

Milbank

Leveraged Finance Client Alert

BEIJING FRANKFURT HONG KONG LONDON LOS ANGELES MUNICH NEW YORK SÃO PAULO SINGAPORE TOKYO WASHINGTON, DC

LATEST REGULATORY ACTIVISM: LEVERAGED FINANCE UNDER THE MICROSCOPE

On March 26, 2012, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Commission (the “Agencies”) released proposed guidelines on leveraged finance, emphasizing that these guidelines encompass exposure to a leveraged obligor’s entire capital structure, from secured leveraged loans to mezzanine debt and high yield bonds (the “Proposed Guidelines”).¹ The Proposed Guidelines update earlier guidelines adopted by the Agencies on the subject in 2001.²

As might be expected, and as in the case of similar guidelines issued by the Agencies about other types of lending, the Proposed Guidelines encourage bank lenders to make sound credit decisions, thoroughly document those decisions, establish internal credit and concentration limits and actively monitor their borrowers’ performance. The Proposed Guidelines are nonetheless notable in the following respects.

Impetus for Proposed Guidelines

The Agencies refer to several developments that appear to have prompted the release. These are (i) the “tremendous growth in the volume of leveraged credit,” (ii) the frequent inclusion of features that reduce lenders’ ability to act early against poorly performing borrowers, including the absence of meaningful maintenance covenants in loan agreements and the inclusion of payment-in-kind toggle features in junior capital instruments, (iii) failures in management information systems (“MIS”) to produce timely and accurate aggregated exposures to leveraged loans and other debt instruments and (iv) the fact that capital structures and repayment prospects for some transactions have been “aggressive in light of the overall risk of the credit.”

For more information regarding this Client Alert, please contact any of the attorneys listed at the end of this Client Alert. In addition, if you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose “Client Alerts” under “News.”

This Client Alert is a source of general information for clients and friends of Milbank. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel. © 2012 Milbank, Tweed, Hadley & McCloy LLP. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.

¹ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120326a1.pdf>

² <http://www.federalreserve.gov/boarddocs/srletters/2001/sr0109a1.pdf>

Definition of Leveraged Finance

The Proposed Guidelines repeat the suggestion of the earlier 2001 guidelines that institutions adopt a definition of leveraged finance that applies across functions and activities. Unlike the 2001 guidelines, however, the Proposed Guidelines identify criteria that the Agencies expect to be included in the definition. These criteria include specific ratios that would qualify a transaction as a leveraged finance transaction: total debt/EBITA in excess of 4:1 and senior debt/EBITA in excess of 3:1, in both cases calculated without netting cash against debt balances. The Proposed Guidelines note that examiners will expect this definition to also include exposure to financial vehicles that engage in leveraged finance activities, even if the vehicle is not itself leveraged.

Credit Policies and Underwriting Standards

The Agencies provide a new level of detail on the components of credit policies and underwriting standards that they expect institutions to adopt after consideration and approval by institutions' boards of directors. Also, in contrast to the 2001 guidelines, the Proposed Guidelines suggest specific numerical underwriting standards be adopted, such as a requirement that base cash-flow projections demonstrate the borrower's ability to fully amortize senior secured debt or repay at least 50 percent of total debt over a five- to seven-year period. Similarly, the Agencies noted that a total debt/EBITA ratio after planned asset sales in excess of 6:1 "raises concerns for most industries." The Agencies also addressed lenders' reliance upon enterprise values and other intangibles when assessing credit risk and expected performance, stating that such valuations should be conducted at origination and periodically over the life of the loan and should be performed or validated by persons independent of the origination function. Underwriting standards will also be expected to address a number of other concerns, including the scope of due diligence, covenant protections, permitted collateral dilution from asset sales and other collateral provisions.

Distribution

The Proposed Guidelines demonstrate the Agencies' view that banks are expected to be gatekeepers, noting several times that the Proposed Guidelines are to apply whether a loan is originated to hold or to distribute. In particular, the Agencies state that lenders "should be mindful of reputational risks associated with poorly underwritten transactions, which may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." The Proposed Guidelines call for institutions to "have strong risk management and controls over transactions in the pipeline," written procedures for "defining and managing distribution fails and 'hung' deals" and "clear expectations," approved by the bank's board of directors, for the disposition of pipeline transactions that have not been sold according to their original distribution plan.

MIS Requirements

The Proposed Guidelines set out the Agencies' expectations about the level of monitoring, reporting and analysis that an institution should be prepared to adopt and the 15 subjects that should be covered in "accurate and timely" reports to management and the board. Notably, these subjects include exposure and performance by deal sponsor, and exposures to a borrower/counterparty booked in other business units, including indirect synthetic exposures and positions held in available for sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Deal Sponsors

In contrast to the 2001 guidelines, the Proposed Guidelines single out the need for institutions to evaluate the qualifications of financial sponsors and to "implement a process to regularly monitor performance." The Agencies acknowledge that a financial sponsor may be a source of financial support to a borrower and that such support may be taken into account in assigning an internal risk-rating to the loan. The Agencies go on to note, however, that "absent a documented commitment of continued support," a sponsor's potential contributions "may not mitigate examiner criticism."

Other Regulatory Considerations

The Proposed Guidelines mention three other subjects of regulatory concern, suggesting the likelihood of increased scrutiny of these topics on examination: (i) Reg W and other conflict of interest concerns that could arise in leveraged finance transactions, including the distribution of loans to affiliates, (ii) the need to comply with securities laws if the leveraged debt instrument constitutes a “security” under federal securities laws and (iii) anti-tying concerns raised by the number of types of debt and bank products involved in leveraged finance transactions.

Comments are requested on the Proposed Guidelines by June 8, 2012. Although they may be adjusted in several respects when issued in final form, the Proposed Guidelines suggest the need for lenders to be prepared for an unprecedented level of attention to be paid by the Agencies and their examiners to leveraged finance transactions and exposures.

If you have questions or wish to discuss this Client Alert, please contact any of the following attorneys in Milbank’s financial regulatory and leveraged finance practices:

Michael Bellucci
mbellucci@milbank.com
+1-212-530-5410

Thomas Inghoven
tinghoven@milbank.com
+49-69-71914-3436

Arnold Peinado, III
apeinado@milbank.com
+1-212-530-5546

Winthrop Brown
wbrown@milbank.com
+1-202-835-7514

Andrew Jánosky
ajanosky@milbank.com
+55-11-2787-6280

Tim Peterson
tpeterson@milbank.com
+44-20-7615-3106

Paul Denaro
pdenaro@milbank.com
+1-212-530-5431

Rainer Magold
rmagold@milbank.com
+49-69-71914-3430

Anthony Root
aroot@milbank.com
+852-2971-4842

Marcus Dougherty
mdougherty@milbank.com
+1-212-530-5323

William Mahoney
wmahoney@milbank.com
+1-212-530-5286

Tobias Stirnberg
tstirnberg@milbank.com
+55-11-2787-6328

Deborah Festa
dfesta@milbank.com
+1 213-892-4400

Suhrud Mehta
smehta@milbank.com
+44-20-7615-3046

Douglas A. Tanner
dtanner@milbank.com
+1-212-530-5505 (T)

Richard Gray
rgray@milbank.com
+1-212-530-5508

Rod Miller
rdmiller@milbank.com
+1-212-530-5022

Gary Wigmore
gwigmore@milbank.com
+852-2971-4815

Lauren Hanrahan
lhanrahan@milbank.com
+1-212-530-5339

Marcelo Motteschi
mmotteschi@milbank.com
+1-212-530-5602

David Zemans
dzemans@milbank.com
+65-6428-2555

Marc Hanrahan
mhanrahan@milbank.com
+1-212-530-5306

James Murray
jmurray@milbank.com
+65-6428-2422

WORLDWIDE OFFICES



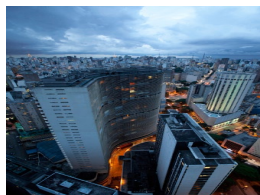
Beijing
Units 05-06, 15th Floor, Tower 2
China Central Place
79 Jianguo Road, Chaoyang District
Beijing 100025, China
+8610-5969-2700



New York
One Chase Manhattan Plaza
New York, NY 10005
+1-212-530-5000



Frankfurt
Taunusanlage 15
60325 Frankfurt am Main
Germany
+49-69-71914-3400



São Paulo
Rua Colômbia, 325
Jardim América
São Paulo, SP
01438-000
+55-11-3927-7700



Hong Kong
3007 Alexandra House
18 Chater Road
Central, Hong Kong
+852-2971-4888



Singapore
30 Raffles Place
#14-00 Chevron House
Singapore 048622
+65-6428-2400



London
10 Gresham Street
London EC2V 7JD
England
+44-20-7615-3000



Tokyo
21F Midtown Tower
9-7-1 Akasaka, Minato-ku
Tokyo, Japan 107-6221
+813-5410-2801



Los Angeles
601 South Figueroa Street
30th Floor
Los Angeles, CA 90017
+1-213-892-4000



Washington, DC
International Square Building
1850 K Street, NW
Suite 1100
Washington, DC 20006
+1-202-835-7500



Munich
Maximilianstrasse 15
(Maximilianhoefe)
80539 Munich
Germany
+49-89-25559-3600