**Regulators on Leveraged Lending: A Cheat Sheet**

*By*

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The leveraged lending guidance is jointly enforced by the Federal Reserve, Office of the Comptroller of the Currency and Federal Deposit Insurance Corp.

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For nearly two years, banks have contended federal regulators haven’t given them clear signs on how to read their guidance on leveraged lending, which typically involves banks providing funds for debt-laden corporate buyouts. On Thursday, regulators got on the phone and gave banks more details.

On a teleconference jointly hosted by the Federal Reserve, Office of the Comptroller of the Currency and Federal Deposit Insurance Corp. that attracted around 1,700 participants, regulators answered questions about guidance they published in March 2013 designed to limit the amount of loans that banks extend to indebted companies.

Regulators also shared what they called “examiner red flags,” or weak loan characteristics that could cause examiners to “take a closer look” or “probe more deeply” when reviewing specific loans.

The existence of red flags for a deal may not necessarily result in an unfavorable rating on it, they said. Too many unfavorable, or “non-pass” ratings at any one bank can result in penalties from regulators.

Here’s a summary of the highlights, Q&A style:

* **Can banks create their own leverage definitions?** Yes. Regulators said it is “reasonable” for banks to define thresholds for an appropriate amount of debt in various industries if they also provide enough support explaining why such metrics are appropriate and undertake periodic reviews to ensure their self-prescribed threshold remains accurate. In the past, regulators have said they would look askance at deals in most industries with a debt ratio north of six times earnings before interest, taxes, depreciation and amortization, or Ebitda. Regulators said Thursday that the six-times limit is not a bright line but anything above it is a red flag.
* **Can cash be “netted” against debt?** No. If cash on hand hasn’t been used to reduce debt, it should not be projected to reduce debt in the future.
* **How should banks look at “baskets,” or incremental debt facilities?** A basket represents an untapped portion of debt that borrowers can use to make investments and pay dividends, among other things. If a basket is not expected to be drawn, a company’s earnings should not “arbitrarily” be adjusted to include potential profits from its use. Baskets should also be included when calculating total leverage, regulators said.
* **How should banks approach adjustments to Ebitda?** Adjustments, which can make a leverage ratio look better, should be supported by third-party due diligence, regulators said. Factors included in projected Ebitda, including expected growth rates, should come with appropriate documentation and “credible justification” that explains how or why changes are attainable and sustainable. Cost savings from restructurings or synergies must be proven, and merger-related integration costs must be included. Regulators said that a “large-percentage” adjustment to Ebitda is a red flag.
* **What do examiners look at when reviewing cash-flow projections?** Red flags arise when examiners see cash-flow projections as “overly optimistic” or unrealistic, and if the projections aren’t stress tested for variables like interest-rate shocks or debt covenant breaches
* **How do regulators think about dividends to private-equity owners of indebted companies?** Examiners look unfavorably on a loan if the private-equity firm in question has a history of paying itself dividends soon after the buyout. If dividends are discretionary, they don’t have to be included when calculating a borrower’s ability to repay debt.
* **Are there concerns around the five-to-seven year repayment period?**Regulators have previously said companies must demonstrate the ability to repay all senior debt or at least half total debt within five to seven years. Regulators said Thursday they get concerned when the bulk of the repayment is projected to occur late in the five-to-seven year time frame. “The higher initial leverage, the more quickly deleveraging should occur,” the agencies said. This scrutiny on timing could make so-called add-on acquisition strategies difficult to execute because rapid repayment of debt often doesn’t fit with plans hatched by a private equity buyer to grow a company after a leveraged buyout. Regulators also stated they do not view a guarantee as collateral – it is considered a secondary source of repayment.
* **What do examiners look for in the credit agreement?** Regulators want to see credit agreements that require lender approval for situations that could negatively impact a company’s ability to repay debt, such as the reduction of liquidity or collateral, say by the sale of a cash-flow-producing asset. Examiners frown upon credit agreements with so-called sidecar loan agreements or accordion features that allow companies to take on more debt in a way that erodes the protection of existing lenders. Accordions or sidecars must be included when measuring total leverage.
* **How should banks approach workout situations?** Agencies say it’s “reasonable” for banks to increase their exposure to a specific leveraged loan if it improves the bank’s chance for collection.
* **Do loans to entities like business development companies, hedge funds, private-equity firms and collateralized loan obligations, or CLOs, count as leveraged loans?** Yes, if those entities are dependent on cash flows from other companies that in turn have leveraged assets
* **Can investment-grade loans also be leveraged loans?** Yes, the guidance does not give a safe harbor for loans deemed investment-grade by ratings firms.
* **Can banks use “springing” covenants in asset-based lending?** Springing covenants are covenants that only kick into gear if a company’s unused loan availability falls below a predetermined level. Asset-based loans are loans that are secured against collateral. Regulators say “springing” controls are acceptable if they’re established by an agreement and at the origination of the loan. Outstanding asset-based debt should be included in total leverage. Banks may originate asset-based loans to non-pass borrowers as long as the ABL itself would obtain a “pass” rating from agencies.
* **If banks lend to a fast-growing company with minimal earnings that has plans for a near-term IPO, does this count as a leveraged loan?** Yes. This loan must be reported to examiners in case an IPO is not consummated, and bank practices should deter the origination of “non-pass” loans.
* **Do bridge loans count as leveraged loans?** Yes, even if they are later going to be replaced by high-yield bonds. (The WSJ [reported in December](http://blogs.wsj.com/moneybeat/2014/12/10/bond-deals-cant-skirt-leveraged-lending-guidance/) that regulators had rejected this workaround to the guidance, when questioned by banks). Bonds are included as part of a borrower’s total debt profile.