MARKETS

Debt Rises in Leveraged Buyouts Despite Warnings

Regulators Urge Banks to Avoid Financing High Levels of Debt

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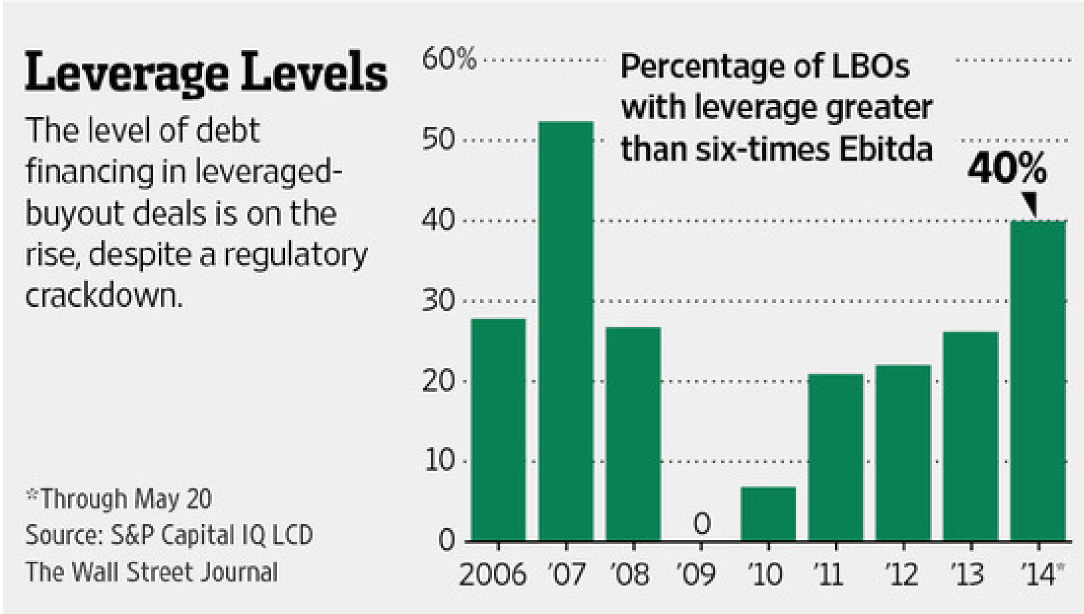
Wall Street banks are financing more private-equity takeovers with high levels of debt, despite warnings by regulators to reduce the amount of risky loans they make.

The Federal Reserve and the Office of the Comptroller of the Currency last year issued guidance urging banks to avoid financing leveraged buyouts in most industries that would put debt on a company of more than six times its earnings before interest, taxes, depreciation and amortization, or Ebitda. The Fed and the OCC also told banks to limit borrowing agreements that stretch out payment timelines or don't contain lender protections known as covenants.

Still, 40% of U.S. private-equity deals this year have used leverage above that six-times ratio deemed the upper acceptable limit by regulators, according to data compiled by S&P Capital IQ LCD. That is the highest percentage since the prefinancial-crisis peak of 52% of buyout loans in 2007. Such lending all but disappeared during the crisis but has risen each year since 2009.

In recent months, bank regulators have impressed upon banks that they aren't happy with the amount of loans fueling buyouts, in which private-equity firms borrow money to buy companies with the intention of later selling them for a profit.



When a private-equity firm buys a company, it typically borrows money to help fund the purchase that goes on the acquired company's books. If the company runs into trouble, paying that debt can prove difficult, and investors in the debt can suffer.

The guidance is designed to deter banks from funding deals that regulators feel are too laden with debt, as companies with higher debt ratios are considered more likely to run into financial trouble.

These loans, provided by a group of banks, are often sold to a wider group of lenders and investors. Regulators are concerned that in the event of a financial downturn and diminished demand from investors, banks may find themselves stuck with large pipelines of risky debt.

The Fed and OCC, which issued the guidance in conjunction with the Federal Deposit Insurance Corp., declined to elaborate beyond previous statements. The agencies have said they share the same goal of ensuring proper risk management and are coordinating closely to implement the leveraged-lending guidance.

Leveraged-finance bankers have complained that the guidance isn't clear, and adherence to the guidelines hasn't been uniform, which some in the industry attribute to the Fed and OCC applying them inconsistently and to confusion around what exactly is allowed under the new policy.

The OCC has articulated a "no exceptions" policy, while the Fed has told the banks it oversees on this issue that they may participate in a small number of the leveraged-buyout deals that stray from the guidance, according to a person familiar with the matter.

The banks are also interpreting the guidance differently, bankers, lawyers and private-equity executives said. One issue is how Ebidta should be calculated, bankers said. Another is what happens if a deal meets some criteria in the guidelines but not all.

Bankers said they are awaiting the results of annual examinations by regulators of banks' books currently under way for more insight on how tough enforcement will be.

The examinations typically wrap up by July, with results publicly disclosed a few months later.

"Banks are taking the guidance seriously and are in regular contact with regulators, but there continues to be a high level of uncertainty around exactly how the regulations are expected to be applied in practice…which may not be known until the conclusion of the annual examinations," said Jason Kyrwood, a partner at law firm Davis Polk & Wardwell LLP who advises banks on leveraged-finance transactions.

One senior leveraged-finance banker said some banks are making a bet that "we can do whatever we want" until the Fed and the OCC align their approaches and repercussions become clear.

So far, plenty of deals are getting done above the ratio set out in the guidance, as low interest rates fuel a rush by investors toward higher-yielding debt such as leveraged loans.

Blackstone Group LP's planned $5.4 billion acquisition of Gates Global Inc. would increase Gates's debt levels to about seven times Ebitda. That deal is being financed by Citigroup Inc., Credit Suisse Group AG , Deutsche Bank AG, Goldman Sachs Group Inc., Morgan Stanley and UBS AG.

Renaissance Learning's leverage ratio rose to about 7.5 times after it was purchased in April for $1.1 billion by Hellman & Friedman LLC, a deal financed by Bank of America Corp. , Credit Suisse and RBC Capital Markets.

Banks on the Renaissance deal consider it acceptable under the guidance because the company's recurring revenue and high cash flow should allow it to quickly pay down debt, according to a person briefed on the deal. Banks see the Gates buyout as acceptable because the company has high cash flow that can enable it to repay debt, a person familiar with that deal said.

The OCC regulates the national banks housed at Bank of America, Citigroup, J.P. Morgan Chase & Co. and Wells Fargo & Co.

The Fed regulates foreign banks, Goldman Sachs and Morgan Stanley in this matter.

Regulators are now digging into the banks' loan portfolios as part of the annual reviews, which kicked off this quarter. The Fed, FDIC and OCC have conducted the exams to review loans provided by banks since the late 1970s, but they are expected to more closely scrutinize the debt levels of takeover loans this year, regulators, bankers and lawyers said.

U.S. regulators will use the examinations "to assess firms' conduct and adherence" to the guidance, focusing on underwriting practices, the accuracy of banks' risk ratings, and systems to identify and track loans to companies with high levels of debt, said Todd Vermilyea, senior associate director in the Fed's Division of Banking Supervision and Regulation, last week at an event in Charlotte, N.C.

"A lot of work has been done to date by the agencies to assess compliance with the guidance, but clearly much more work remains to be done and stronger supervisory action may be needed," Mr. Vermilyea said.

The Fed and the OCC can fine banks a maximum of $1 million a day if lenders knowingly flout the leveraged-lending guidance, which was issued in March 2013 and reiterated in letters to banks last summer.

— Ryan Tracy contributed to this article.

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