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Perspectives on Leveraged Lending

Remarks by

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at

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Good afternoon. I want to thank the organizers of this conference.[1] I am grateful for the opportunity to address this important gathering of professionals in the syndicated credit industry.

My name is Todd Vermilyea. I lead the Risk, Surveillance, and Data sections of the Division of Supervision and Regulation at the Federal Reserve Board. My areas of responsibility include the Shared National Credit program--a key interagency program that reviews and assesses risk in the largest and most complex credits shared by multiple financial institutions.

As you know, the syndicated credit market is approximately $4.5 trillion, of which $1.3 trillion is comprised of leveraged loans. An efficient syndicated credit market is vital to the effective allocation of credit, which in turn helps our economy to grow and prosper. I believe your work is both beneficial and important to our economy.

In my remarks this afternoon, I will expand on trends that supervisors are observing that indicate there may be material loosening of terms and weaknesses in risk management of the leveraged loan market. Some institutions could be taking on risk without the appropriate mitigating controls. In general, supervisors expect regulated institutions to have prudent credit underwriting standards and the appropriate risk management practices.

So, what trends are supervisors observing that are leading us to take a closer look at business and risk management practices in the leveraged finance market? Let me mention three particular areas that we are focused on:

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[1] I should say at the outset that the views expressed in this presentation are my own and do not necessarily represent those of the Federal Reserve Board or the Federal Reserve System.

1. Covenant-lite refers to loans that do not contain financial performance safeguards for the lender, such as specific commitments to maintain financial ratios related to debt service. These types of loans used to be reserved for the highest quality borrowers. Today, "cov-lite" structures are widespread. How cov-lite loans would perform in a downturn is not well understood because data are not available.
2. Similarly, incremental facilities (IFs), which allow additional borrowing that is pari passu, or of equal seniority, with their existing bank loan, often without the consent of the lender, have grown in the marketplace and are now both more widespread and with looser restrictions than in the past. While IFs can provide an economic benefit to borrowers, IFs rarely limit the use of IF-provided proceeds and can be used for non-earnings purposes.
3. And more recently, supervisors and other market watchers have noted growth in "EBITDA add backs," which add back expenses and cost savings to earnings, and could inflate the projected capacity of the borrowers to repay their loans. Additionally, supervisors have noted transactions where borrowers were able to transfer secured collateral beyond the reach of their senior creditor banks that issued the original leveraged loans, a practice known as "collateral stripping."

The risks posed by these various contractual provisions could be mitigated with the appropriate risk management controls. Some of these provisions could even be beneficial to the borrower--and are, presumably, benefits borrowers are willing to pay for--representing opportunities for originating firms. However, the presence of these practices, especially without the appropriate controls, may lead to safety and soundness concerns.

The risks I've outlined here today are areas of supervisory focus. That supervisory focus includes an assessment of risk management practices designed to assess, measure, and monitor the impact of transaction structure on portfolio risk.

Supervisors, including through their work as part of the Shared National Credit program, will continue to assess bank practices on credit underwriting and loan documentation to confirm both are done in a safe-and-sound manner. Additionally, supervisors will aim to ensure that underwriting standards are aligned with risk appetite and that risk management practices are keeping pace with changing market dynamics for loans.

Once again, I want to thank the conference organizers.