.com/articles/ ge-to-sell-buyout-unit-to-canada-pension-fund-for-12-bil- lion-1433846821.

[14] Jacobius.

[15] Prequin Report p, 2, Fig 2.

[16] Prequin Report p. 6.

[17] Prequin Report p. 4, Fig 3.

[18] Ruckin.

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