

Unraveling Bank Regulatory Developments Affecting Lending: Leveraged Lending Guidance, Basel III Capital and Liquidity Coverage Ratio Rule and More

Navigating Changes in the Long-Term Lending, Leveraged Lending, Securities Finance and Repo Markets

THURSDAY, SEPTEMBER 10, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Lisa M. Ledbetter, Partner, **Jones Day**, Washington, D.C.

Ralph F. (Chip) MacDonald, III, Partner, **Jones Day**, Atlanta

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-873-1442** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about CLE credit processing call us at 1-800-926-7926 ext. 35.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.



**JONES
DAY**[®]

One Firm WorldwideSM

**LEVERAGED LENDING
AND
BANK CAPITAL AND LIQUIDITY**

September 10, 2015

Chip MacDonald
(404) 581-8622
cmacdonald@jonesday.com

Lisa Ledbetter
(202) 879-3933
lledbetter@jonesday.com



Regulatory Framework

I. Born of Basel

- The G20 ratified the Basel Committee's proposals for strengthening capital and liquidity standards in December 2010, thereby committing the global banking industry to significant change for many years to come
- The new accord expands and strengthens bank capital, liquidity and leverage requirements
- At its core, Basel III is designed to improve financial stability and ensure that governments are never again required to bail out the banking sector



I. Born of Basel (cont'd)

- Key Basel III objectives
 - To raise the quality, quantity and transparency of capital to ensure banks can absorb losses;
 - To strengthen the capital requirements for counterparty risk exposures;
 - To supplement Basel II risk-based capital through a leverage ratio;
 - To promote higher capital buffers in good times that can be drawn upon in times of stress
 - To set a global minimum liquidity standard



I. Born of Basel (cont'd)

- Basel III reforms include:
 - Tighter definitions of regulatory capital
 - not all Tier 1 regulatory capital proved to be loss-absorbing during the financial crisis
 - Increased requirements to hold regulatory capital
 - New treatment for counterparty credit risk
- Bank capital effects on bank lending
 - Following increases in capital, banks tend to:
 - Maintain their buffers of capital above the regulatory minimums,
 - Reduce lending, and
 - Change types and risks of assets.



I. Born of Basel (cont'd)

- These tendencies vary on a global, national and individual-bank basis
- Some studies show a reduction in corporate lending especially to the commercial real estate sector



Regulatory Framework

II. Regulatory Concerns Over Leveraged Lending

- Leveraged lending has been a long-term regulatory concern:
 - Federal Reserve SR 98-18 (1998)
 - OCC Advisory Letter AL 99-4 (1999)
 - Federal Reserve SR 99-23 (1999)
 - Interagency Guidance on Leveraged Financing (2001) (“2001 Guidance”)
 - Interagency Guidance on Leveraged Lending 78 F.R. 17766 March 22, 2013) (“2013 Guidance”)
- Since 2001, regulators have seen:
 - tremendous growth in leveraged credit and participation of unregulated lenders
 - reduced covenants and more PIK toggles
 - more “aggressive” capital structures and repayment prospects



Regulatory Framework (cont'd)

III. 2013 Leveraged Lending Guidance

- Applicable to all financial institutions that originate or participate in leveraged lending transactions.
- Not applicable, generally, to
 - Small portfolio C&I loans; and
 - Traditional asset-based lending (“ABL”), subject to the borrower’s capital structure.
- Reflects post-credit crisis emphasis on systemic as well as individual institution risks.



Regulatory Framework (cont'd)

- Elements of the 2013 Guidance
 - “Leveraged Lending” defined
 - Policy expectations
 - Underwriting standards
 - Valuation standards
 - Pipeline management
 - Reporting and analytics
 - Risk ratings
 - Credit analysis and review
 - Problem credit management
 - Deal sponsors
 - Stress testing
 - Reputational risk
 - Compliance



Regulatory Framework (cont'd)

Leveraged Lending

- Criteria
 - Tested at origination, modification, extension or refinancing.
 - Proceeds used for buyouts, acquisitions or capital distributions.
 - Total Debt (not reduced by cash) divided by EBITDA exceeds 4X; or Senior Debt (not reduced by cash) divided by EBITDA exceeds 3X; or other defined measure appropriate for the industry.
 - Debt exceeding 6X Total Debt/EBITDA after asset sales is generally excessive.
 - Leverage, such as debt to assets, net worth or cash flow exceed industry norms or historical levels.
- Must be applied across all organization business lines and entities.
- Describe clearly the purposes and financial characteristics common to these transactions.
- Must cover direct and indirect risk exposures, including limited recourse financing secured by leveraged loans.



Regulatory Framework (cont'd)

Policy Expectations

- Risk appetite of the bank and affiliates, including effects on:
 - earnings
 - capital
 - liquidity
 - other risks
- Risk limits
 - Single obligors and transactions
 - Aggregate hold portfolio
 - Aggregate pipeline exposure
 - Industry and geographic exposure
- Management approval authorities
- Underwriting limits, using loss stresses, economic capital usage, earnings at risk, etc. for “significant transactions”





Regulatory Framework (cont'd)

- Appropriate ALLL methodology
- Accurate and timely board and management reporting
- Expected risk adjusted returns
- Minimum underwriting standards for primary and secondary transactions
- Participations purchased require risk management guidelines, and:
 - Full independent credit analyses
 - Copies of all documents
 - Continuing monitoring of borrower performance



Regulatory Framework (cont'd)

Underwriting Standards

- Written and measurable standards consistent with organization's risk appetite
- Borrower's business premise should be sound and capital structure should be sustainable
- Borrower's capacity to repay and deliver over a reasonable period
 - Fully amortize senior secured debt or repay a significant portion of all debt over the medium term (5-7 years)
- Alternative strategies for funding and disposing of loans and potential losses during market disruptions
- Sponsor support
- Covenants, including control over assets sales and collateral
- No intent to discourage pre-pack bankruptcy financings, workouts or stand-alone ABL facilities



Regulatory Framework (cont'd)

Valuation Standards

- Enterprise values often used to evaluate loans, planned asset sales, access to capital markets and sponsors' economic incentive to support a borrower
- Valuations to be performed by “qualified independent persons” outside the loan origination group
- Since valuations may not be realized, lender policies should provide loan-to-value ratios, discount rates and collateral supported by enterprise value



Regulatory Framework (cont'd)

Pipeline Management

- “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

Large Bank CEO on buyout financing in *Financial Times* (July 9, 2007)

- Need strong risk management and controls over pipelines
- Documented appetite for underwriting risk considering pipeline exposures and effects on earnings, capital, liquidity, and other effects.
- Written policies defining and managing failures and “hung deals” approved by the board of directors.
- Periodic pipeline stress tests, and evaluation of variances from expectations
- Limits on pipeline commitments and amounts an institution will hold on its books
- Hedging policies





Regulatory Framework (cont'd)

Analytics and Reporting

- Comprehensive, detailed reports, at least quarterly with summaries to the board of directors regarding all higher risk credits, including leveraged loans

Risk Ratings

- Fully amortize senior secured debt *or* repay at least 50% of all debt over 5-7 years provides evidence of “adequate repayment capacity”
- Adverse ratings, if refinancing is the only viable repayment option
- Avoid masking problems with loan restructurings or extensions
- Generally, inappropriate . . . to consider enterprise value as a secondary source of repayment, unless that value is well supported
- Strong, independent credit review function should be able to identify risks and other findings to senior management



Regulatory Framework (cont'd)

Risk Ratings (cont'd)

- Credit reviews of leveraged lending portfolio should be performed in greater depth and more often than other portfolios
- At least annual reviews, or more frequently, especially where relying on enterprise value, or other factors
- Credit reviews should include reviewing of leveraged lending practices, policies and procedures and compliance with the 2013 Guidance and other regulatory guidance



Regulatory Framework (cont'd)

Other Elements of 2013 Guidance

- Periodic stress testing – especially for CCAR and DFAST participants
- Problem credit management
- Deal sponsors – what are the levels and experience with sponsor commitments (e.g. verbal assurance, written comfort letters, guarantee or make well) and the sponsor's capacity to perform
- Reputational risks – lenders that distribute loans which have more performance issues or defaults or fail to meet their underwriting and distribution legal responsibilities, will have damaged reputations and less ability to dispose of leveraged loans
- Periodic compliance reviews should be conducted to avoid potential conflicts and evaluate legal compliance, including anti-tying, securities law disclosures and avoidance of inappropriate disclosure of material, nonpublic information



Regulatory Framework (cont'd)

IV. Early Experience with the 2013 Guidance

- Shared National credit (“SNC”) Report (Oct. 10, 2013)
 - Leveraged loans totalled \$545 billion of SNC credits and \$227 billion (75%) of criticized SNC assets
 - Material, widespread weaknesses in underwriting practices, including excessive leverage, inability to amortize debt over a reasonable period, and a lack of meaningful financial covenants
 - 2014 SNC Report (Nov. 7, 2014)
 - Leveraged loans totalled \$7.67 billion of SNC credits, and \$254.7 billion of criticized SNC assets. The regulators criticized 33.2% of leveraged loans.
 - \$623 billion in commitments were reviewed, accounting for 63.9% of leveraged borrowers and 81% of total leveraged loan by dollar amount.
 - Thomson Reuters LPC reports deals with leverage ratios above regulatory quantitative leverage levels
 - Oct. 2013 – Mar. 2014 – 24 deals
 - Since Mar. 2014 – 19 deals
- International Financing Review* (June 6, 2014)



Regulatory Framework (cont'd)

Federal Reserve Commentary

In prepared remarks to the 2014 Credit Markets Symposium in Charlotte, North Carolina, Todd Vermilyea, Senior Associate Director for Banking Supervision and Regulation at the Fed, warned:

“Recent industry level data suggest that despite the issuance of the leveraged lending guidance and the MRAs, terms and structures of new deals have continued to deteriorate in 2014,” Vermilyea said in his opening statement. . . . “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. . . .



Regulatory Framework (cont'd)

Vermilyea said the Fed, OCC and FDIC intend to use the upcoming SNC review to assess banks' conduct and adherence to "safe and sound lending standards".

"U.S. Fed Warns of more bank scrutiny over leveraged loans", Thompson Reuters (May 13, 2014).

- "FAQs for Implementing March 2013 Interagency Guidance on Leveraged Lending" (Nov. 7, 2014)
- SNC Report due in Fall 2015 may trigger further guidance.



Regulatory Framework (cont'd)

V. Other Regulatory Guidance that Influences Leveraged Loans

- Dodd-Frank Act, Section 165(h) -- all institutions with over \$10 billion in assets must have a risk committee.
- Enhanced prudential standards applicable to \$50 billion and greater asset organizations and non-bank SIFIs – Dodd-Frank Act, Section 165 and Federal Reserve “Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations”, 79 F.R. 17240 (Mar. 27, 2014)
- The 2013 Guidance emphasizes the role of senior management and the board of directors in overseeing adherence to the Guidance.
 - The FDIC has commonly accused directors of failed banks of negligence, gross negligence and breach of fiduciary duty for approving risky loans and risky loan practices.
 - Tarullo, “Corporate Governance and Prudential Regulation” (June 9, 2014).



Regulatory Framework (cont'd)

FDIC Insurance Effects

- Many leveraged loans will be “higher risk commercial and industrial loans and securities” reportable on Call Report, Schedule RC-O, Item 9, which will be used to reflect risk and calculate deposit insurance premiums.



Regulatory Framework (cont'd)

Incentive Compensation

- *Interagency Guidance on Sound Incentive Compensation*, 75 F.R. 36395 (June 25, 2010) – (“Final Incentive Guidance”)
- Final Incentive Guidance – Core Principles
 - provide employees incentives that appropriately balance risk and reward;
 - compatible with effective controls and risk-management; and
 - supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.



Regulatory Framework (cont'd)

- **Covered employees include**

- Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
- Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., *traders with large position limits relative to the organization's overall risk tolerance*); and
- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., *loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk*).



Regulatory Framework (cont'd)

- “Incentive Compensation,” Testimony before the House Committee on Financial Services by Scott G. Alvarez, General Counsel Federal Reserve (Sept. 24, 2010)
- Dodd-Frank Act, §956 “Enhanced Compensation Structure Reporting”
 - Proposed Interagency Rule “Incentive-Based Compensation Arrangements” 76 F.R. 21170 (Apr. 14, 2011)



Regulatory Framework (cont'd)

Volcker Rule Affects Distributions

- BHC Act §13(a)(1)(B) prohibits “banking entities” from acquiring or retaining an ownership interest in, or sponsoring a private equity or hedge fund
- §13(g)(2) permits the sale or securitization of loans
- “Hedge fund” and “private equity fund” means a fund that would be an “investment company” but for §§3(c)(1) or 3(c)(7) of the ICA of 1940. Most CLOs rely on these exemptions
- Volcker Regulations adopted in 79 F.R. 5536 (Jan. 31, 2014)
 - CLOs are used to distribute leveraged loans
 - CLOs generally have included junk bonds up to 10% of assets, which are not “permitted securities,” and bring the CLOs within Volcker’s prohibition
 - Volcker Regulations may even include “notes” as ownership interests. *See* Volcker Regs. §____.10(d)(G)(i)



Regulatory Framework (cont'd)

Internal Controls, etc.

- Failure to comply with leveraged loan processes could result in:
 - Internal control weaknesses/deficiencies
 - Misstatement of the ALLL and financial results and condition
 - Regulatory enforcement



Regulatory Framework (cont'd)

VI. Liquidity

- A period of excess liquidity prevailed before the financial crisis, causing liquidity risk to receive comparatively little scrutiny by banks and regulators
- As the crisis developed, banks had insufficient liquidity reserves to meet their obligations and inadequate loss absorbing capital, which created a cycle of decreasing capital ratios and de-leveraging through sales of assets, compounded by mark-to-market accounting
- All of the above and more meant that central banks provided liquidity support and capital support



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards

- A principal feature of Basel III is the introduction of global liquidity standards:
 - The Liquidity Coverage Ratio (“LCR”), a short-term measure, and
 - The Net Stable Funding Ratio, a complementary longer-term measure (“NSFR”)
- The LCR helps ensure that banks hold a defined buffer of high-quality liquid assets to allow self-sufficiency for up to 30 days of stressful conditions and a market downturn
- The NSFR encourages banks to better match the funding characteristics of their assets and liabilities beyond a one-year period



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- The US LCR rule was finalized in 79 Fed Reg 61439 (10/10/14)
- The LCR aims to ensure a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute institution-specific and systemic short-term stress scenario that includes:
 - a significant rating downgrade;
 - partial loss of deposits;
 - loss of unsecured wholesale funding;
 - an increase in secured funding haircuts; and
 - increases in collateral calls



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- LCR Application and Transition
 - The LCR rule applies to banks with more than \$250B in assets or those with at least \$10B in foreign banking assets, and subsidiaries of those large banks with at least \$10B in assets
 - For these institutions, compliance began this year with full compliance expected by 1/1/17
 - Banks with assets between \$50B and \$250B are subject to a less stringent LCR and compliance begins 1/1/16



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- High-Quality Liquid Assets
 - The LCR rule requires banks to hold an adequate amount of unencumbered High-Quality Liquid Assets (“HQLA”) that can be converted easily and quickly into cash
 - Banks are required to demonstrate that their LCR ratio—HQLA divided by total net cash outflows over a specified 30-day stress period—is always greater than 100%
 - The LCR divides eligible assets into buckets—Level 1, Level 2A and Level 2B, a bucket that includes various assets not previously eligible for Level 2, including certain RMBS, corporate debt securities (including commercial paper), and common equity



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- LCR Effects
 - Bank liquidity rules have the desirable goals of both reducing the likelihood of bank runs and increasing the likelihood that banks will survive runs, should they occur
 - However, by increasing banks' incentives to hold HQLA (lower-risk, more liquid assets), such rules could also reduce the supply of loans and increase their cost



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- Potential LCR Effects
 - The American Bankers Association in a public comment letter indicated that the LCR rule could create a shortage of HQLA that could trigger a rush for acquisition of liquid assets and lead to crisis conditions in times of financial stress when demand would likely rise sharply and supply would disappear
 - A Federal Reserve study-in-progress suggests that imposing liquidity rules as envisioned under Basel III (additive to capital rules) would, in the long-run, increase lending rates by 20 basis points and reduce loans made by 5 percent
(http://www.frbsf.org/economic-research/events/2013/january/federal-reserve-day-ahead-financial-markets-institutions/files/Session_2_Paper_2_Covas_Driscoll_regulations.pdf)



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- Regional and community banks that are not subject to the LCR rule may be able to pursue opportunities that are no longer advantageous for their larger competitors such as:
 - Pursuing correspondent banking clients, and
 - Offering higher deposit account interest rates
- Nonbank institutions that have been designated as systemically important by the Financial Stability Oversight Council are not subject to the LCR rule at this time, but the Federal Reserve may issue a rule later and may issue orders covering basic liquidity provisions



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- Federal Reserve Governor Tarullo stated in June that regulatory changes are just one factor driving changes to how bond and other asset markets function
 - “We’ve had significant changes to market structure” and markets may be in a “transitional period, where markets and market actors are still adjusting to all the things that have happened.”
- The Global Financial Markets Association and the Institute for International Finance in August released a report authored by PwC on the state of global market liquidity suggesting that –



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- there are signals that regulation and other market factors are contributing to a reduction in aspects of secondary market liquidity, and
- stakeholders should better understand the link between regulation and market liquidity so that future rules strike the right balance



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- The NSFR released by the Basel Committee in October 2014 would:
 - require banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities
 - limit banks' use of volatile short-term borrowings to fund illiquid assets
- The objective is to reduce maturity mismatches between assets and liabilities and thereby reduce funding and rollover risk



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- The NSFR is designed to work in conjunction with the LCR by restricting banks' ability to fund liquid assets with short-term funding that matures just outside of the 30-day time horizon of the LCR
- Federal Reserve Governor Tarullo has indicated that the US version of the NSFR may be modified before adoption (See <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>)



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- Market pressure is causing banks to adjust their funding profiles to meet the NSFR requirements ahead of the January 2018 implementation date
- Some bank participants in the long-term lending markets have announced reduced operations in this market due to increased costs
 - This impact may be diminished by the entry of banks and/or shadow-banking lenders that are not subject directly to the NSFR or LCR



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

- Federal Reserve Chair Yellen has suggested that because the LCR and NSFR
 - focus on the liquidity positions of individual firms as opposed to the entire financial system;
 - apply only to internationally active banks; and
 - do not address financial stability risks of matched books of securities financing transactions . . .
- The Fed is considering requiring large banking organizations to hold larger amounts of stable funding based on their use of short-term wholesale funding (See <http://www.federalreserve.gov/newsevents/speech/yellen20140415a.htm>)



Regulatory Framework (cont'd)

VII. Basel III Liquidity Standards (cont'd)

What's Next



Regulatory Framework (cont'd)

VIII. Non-Basel Liquidity Guidelines Applicable to Smaller Banks

- OCC Liquidity Handbook
- Interagency Policy Statement on Funding and Liquidity Risk Management, 75 F.R. 13656 (Mar. 22, 2010).



Regulatory Framework (cont'd)

IX. Brokered Deposits – Liquidity and Funding or Threat to Safety and Soundness

- Prompt Corrective Action – Section 131 and FDI Act Section 39
- Brokered Deposits – FDI Act Section 29, and FDIC Regs. 337.6
- “FDIC Study on Core Deposits and Brokered Deposits” (July 8, 2011) mandated by the Dodd-Frank Act, Section 1506
- FDIC Guidance on Identifying, Accepting, and Reporting Brokered Deposits – Frequently Asked Questions (Updated 12/24/2014)