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Guidance Counselors

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On December 3rd, the OCC and FDIC announced they were withdrawing the Leveraged Lending Guidance they (with the Fed) had instituted in 2013. This guidance had been an outgrowth of the GFC which created widespread devaluation of bank balance sheets globally.

Though the proximal cause of the downturn was poor sub-prime mortgage underwriting that spread like wildfire through the banking system, regulators had long identified “risky loans,” i.e. loans with high leverage used in financing private equity buyouts, as a similar threat that needed additional supervision and oversight to protect from systemic risk.

At once controversial, this guidance was softened in 2014 by a list of FAQs that attempted to demonstrate how the new framework would be implemented and what it covered. Then in 2018, under pressure from the Trump Administration, the agencies issued a clarification, saying “guidance” didn’t imply “regulation,” which would have to be approved by Congress.

Instead of, for example, restricting loans above six times leverage (debt as a multiple of Ebitda), banks will “manage leveraged lending exposures consistent with general principles for safe and sound lending.” This allows them, according to the statement, to be more competitive with non-lenders and bring leveraged loans back inside the “regulatory perimeter.”

The media narrative around this news has been to suggest that banks will now be more aggressive about re-entering the leveraged loan business and compete more effectively with direct lenders for leveraged buyout financings. This, the argument goes, will put further pressure on credit spreads and yields and weaken terms and structures.

Why is this not the whole picture? The truth is that banks have had an uncomfortable relationship with leverage loans dating back at least four decades. Bankers of a certain vintage will recall regulators in the late 1980’s calling out “Highly Leveraged Loans” (HLTs). Over the years major banks have built risk/compliance platforms with hundreds of staff on-site, fostering a culture of loan risk oversight and avoidance that won’t change overnight.

The economic model for banks still greatly favors “moving” loans, not “storing” them, earning significant syndication fees from distributing loans, not holding them on behalf of investors.

Does guidance removal impact private credit managers? By virtue of their scale and investment banking focus, banks synch their lending with M&A and bond offerings in public credit. There will be little impact on private credit managers that stick to the traditional middle market.

Interestingly, the agency report referred to banks’ providing leverage for BDCs and credit funds. Loosened restrictions could help improve those structures for top private credit managers. Add to that speed and certainty of execution and terms confirms the attractiveness for private equity firms of using managers whose histories and frameworks are designed specifically for leveraged lending.