Is Regulatory Relief in Sight?

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Overview

Impact of the Leveraged Lending Guidance
- What we have learned
- What we are seeing

Avenues for Regulatory Relief
- Executive Order
- Legislative Fixes
- Regulatory Fixes
Leveraged Lending Guidance Recap

- Banks cannot originate* non-pass credits
  - Generally viewed as loans to companies that cannot show the ability to repay all senior debt or half of total debt in 5-7 years from base cash flows
  - Leverage > 6x raises concerns
  - Discomfort around the lack of maintenance covenants
  - Casts a skeptical eye on EBITDA adjustments, incremental baskets
- Includes onerous reporting requirements, including for non-leveraged loans swept up into the “leveraged” definition

*Originate means originate, refinance or modify
Banks Constrained From Originating Non-Pass Credits

- Increasing non-bank share in LBOs
- Increasing direct lending

Source: TR-LPC
Leveraged Lending Guidance: Market Impact

• Adjusted leverage on LBO loans has stabilized/come down
• However, EBITDA adjustments have increased – thus increasing the gap between reported and adjusted EBITDA
• But regulators generally happy with the effect of Leveraged Lending Guidance
U.S. Underwritings Generally in Line With SNC, But…

*Shared National Credit (“SNC”) review flags some progress…*
“The first quarter 2016 SNC review found the incidence of non-pass loan originations has reduced to a de minimis level. Examiners noted continued progress toward full compliance with underwriting and risk management expectations set forth in the 2013 leveraged lending guidance.”

*But... “some weaknesses in underwriting practices persist; examiners observed structures with ineffective or no covenants, liberal repayment terms, incremental debt provisions, that allow for increased debt which may inhibit deleveraging capacity and dilute senior secured creditor positions” … SNC Review*

*And from the Wall Street Journal…*
“The Ultimate Ebitda Fighting Championship”

*Sale of UFC and other buyout deals are raising concerns among regulators that banks and clients are being too liberal with adjustments to earnings to justify more borrowing for transactions… Oct 16, 2016*
There is Hope for Regulatory Relief

- New Trump administration
- Republican majorities in both houses of Congress
- A lot of turnover at the banking agencies
  - We will see new heads of the OCC, FDIC and the Federal Reserve
  - Fed Governor Tarullo has resigned; new Vice-Chair of Supervision at the Federal Reserve to be appointed
- Executive orders
- Legislative fixes
- Regulatory fixes
Guidance and DC: Is LLG a Rule?

- Senator Toomey Letter: Is Leveraged Lending Guidance a rule?
- Congressional Review Act (CRA)
  - Definition of a “rule” is very broad:
    - “[R]ule means the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services, or allowances therefor or of valuations, costs, or accounting, or practices bearing on any of the foregoing”.

  - Requires that before an agency rule becomes effective, it must be submitted to Congress for review
  - Congress has 60 days to disapprove rule by 51% majority; President has to sign it
  - If disapproved, a new rule cannot be issued in same substantive form without legislative authorization
- Government Accountability Office (GAO)
  - Since 1996, the GAO has provided at least 11 opinions addressing whether a particular agency action was a “rule” under the CRA
  - In addition, in relation to an info memorandum concerning TANF, GAO rejected HHS’s view “that guidance documents are not rules for the purposes of the CRA.”
Guidance and DC: What Happens if LLG is a Rule?

Possible Outcomes

- It’s guidance, not a rule
- It’s a rule, and regulators withdraw it before Congress opines
  - And possibly reintroduce it later
- It’s a rule, and Congress disapproves it
- It’s a rule, and Congress affirms it