

Shared National Credits Program

2014 Leveraged Loan Supplement

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

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Executive Summary – 2014 SNC¹ Supplemental Leveraged Loan Commentary

The 2014 interagency Shared National Credit (SNC) Review focused significant attention on leveraged lending, including assessing the March 2013 Interagency Guidance on Leveraged Lending (2013 guidance). The review found that risk in the overall SNC portfolio was centered in the leveraged portfolio, noting a criticized rate of 33.2 percent for leveraged loans compared with 3.3 percent for the non-leveraged portfolio. While the high criticized rate for leveraged loans illustrates the risk inherent in this portfolio, the pass portion of the leveraged portfolio carried more than the normal degree of risk, as these borrowers were considered to be more vulnerable to risk rating downgrades during an economic downturn. The analysis also showed that borrower leverage was not the sole driver of an adverse rating classification; rather, it was an important factor because of its influence on repayment capacity. The agencies stress that institutions should employ safe and sound practices when engaging in the origination, purchase and/or distribution of leveraged loans.

The review also found serious deficiencies in underwriting standards and risk management of leveraged loans. Overall, the SNC review showed gaps between industry practices and the expectations for safe- and- sound banking articulated in the guidance. Thirty-one percent of leveraged transactions originated within the past year exhibited structures that were cited as weak, mainly because of a combination of high leverage and the absence of financial covenants. Other weak characteristics observed included nominal equity and minimal de-leveraging capacity.

Covenant protection deteriorated, as evidenced by the reduced number of financial maintenance covenants, the use of net debt in many leverage covenants, and features that allow increased debt above starting leverage and the dilution of senior secured positions. In particular, transactions that increase leverage without a subsequent increase in cash flow generation (e.g., loans used to pay dividends to equity investors) should be viewed with greater caution. In many cases, examiners questioned the borrower capacity to repay newly underwritten loans if economic conditions deteriorated or if interest rates rose to historical norms. As noted in the 2013 guidance, financial institutions should ensure borrowers can repay credits when due, and that borrowers have sustainable capital structures, including bank borrowings and other debt, to support their continued operations through economic cycles.

The 2014 SNC review also identified several areas where institutions need to strengthen risk management practices. Risk management failures observed during the SNC examination include: inadequate support for enterprise valuations and/or reliance on dated valuations, weaknesses in credit analysis, and overreliance on sponsor's projections.

The agencies recognize that leveraged lending is an important type of financing for the U.S. and global economies, and that the U.S. banking system plays a key role in making credit available by syndicating credit to investors. However, banks must not heighten risk by originating and distributing poorly underwritten and low quality loans. Institutions that participate in this lending activity, without implementing strong risk management processes consistent with the 2013 guidance, will be subject to criticism by the appropriate agency. As a result of the recent SNC leveraged lending findings, supervisors will increase the frequency of reviews around this business line to ensure risks are well understood and well controlled.

¹ The SNC program, governed by an interagency agreement among the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the agencies), is designed to review and assess risk in the largest and most complex credits shared by multiple financial institutions. The program provides uniform treatment of, and increased efficiency in, the risk analysis and classification of shared credits.

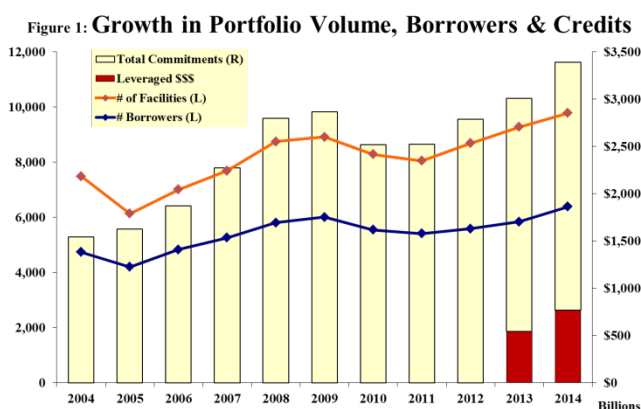
About the Leveraged Loan Subset of the 2014 SNC Review

For the 2014 SNC review, supervisors placed significant emphasis on reviewing leveraged loans to evaluate safety and soundness of bank underwriting and risk management practices relative to expectations articulated in the 2013 guidance. This supplement highlights SNC findings specific to leveraged loans. The 2014 SNC review included an examination of 782 leveraged loan obligors with \$623 billion in commitments or 63.9 percent of leveraged SNC borrowers, representing 81 percent of all leveraged loans by dollar commitment. Results of the review are based on analyses prepared in the second quarter of 2014, using credit-related data provided by federally supervised institutions as of December 31, 2013 and March 31, 2014.

Reporting agent institutions determine which loans are considered leveraged loans and they do not use identical definitions. The 2013 guidance states that the policies of financial institutions should include criteria to define leveraged lending that are appropriate for their institution. The criteria should focus on a measurement of leverage that makes sense for the institution's activities.

Leveraged SNC Portfolio

The 2014 leveraged SNC portfolio totaled \$767 billion in commitments (of \$3.4 trillion in total SNC commitments) with 1,229 obligors and 2,494 facilities. As illustrated in Figure 1, the leveraged portfolio (denoted in the red bar) showed significant growth year-over-year. However, the agencies' 2013 SNC data collection efforts did not include all agent banks that originated leveraged loans. The 2014 review expanded the data request to all reporting institutions.



The five largest industry segments represented in the leveraged portfolio are: Media/Telecom (\$112 billion), Healthcare (\$85 billion), Durable Manufacturing (\$78 billion), Finance/Insurance (\$78 billion) and Utilities (\$50 billion). These five sectors represented, in aggregate, 52.6 percent of all leveraged commitments, among 24 industry segments tracked by the agencies.

Leveraged SNC Credit Quality

The percentage of criticized and classified leveraged assets² is very high at 33.2 percent and 19.0 percent, respectively. Leveraged loans make up 72.9 percent of all SNC special mention assets, 75.3 percent of all substandard loans, 81.6 percent of all doubtful loans and 83.9 percent of all nonaccrual loans. The prevalence of leveraged lending is the primary contributor to the overall SNC criticized rate of 10.1 percent. Highly leveraged borrowers typically have limited financial flexibility and are particularly susceptible to negative changes in the competitive and economic environment. For this reason, the pass portion of the leveraged portfolio also carries more than the normal degree of risk. Continued growth in leveraged originations or an economic downturn would further elevate the volume of non-pass credits in the overall SNC portfolio. The 2013 guidance states that financial institutions should ensure that they do not heighten risk in the financial system by originating poorly underwritten loans, and the guidance outlines high-level principles related to safe-and-sound leveraged lending activities. Within that context, banks should not originate non-pass risk rated (special mention or worse) leveraged loans.

² See SNC Press Release for definitions of Criticized and Classified.

The 2014 SNC review found that institutions continue to originate a large volume of non-pass transactions at inception to either hold or distribute. Further, the SNC review noted that institutions were also participants in non-pass SNC transactions. As explained in the 2013 guidance, the origination of leveraged 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.

Given the supervisory concern noted with leveraged lending, the agencies expect that all firms with leveraged loan exposure will:

- Establish underwriting standards to prevent the origination of new non-pass credit.
- Establish policies to enhance the credit position of non-pass borrowers seeking refinance of current credit structures.
- Set prudent limits for leveraged transactions to highly cyclical industries that would struggle to meet obligations during a down cycle.
- Set prudent limits for leveraged transactions that do not result in increased cash flow for the borrower, such as dividend recapitalizations.

Leveraged Loan Underwriting

Weakness in underwriting was far more prevalent in leveraged lending compared with non-leveraged SNC loans. Thirty-one percent of leveraged transactions originated within the past year exhibited structures that were cited by examiners as weak, mainly because of a combination of high leverage and the absence of financial covenants. Other weak characteristics observed include: equity cures, nominal equity, and minimal de-leveraging capacity. In addition, covenant protection deteriorated, as evidenced by 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.

The SNC sample included the refinancing of non-pass leveraged loans where the transactions did not evidence meaningful improvements in structure or controls. Steps taken by institutions to strengthen non-pass credits were generally limited to a reduction in interest rate or an extension of maturity, which are insufficient for meeting supervisors' expectations for such credits. The agencies expect a strategy that actively pursues and executes meaningful improvements in structure or controls during the refinancing of a non-pass borrower. These can include, but are not limited to, implementation of new covenants or tightening of existing covenants; equity injections; line reduction; step-ups to a term loan A structure with increased amortization; the addition of collateral; restrictions on new acquisitions; or issuance of additional debt. The agencies do not view reductions in pricing, extension of maturities or a decrease in bank exposure as substantive actions to place the borrower on a path towards a pass rating.

The 2013 guidance describes prudent practices for risk limits and risk management, among other things. It was not intended to discourage institutions from providing financing to borrowers engaged in workout negotiations. Workouts typically include existing transactions rated at least substandard or doubtful, prior to a refinancing, or transactions identified or managed under an institution's problem loan policy. For special mention loans that were refinanced, examiners noted that institutions frequently did not identify and document efforts to strengthen these credits. Credit approval documents should clearly identify and document the mitigating actions taken to strengthen risk management concerns at refinance. Examiners also noted the absence of interim goals or metrics that could be measured periodically to track progress toward eventually achieving a pass rating.

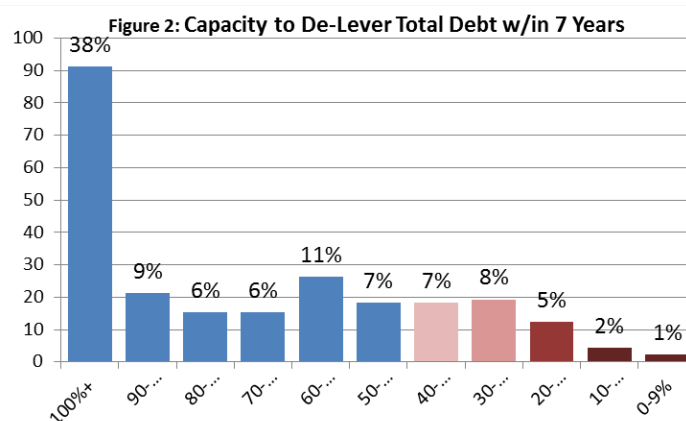
Lastly, examiners noted an overreliance on borrower/sponsor base case projections when evaluating borrower performance. For some credits, Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) calculations used to determine leverage and measure repayment capacity

included difficult- to- support adjustments, such as unrealized cost savings from mergers and acquisitions. In addition, EBITDA growth rates used in projections to measure repayment capacity appeared overly optimistic and differed significantly from historical performance. All institutions should evaluate current and potential transactions in the context of internally generated base case scenarios to support compliance with internal underwriting standards, leveraged lending definitions, and enterprise valuation calculations. Examiners also noted unrealistic stress scenarios and a lack of documentation around stress testing. Institutions should stress these base case scenarios to sufficiently measure borrower sensitivities to economic downturns. Institutions should fully document these processes and include the institutions' base case scenario and underlying assumptions that drive financial projections.

Impact of Interagency Guidance on Leveraged Lending

The 2014 SNC review identified several areas where institutions need to strengthen compliance with the guidance, including provisions addressing borrower repayment capacity, leverage, underwriting and enterprise valuation. While the institutions have formally addressed many of the risk management issues noted in the guidance, execution and full implementation has not been achieved. Examiners noted numerous exceptions at all the large agent institutions that originate leverage loans.

The 2013 guidance sets expectations around borrower repayment capacity at 50 percent of total debt over a five to seven year period. Figure 2 shows expectations for borrower capacity to repay debt on the population of leveraged credits in the sample. The data uses borrower-provided projections to estimate capacity to repay for transactions occurring after June 1, 2013. Where projections were not available for the entire seven year period, the agencies took the final year of available information and carried it forward to complete a seven year time horizon. Using the maximum time of seven years, the chart shows that only 77 percent of borrowers are projected to repay 50 percent of total debt within seven years, compared to 83 percent prior to June 1, 2013.



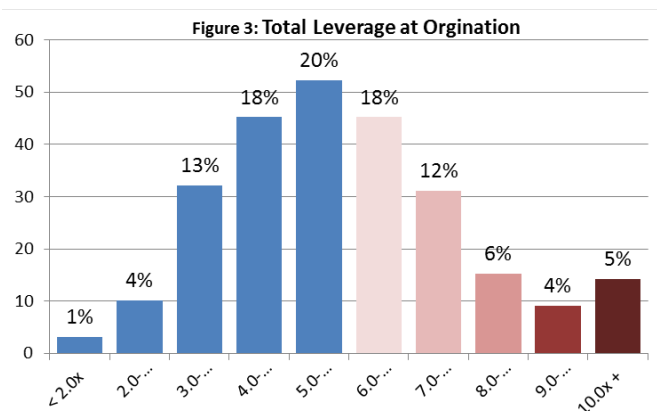


Figure 3 uses a similar methodology to analyze leverage levels in transactions occurring after June 1, 2013. The guidance states that leverage in excess of 6.0X raises supervisory concern. As illustrated in Figure 3, a significant volume of credit carries leverage over this threshold. In particular, 15 percent of transactions showed leverage in excess of 8.0X.

Not surprisingly, transactions where repayment capacity failed to meet minimum expectations or leverage exceeded 6.0X were far more likely to be criticized. Additionally, fifty-four percent of loans originated since June 2013 to obligors with leverage in excess of 6.0X were criticized.

The agencies recognize that leveraged lending is an important type of financing for the U.S. and global economies, and the U.S. banking system plays a key role in making credit available by syndicating credit to investors. However, banks must not heighten risk by originating and distributing poorly underwritten and low-quality loans. A poorly underwritten or low-quality leveraged loan that is pooled with other loans or is participated with other institutions can generate excessive risk to the financial system. The 2013 guidance addresses the agencies' supervisory focus and risk management expectations for supervised financial institutions involved in leveraged lending activities. Institutions that participate in this lending activity without implementing strong risk management processes consistent with the guidance will be criticized by the appropriate agency. Underwriting standards for loans originated to hold, distribute, or purchased should be similar and consistent with board approved risk criteria and lending policies. The agencies 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. As a result of the recent SNC leveraged lending findings, supervisors will increase the frequency of reviews around this business line to ensure risks are well understood and well controlled.