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Leveraged Lending Guidance and Enforcement: Moving the Fulcrum

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LEVERAGED LENDING GUIDANCE AND ENFORCEMENT: MOVING THE FULCRUM

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I. INTRODUCTION

While countless articles and commentaries have been published about the causes of the 2008 financial crisis, as well as the appropriateness of governmental responses, the end result has been a heightened concern over the structure, oversight, and stability of the largest financial institutions in the United States.[1] The clearest example of the U.S. Government's response was the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] The Dodd-Frank Act significantly increased regulatory oversight of large banks in an effort to increase stability in the complex and interconnected United States and global financial systems.[3] However, significant changes

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1. One of the most significant regulatory changes promulgated in the Dodd-Frank Wall Street Reform and Consumer Protection Act was the creation of the Financial Stability Oversight Council and the authorization for it to designate certain banks and other financial institutions as "Systemically Important Financial Institutions" or "SIFIs." *See* 12 U.S.C. § 5463 (2012).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of U.S.C.); *see* Helen Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES (July 21, 2010) ("The law subjects more financial companies to federal oversight and regulates many derivatives contracts while creating a consumer protection regulator and a panel to detect risks to the financial system. . . . The law expands federal banking and securities regulation from its focus on banks and public markets, subjecting a wider range of financial companies to government oversight.").

3. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,

within large financial institutions and improved oversight thereof have proven difficult as the diversity, sophistication, and interconnectedness of the modern financial services industry pose increasingly complex regulatory challenges.[4]

In furtherance of implementing the Dodd-Frank Act, bank regulators called for reduced risk in many areas of the financial markets, including leveraged lending.[5] While leveraged lending is difficult to define specifically, it generally encompasses large loans to corporate borrowers for the purposes of "mergers and acquisitions, business recapitalization and financing, equity buyouts, and business . . . expansions."[6] The common attributes of leveraged loans are that they involve greater risk because of the size of the loan relative to the borrower's cash flow and they are generally used to finance one-time business transactions rather than a company's ordinary course of business activities.[7] Such loans obviously increase the amount of debt in a company's capital structure, but therefore can also increase the company's earnings per share or return on equity.[8]

Interagency Guidance first published on March 22, 2013 ("Guidance"), included a general warning against these kinds of loans to borrowers with high leverage ratios or other characteristics that might indicate an inability of the borrowers to repay the loans.[9] The underlying

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124 Stat. 1376 (2010). The Preamble to the Act states its purpose, "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." Id.

4. *See, e.g.*, Henry T. C. Hu, Swaps, *The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 341 (1989) ("There is a social price to be paid for all this financial innovation. Among other things, these new financial products and the underlying process through which they arise and evolve can generate enormous risks of virtually unfathomable complexity for the increasingly interdependent world capital markets."); Steven McNamara, *Informational Failures in Structured Finance and Dodd-Frank's "Improvements to the Regulation of Credit Rating Agencies,"* 17 FORDHAM J. CORP. & FIN. L. 665, 671 (2012) (describing the "spectacular growth in the sophisticated financial products developed on Wall Street over the past 25 years").

5. *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar. 22, 2013).

6. Office of the Comptroller of the Currency, Leveraged Lending: Comptroller's Handbook, 1 (Feb. 2008).

7. *See id.* at 1–3.

8. *Id.*

9. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17772.

rationale for the guidance was to encourage a minimum standard of creditworthiness for commercial borrowers and adequate risk management by commercial banks.[10] These measures, in turn, were intended to improve the creditworthiness and stability of the banks that held the loans and the market for such debt overall.[11]

Commercial banks, however, are not disinterested intermediaries but rather for-profit corporations that must answer to shareholders as well as to government regulators. Participating in leveraged lending can provide banks additional return to their shareholders. As capital market participants, banks impose higher interest rates and fees on less creditworthy and, thus riskier, borrowers. Furthermore, syndicated lending allows commercial banks to act as arrangers by finding other lenders and investors to underwrite the various portions of commercial loans, thus spreading the risk to multiple parties.[12] This means that a bank, if arranging but not underwriting an entire loan, may avoid exposure to both default and counterparty risk while still collecting fees

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> At a minimum, an institutions' underwriting standards should consider . . . borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base cash flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction.

The Guidance was issued jointly by the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation ("FDIC"). Id. at 17766.

10. *See* Douglas Landy et al., *U.S. Bank Regulatory Agencies Issue Final Guidance on Leveraged Lending Practices: High-level Considerations for Financial Institutions*, 28 BUTTERWORTHS J. OF INT'L BANKING AND FIN. L. 333, 333 (2013) [hereinafter BUTTERWORTHS] ("In an effort . . . to address the potential for deteriorating underwriting practices by U.S. financial institutions . . . the U.S. federal bank regulatory agencies have issued final joint guidance for the Financial Institutions that they supervise and which engage in leveraged lending activities.").

11. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17772 ("The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of financial instruments and exacerbate systemic risks within the general economy.").

12. *See* Office of the Comptroller of the Currency, *supra* note 6 ("Syndication of leveraged loans allows originating lenders to serve client needs while at the same time ensuring appropriate risk diversification in their permanent loan portfolios.") The handbook goes on to explain the benefits of syndication to both banks and borrowers. *Id*.

for the arrangement of a leveraged loan.[13] Finally, institutional and other corporate debt investors have developed an increased appetite for higher interest-bearing investments and corporate borrowers have an increasing need for capital.[14] The cumulative effect of these interests creates heightened market pressure on banks to arrange precisely the kinds of leveraged loans that government regulators seek to limit.[15]

This pressure resulted in increased volume of leveraged loan origination from 2009 through 2015.[16] The Shared National Credits Program 2014 Review ("SNC Program" or "2014 SNC Review") highlighted an increase in leveraged loan activity and the growing gap between industry practice and regulator expectations.[17] As leveraged loan commitments totaled approximately $767 billion 2014 and over one trillion dollars in 2015, it is clear that the leveraged loan market is a significant component of the U.S. and global financial systems and plays a pivotal part in the health of such systems.[18] Regulators, therefore, must find more effective ways to reduce the systemic risk posed by the issuance of these high-risk, leveraged commercial loans.

This article analyzes the Guidance issued jointly by the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance

13. *See* Office of the Comptroller of the Currency, *supra* note 6.

14. *See, e.g.*, *Six Years of Low Interest Rates in Search of Some Growth*, THE ECONOMIST (Apr. 6, 2013) ("[I]n their desperate search for yield, investors are rediscovering a worrying appetite for the kind of structured debt products that many had thought had disappeared for good after 2008.").

15. *See* Meredith Coffey, *Considerable Confusion: Syndication Loan Market Sideswiped by Regulation*, ABF JOURNAL, (May/June 2014) ("While banks say that the regulators are pressuring them not to originate or distribute criticized loans, the market appears to be awash with them.").

16. Board of Governors of the Federal Reserve, Federal Deposit Insurance Company, Office of the Comptroller of the Currency, *Shared National Credits Program Review 2014: Leveraged Loan Supplement* 4 (Nov. 2014) [hereinafter *Shared National Credits Program Review* 2014] (noting significant growth in the leveraged loan market year-on-year); Board of Governors of the Federal Reserve, Federal Deposit Insurance Company, Office of the Comptroller of the Currency, *Shared National Credits Program Review 2015* 3 (Nov. 2015) [hereinafter *Shared National Credits Program Review 2015*] (noting a 5.3 percent increase in total SNC commitments to $3.9 trillion, and an 18.5 percent increase in Substandard dollar volume from 2014, largely due to a downturn in the oil and gas industry).

17. *Shared National Credits Program Review 2014*, *supra* note 16 ("The review . . . found serious deficiencies in underwriting standards and risk management of leveraged loans. Overall, the SNC [Shared National Credits] review showed gaps between industry practices and the expectations of safe-and-sound banking articulated in in the 2013 guidance.").

18. *Shared National Credits Program Review 2014*, *supra* note 16.

Corporation ("FDIC"), and the Federal Reserve Board ("Fed") and argues that such external regulation is not the most effective way of reducing risk in the syndicated loan market. Part II analyzes the Guidance itself. Part III looks more closely at recent market trends in leveraged lending. Part IV examines the enforcement tools available to regulators when enforcing the Guidance. Part V considers the syndication of leveraged loans and the emergence of the leveraged loan market as an alternative to high-yield bonds, and draws parallels between the mechanics of loan syndication and the sub-prime mortgage market leading up to the 2008 crisis. Part VI considers how a self-regulatory body might more effectively influence and regulate lending activity by more clearly articulating, monitoring and enforcing regulatory expectations. Part VII concludes

II. LEVERAGED LENDING GUIDANCE

The Guidance responded directly to increasingly risky activity in the leveraged lending market in 2013 and revised existing regulatory guidance.[19] This section describes the Guidance in detail, including the regulators' goals for banks and the particular mechanisms that regulators expected banks to implement in order to meet those goals.

A. Guidance in Context

The overriding concern of regulators is that excessively risky lending will put bank balance sheets at risk, as well as introduce too much risk into the financial system as a whole.[20] The Guidance is fundamentally a statement from bank regulators expressing an expectation that banks change their underwriting and lending practices by arranging and issuing fewer high-risk loans to companies with too much debt.[21] Specifically, the Guidance discourages banks from making

19. On March 22, 2013, Guidance updated and revised a 2001 Guidance, as well as the Comptroller's Handbook for Leveraged Lending, published in 2008. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17768 (Mar. 22, 2013); *see* OCC Bulletin 2001-18; Board SR Letter 01-9, "Interagency Guidance on Leveraged Financing" (Apr. 9, 2001); Comptroller of the Currency, *supra* note 6

20. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17770.

21. *Id.*

"leveraged loans," but provides only a general definition of such loans and ultimately leaves the precise definition of the term to the banks themselves.[22] However, the Guidance does list a number of factors that banks should consider when crafting an internal working definition of leveraged loans and articulating their risk management policies for such lending.[23] Those factors include: (i) a borrower's debt to EBITDA ratio; (ii) covenant levels; (iii) ability of the borrower to amortize its senior secured debt and de-lever its balance sheet; (iv) the expectation of financial support from a deal sponsor and the capacity of such sponsor to fulfill that expectation; (v) the level of due diligence performed in evaluating the loan; and (vi) the level of "reliance on enterprise value and . . . valuation methodologies" employed in evaluating loan repayment.[24]

However, the Guidance also suggests that no one of these factors will automatically trigger regulatory criticism of a loan and that a loan with one or several suspect characteristics might still be appropriate in some circumstances.[25] For example, when higher leverage ratios are the norm in a particular industry, or if there is a well-founded and documented reason to believe that a borrower's income will increase dramatically over the term of the loan, a loan with a higher leverage ratio or a covenant-lite loan may be appropriate.[26] Instead, the Guidance

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22. *Id.* at 17768.

23. *See* David A. Brittenham et al., *What's New: Leveraged Lending Guidance*, 14 DEBEVOISE & PLIMPTON PRIVATE EQUITY REP. 1 (Winter 2014) (noting that the Guidance suggests that the following loan attributes cause regulatory concern: "(1) the borrower's total leverage ratio of debt to EBITDA exceeds 6:1; (2) the borrower would not pay off roughly half of its debt over 5-7 years; (3) typical financial maintenance covenants are not included ("covenant-lite loans"); or (4) the borrower may sell or exchange collateral or cash flow without lender approval.").

24. *See* 78 Fed. at 17772–73. Debt to EBITDA is a measure of a company's debt load divided by its cash flow, as expressed by EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortization); Katherine Arline, *What is EBITDA?*, BUS. NEWS DAILY (Feb. 25, 2015); *See infra* notes 45 through 47.

25. The Guidance states that "[a]t a minimum, an institution's underwriting standards should consider" the above mentioned characteristics, but does not go so far as to state that any loan with these characteristics shall be subject to regulatory criticism. 78 Fed. Reg. at 17772 (Mar. 22, 2013).

26. *See* Interagency Press Release, *Frequently Asked Question (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending* (Nov. 7, 2014) (released as part of the Shared National Credits Report, infra note 60). For further discussion of covenant–lite loans, see Allison Collins, *Loosening Up with Covenant Lite Loans*, AM. BANKER, July 28, 2014 ("The shift back to covenant-lite loans — which eliminate lender protections such as

"set[s] forth in new detail certain expectations with respect to the factors a financial institution must consider in its underwriting process."[27] In short, the Guidance expresses regulators' expectation that banks only underwrite or issue loans to creditworthy borrowers.[28]

B. Outcome and Diligence Focused Approach

Rather than providing clear limits on leveraged loans, the Guidance requires that banks issuing leveraged loans adequately evaluate the creditworthiness of the borrower and the suitability of each loan.[29] This approach is consistent with prior guidance from banking regulators in that it merely requires that banks have systems in place that measure and document the risk profile of each credit.[30] The Guidance does not establish a bright line rule for banks on whether to issue specific kinds of leveraged loans and instead prescribes what risk management policies must achieve rather than what they must avoid.[31]

The Guidance indicates that banks underwriting leveraged loans can avoid regulatory scrutiny and criticism by maintaining thorough records that reflect an objective evaluation of the risk of such loans. Appropriate risk management procedures regarding the issuance of leveraged loans include: (i) clear policies articulating a bank's risk appetite for both the issuance and retention of loans; (ii) valuation standards for borrowers both at the time of issuance and on an ongoing basis throughout the term of the loans; (iii) ongoing management and monitoring of deal flow within a bank in general; (iv) accurate and timely

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restrictions on third party debt and ratios governing leverage and interest coverage — represents a change for banks, which lately have had the upper hand in lending discussions.").

27. Brittenham, *supra* note 23.

28. Brittenham, *supra* note 23.

29. *See* Interagency Press Release, *supra* note 26 (released as part of the Shared National Credits Report, infra note 60) ("Institutions should use the characteristics outlined in the Guidance as a starting point for developing an institution-specific definition of leveraged loans, which takes into account the institution's individual risk management framework and risk appetite."); *see also id.* at 2 ("Q2: Are all loans that meet any one common characteristic, such as exceeding three times senior debt or four times total debt divided by earning before interest, taxes, depreciation, and amortization (EBITDA), automatically considered leveraged? [Answer] No. Leverage is an important indicator, but it should be considered in relation to other loan characteristics.")

30. Comptroller of the Currency, *supra* note 6

31. *See* Interagency Press Release, *supra* note 26.

exposure reporting and analytics; and (v) articulated policies for analyzing sponsors' financial support.[32] In short, banks must have clearly articulated risk monitoring and risk management policies and the decision to underwrite any particular loan must be made within the scope of such policies.

The Guidance requires banks to implement these policies to monitor and control the risk levels of not only the loans that they issue and loan participations that they purchase, but also loans that they underwrite or merely arrange.[33] That is to say that banks have an equal responsibility to independently assess the creditworthiness of a particular credit to a borrower regardless of whether they will maintain the credit on their balance sheet. This requirement reflects a shift in the regulatory framework as it aims to reduce both risk to the lending bank as well as systemic risk to other institutions created by the issuance and syndication of risky loans.[34] Banks are therefore responsible not only for closely monitoring their own exposure to leveraged lending, but also for ensuring that high-risk leveraged loans are not issued and disbursed into the greater financial system.[35]

C. Default Versus Repayment

The Guidance requires banks to primarily consider the likelihood of *default*, rather than the likelihood of *loss*.[36] This is a subtle but important distinction, as lenders to a borrower in default may nevertheless be paid in full if the lenders' loans are senior in the borrower's capital structure, and especially if the lenders are fully secured

32. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17772–75 (Mar. 22, 2013).

33. *See id.* at 17772 ("Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds."); *Id.* ("A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged transactions.").

34. *See* Coffey, *supra* note 15 ("It appears that the Guidance has a dual mandate. The first . . . exists to protect the safety and soundness of the banks. . . . The second mandate is to ensure that "high risk" loans do not go into the system.").

35. *See* Coffey, *supra* note 15.

36. *See* Coffey, *supra* note 15 ("[T]he leveraged and criticized definitions do not seem to look at the expected loss of the bank's position, but rather at the probability that the company might default.").

in an asset based loan.[37] The Guidance's more cautious approach reflects the general purpose to reduce risk to both banks individually and the financial system as a whole. However, the Guidance's design also constricts banks' flexibility in offering loans, even loans that are collateralized and very likely to be repaid.

A common metric for evaluating the creditworthiness of a borrower is its enterprise value.[38] Broadly speaking, evaluating enterprise value is the kind of inquiry in which bankers specialize, as the feasibility and profitability of commercial loans, mergers and acquisitions, and spin-offs all largely depend on what a company is actually worth as a whole. The determination of enterprise value is highly case-specific, and several methods are often used to arrive at a final calculation. For example, the book value of a company is essentially the value of the company's assets minus liabilities on its balance sheet,[39] while other methods look at the earnings per share that a company has been able to produce over a specific period of time and compares those earnings to those of similar businesses.[40] Finally, analysts might consider the liquidation value of the company by valuing solely the company's assets, independent of their use in the business as currently configured.[41] Sometimes a company with multiple business lines may even be worth more if broken up than if it continues as a single entity.[42] The Guidance, however, indicates a general preference for cash flow or income analysis as the valuation method over other valuation methods.[43] The cash flow

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37. *See* Coffey, *supra* note 15 ("Thus, a small, well-structured ABL [Asset Based Loan] loan sitting atop a leveraged capital structure still may be criticized, even though it is a safe loan itself.").

38. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17773 ("Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and (4) estimating the strength of a secondary source of repayment.").

39. *See* Ian H. Giddy, *Methods of Corporate Valuation* (Apr. 10, 2015, 11:25 AM), http://people.stern.nyu.edu/igiddy/valuationmethods.htm.

40. *See id.*

41. Howard Rosen, James Nicholson & Jeff Rodgers, *Going Concern Versus Liquidation Valuations, The Impact On Value Maximization In Insolvency Situations*, FTI CONSULTING INTERNATIONAL ARBITRATION PRACTICE GRP. (Apr. 10, 2015, 11:33 AM), http://www.fticonsulting.com/global2/media/collateral/united-states/going-concern-versus-liquidation-valuations-the-impact-on-value-maximization-in-insolvency-situations.pdf.

42. *See* Giddy, *supra* note 39.

43. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17773 ("Final

analysis is preferable because regulators believe that borrowers should be expected to pay their debts from cash flow, not from the sale of existing assets. Here again, the Guidance seems to emphasize that banks should consider the ability of a borrower to avoid default (not just ultimate loss) and repay the loan exclusively with earnings rather than with proceeds from assets.[44]

Cash flow, however, can be defined in a multiple ways. Modern credit agreements often use earnings before interest, tax, depreciation and amortization expense ("EBITDA") as a proxy for cash flow.[45] More recently, however, the defined term "Adjusted EBITDA" has been introduced as a measure for cash flow and can include add-backs for one-time transactions and expenses.[46] These adjustments to EBITDA should provide a more realistic picture of a borrower's cash flow going forward, but the definition can also be negotiated by the borrower to include add-backs that may artificially increase its cash flow.[47]

D. Pipeline and Information Management

Since banks often commit to funding a leveraged loan before the loan is fully syndicated, at any given time a bank will have outstanding commitments to fund loans without knowing exactly when the loan will

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estimates [of enterprise value] should be based on the method or methods that give supportable and credible result. In many cases, the income method is generally considered the most reliable.").

44. Regulators' preference for the use of discounted cash flow analysis suggests that banks should focus on the borrower's ability to pay back the loan from income, rather than with proceeds from asset sales and other liquidations. See id.

45. Richard Wight, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE 292–93, McGraw-Hill, 2009.

46. *See* Ningzhong Li, *Negotiated Measurement Rules in Debt Contracts,* 48 J. OF ACCT. RES. 1103 (2010); Josef Rashty & John O'Shaughnessy, *Reporting Disclosures Using Non-GAAP Financial Measures*, CPA J. 36, 36–38 (Mar. 2014) (describing various adjustments to EBITDA in the context of SEC required financial reporting).

47. *See* Li, *supra* note 46; Rashty & O'Shaughnessy, *supra* note 46 (describing various adjustments to EBITDA in the context of SEC required financial reporting). Since credit agreements are negotiated contracts, "Adjusted EBITDA" can mean whatever the parties agree it should mean and the borrower may negotiate the inclusion of certain revenues into the calculation without including the commensurate expenses. Furthermore, the borrower and lender might agree that certain one-time transactions will be included in the calculation of Adjusted EBITDA.

be issued.[48] This process creates a "pipeline" of loans at various stages of syndication to which a bank has committed.[49] The Guidance requires banks to thoroughly implement and document a policy for managing its pipeline and credit commitments.[50] For example, banks should place "limits on aggregate pipeline commitments; limits on the amount of loans the institution is willing to retain on its own books . . . and limits on the underwriting risk that will be undertaken for amounts intended for distribution."[51] In addition to considering the "performance of the pipeline against original expectations," banks should also "conduct periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions."[52] While banks monitored their loan pipelines before the Guidance was issued, the Guidance clarified and emphasized regulators' concerns regarding deal flow.

Under the Guidance, banks are also expected to closely monitor risky and leveraged loans individually, including non-performing loans.[53] The Guidance requires banks to have Management Information Systems in place to ensure that managers and directors are adequately informed of credit exposures, including both outstanding credits and those in the pipeline.[54] Again, the Guidance requires banks to accomplish a certain level of monitoring without clearly specifying how banks can demonstrate compliance or otherwise providing a safe harbor for banks.[55] Furthermore, "the [a]gencies do not state whether examinations will emphasize particular statements in the Guidance more than others," or

48. *See* Office of the Comptroller of the Currency, *supra* note 6 (describing the syndication process).

49. For the purposes of the Guidance, the pipeline includes only committed loan underwriting and not "best efforts" deals.

50. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17774 (Mar. 22, 2013); *see* BUTTERWORTHS, supra note 10 at 333. ("The Guidance emphasizes that a Financial Institution should have strong risk management controls over leveraged loan transactions in its pipeline, including loans to be held and distributed, in order to avoid incurring material losses in a market environment where selling down such loans is difficult.").

51. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17774.

52. *Id.*

53. *Id.*

54. *Id.*

55. *See* BUTTERWORTHS, *supra* note 10, at 336 ("The Agencies do not, however, offer clarity regarding the manner in which the Guidance will be expected to be practically applied to, and affect the availability of, credit provided to borrowers by Financial Institutions."); Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17774.

whether the Guidance itself will be the basis of any formal regulatory enforcement actions.[56] While the requirement for some kind of risk management strategy instead of bright line rules defining risky leveraged loans provides issuing banks with greater flexibility to tailor loan products to borrowers in evolving and dynamic market conditions, it also fails to provide predictability regarding regulatory scrutiny, criticism, and enforcement.[57]

III. REGULATORY REMEDIES

As described above, the Guidance sets out risk management expectations in broad terms by describing desired outcomes. Regulators have a variety of tools at their disposal to encourage or require banks to achieve those outcomes and observe safe and sound lending practices. This section provides an overview of ways in which bank regulators initially sought to implement the risk management requirements discussed in the previous section.

A. Loan Ratings

The first consequence of issuing an overly leveraged loan is a poor loan rating assigned by regulators and, potentially, rating agencies.[58] The Guidance indicates that the rating agencies' ratings of a borrower may not always correspond with regulatory ratings of a loan to that borrower.[59] Syndicated loans receive one of five ratings from regulators, which are divided into two classes, adversely classified and not adversely classified. "Pass/satisfactory"[60] and "special mention"[61] loans are not

56. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17774.

57. *See* Coffey, *supra* note 15 ("Despite being more than a year old as of this writing [May 2014], there is still mass confusion around what the Leveraged Lending Guidance is supposed to do.").

58. *See* Coffey, *supra* note 15.

59. *See* BUTTERWORTHS, *supra* note 10, at 333 ("Notably, borrowers do not appear to be considered investment-grade by virtue of the ratings assigned to them by credit rating agencies . . . [I]t is possible that investment-grade ratings issued to borrowers by credit rating agencies are overridden by such tests in the Guidance.").

60. *See Shared National Credits Program Review 2014*, *supra* note 16, at 6 ("Pass – A credit that is in good standing and is not criticized in any way.").

61. *Id.* ("Special mention assets have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses could result in further

adversely classified, while loans rated "substandard,"[62] "doubtful,"[63] or "loss"[64] are adversely classified. A "criticized" loan is any loan that is not rated "pass."[65] While a single criticized or classified loan may not have serious repercussions for a bank that underwrites or arranges many loans, the Guidance makes clear that issuing such loans is not advisable.[66]

B. Informal and Formal Regulatory Measures

At the institutional level, the various bank regulators have several monitoring, compliance, and enforcement tools at their disposal. Regulators are expected to communicate frequently with a bank, both formally and informally, during the bank's examination process.[67] When bank examiners have concerns regarding a bank's risk profile, those concerns must be expressed formally and in writing as "matters requiring attention" or "MRA"s.[68] Examiners label more serious concerns found

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deterioration of the repayment prospects, or in the institutions' credit position in the future. Special mention assets are not adversely rated and do not expose institutions to sufficient risk to warrant adverse rating.").

62. *Id.* ("Loans classified Substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected."); *see also*, FDIC, "How Do Examiners Assign Loan Classifications on Your Examination?" 2012 New York Region Directors College Monroeville, PA, at slide 4, available at https://www.fdic.gov/regulations/resources/director/college/ny/materials/2012-loans.pdf.

63. *Shared National Credits Program Review 2014*, *supra* note 16, at 6 ("Doubtful assets have all of the weaknesses inherent in those classified substandard and when the weaknesses make collection or liquidation in full, on the basis of currently known information, highly questionable and improbable.").

64. *Shared National Credits Program Review 2014*, *supra* note 16, at 6 ("Assets classified as Loss are uncollectible and of such little value that their continuance as a bankable asset is not warranted. Amounts classified as loss should be promptly charged off. This classification does note that there is no recovery or salvage value, but rather that it is not practical or desirable to defer writing off these assets even though some value may be recovered in the future.").

65. *Shared National Credits Program Review 2014*, *supra* note 16, at 6 ("Criticized assets include all assets rated special mention, substandard, doubtful, and loss.").

66. *See supra* notes 9 through 11, and accompanying text.

67. *See* Office of the Comptroller of the Currency, *Comptroller's Handbook: Bank Supervision Process* 32 (Jan. 2010) ("Communication should be ongoing throughout the supervision process and must be tailored to a bank's structure and dynamics.").

68. *See id.* at 100 ("Examiners shall describe the practices that resulted in the concerns, as well as the board's or management's commitment to corrective action, in "Matters

during an examination as "matters requiring immediate attention" or "MRIAs."[69] For instance, Credit Suisse received an MRIA in July 2014 warning that its underwriting standards did not meet regulators' expectations.[70] Reports indicate that other banks have received MRA letters regarding leveraged lending activities.[71] The Credit Suisse letter was intended as a clear message not only to Credit Suisse, but to the entire industry that the Guidance should be taken seriously and that banks should change certain facets of their lending practices.[72] As one observer noted, "[t]he timing of the news - which coincided with Credit Suisse's annual leveraged finance conference in Florida - also raised eyebrows and led many to conclude that regulators wanted to make an example of the bank and cause it as much embarrassment as possible."[73] Thus, the Credit Suisse letter was an informal enforcement action well-calculated to send a clear message not just to Credit Suisse, but to makers of leveraged loans more generally.[74]

Regulators may also employ more serious formal enforcement tools.[75] Generally, banks that promptly take appropriate measures to respond to MRAs or MRIAs will not face formal enforcement actions,

Requiring Attention" (MRA) in the ROE or in other periodic formal written communication." *Id.* at 32.); Office of the Comptroller of the Currency, *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution* 24 (Jan. 2001) ("MRAs should address bank practices that 'deviate from sound fundamental principles and are likely to result in financial deterioration if not addressed,' or that 'result in substantive noncompliance with laws.'") (internal citations omitted); Ryan Tracy, *Feds Win Fight Over Risky-Looking Loans*, WALL ST. J. (Dec. 2, 2015) ("Starting in late summer [2013], roughly a dozen big banks received a Matters Requiring Attention letter from the OCC and Fed . . . Regulators 'came down and started auditing for [lax and inadequate application of the leveraged loan guidelines] – and I mean auditing hard, every one of us').

69. *See* Gillian Tan & Ryan Racy, *Credit Suisse Loans Draw Fed Scrutiny*, WALL ST. J. (Sept. 16, 2014).

70. *Id.*

71. *See id.*; Tessa Walsh & Natalie Harrison, R*LPC-IFR-Lenders Cowed by Fed Rebuke on US Leveraged Loans*, REUTERS (Sept. 30, 2014) ("Although no other banks received MRIA letters at the same time as Credit Suisse in July, other Fed-regulated banks also received less pressing 'Matters Requiring Attention' letters at the same time, two loan bankers said. 'Other banks have got letters. The reason that Credit Suisse drew comment is that they were asked to do something urgently,' the loan syndicate head said.").

72. Natalie Harrison et al., *Fed Slaps Credit Suisse for Risky Lending*, REUTERS (Sept. 22, 2014).

73. *Id.*

74. *Id.*

75. *See* Donald R. Glancz & Meredith Boylan, *Overview of Federal Bank Enforcement Actions*, VENABLE LLP (2012).

but this is not always the case.[76] Formal enforcement actions that may pertain to leveraged lending include cease and desist orders, formal written agreements under U.S. federal law, and Prompt Corrective Action Directives.[77] To date, no formal enforcement actions have been reported that specifically target any single bank's leveraged lending practices.[78]

C. CAMELS Ratings

More broadly, a bank's leveraged lending activities can have a substantial impact on a bank's CAMELS rating.[79] Regulators assess a bank's safety and soundness on a five-point scale, with a score of one reflecting "sound in every respect" and five meaning "extremely unsafe and unsound."[80] Banks receive a score of one to five in each of six categories: "capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk" (thus, "CAMELS").[81] Finally, "[c]omposite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance."[82]

Noncompliance with the Leveraged Lending Guidance may

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76. *Id.*; *see* OCC PPM 5310-3 at 8 (Sept. 9, 2011).

77. A PCA Directive would likely only be appropriate if a bank was undercapitalized and seems a disproportionate response to merely issuing overly-leveraged loans. See Comptroller of Currency. OCC 2011-37 and PPM 5310-3 (REV) at 5 (Sept. 9, 2011).

> PCA actions are triggered by a bank's capital category as defined in 12 USC 1831o, 12 CFR 6, and 12 CFR 165 Depending on a bank's PCA capital category, certain restrictions and actions are automatically imposed by operation of law. Discretionary PCA actions include the issuance of directives that impose actions or restrictions permitted or otherwise required under 12 USC 1831o, 12 CFR 6, and 12 CFR 165. Except in rare instances, the OCC provides prior notice of intent to issue a PCA directive. Unlike some other enforcement actions, there is no provision for an administrative hearing prior to the issuance of PCA directives.

78. *See* Walsh & Harrison, *supra* note 71. The fact that the MRIA letter received by Credit Suisse came as such a shock to market participants suggests that no more serious action has yet been taken by regulators. *See* Harrison, *supra* note 70 ("This [letter to Credit Suisse] is the first evidence in the market. It will absolutely have an effect. All risk managers will say 'thank God it's not us, and let's look at it to make sure we're not in the public eye'.").

79. Uniform Financial Institutions Rating System 62 Fed. Reg. 752, 753 (Jan. 6, 1997).

80. *Id.*

81. *Id.*

82. *Id.*

affect a bank's CAMELS rating in several ways. First, when a bank holds portions of leveraged loans that it has underwritten, or when a bank purchases leveraged loan participations, the quality of those assets will be directly reflected in the bank's asset quality score.[83] In fact, one of the key factors in assessing asset quality is the "adequacy of underwriting standards," which is the precise focus of the Guidance.[84] Criticized loans are so rated, because they are considered poor quality assets.[85] What the Guidance leaves ambiguous, however, is what amount of criticized loans might impact a bank's asset quality score, as the Guidance includes very few concrete metrics.[86]

The Guidance does note that lenders should consider the ability of borrowers to make payments on time even during an economic downturn, which speaks specifically to the assessment of market risk over the life of the loan.[87] While, for example, a leverage level of 6X as measured by debt to EBITDA triggers increased scrutiny, the Guidance's actual requirements are difficult to define concretely.[88] There are no guarantees that a bank's normal and downside projections will be consistent with regulators' projections at the time of examination as market conditions can change rapidly, and small quantitative differences in assumptions can lead to very different projections over a five to seven year period.[89] Thus, while a bank's leveraged loan exposure can be a

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83. *See id.* at 754 ("The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions.").

84. *Id.* ("The asset quality of a financial institution is rated based upon . . . assessment of the following evaluation factors: The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices. . .").

85. *See supra* notes 58 through 66, and accompanying text.

86. The Guidance and accompanying FAQ make clear that debt to EBITDA ratios of 6X and greater will automatically draw increased regulatory scrutiny, as will the inability of a borrower to amortize 50 percent of a loan within seven years, but carrying a marginal volume of such loans, on its own, will not cause a bank's asset quality score to drop. *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766, 17772–73 (Mar. 22, 2013).

87. *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg at 17773 ("Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections.").

88. *See supra* notes 30, 53 through 57, and accompanying text. While the Guidance does require banks to model downside scenarios, it does not include parameters for creating such models. Interagency Guidance on Leveraged Lending 78 Fed. Reg. at 17774.

89. *See supra* notes 30, 53 through 57, and accompanying text.

significant part of its overall risk exposure, the Guidance leaves it to each bank to develop its own policies for managing this exposure, while only providing abstract parameters for what those policies must achieve.

For example, the Guidance goes to great lengths in describing the management requirements for banks engaged in leveraged lending.[90] As discussed earlier, it requires that institutions have Management Information Systems to ensure that managers have all the necessary information to adequately monitor the institutions' leveraged lending exposures.[91] Thus, the management component of an institution's CAMELS rating is the most appropriate area for regulators to reflect a bank's compliance or noncompliance with this aspect of the Guidance.

Leveraged lending can also impact a bank's liquidity, because even a relatively small decrease in the cash flow of a heavily leveraged borrower can seriously affect its ability to make debt service payments on time. In an economy-wide slowdown, this can potentially put a bank in a serious capital or liquidity situation. This fact became abundantly clear during the 2008 financial crisis as the uptick in mortgage defaults sent ripple effects throughout the financial system.[92] Therefore, the extent of a bank's participation in the leveraged lending market can significantly impact its liquidity score in its CAMELS rating. The Guidance requires that banks have "[w]ritten policies and procedures for defining and managing distribution failures and 'hung' deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing)."[93] Inadequate pipeline management resulting in either too many hung deals or simply

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90. *See supra* notes 30, 53 through 57, and accompanying text. Each section of the Guidance outlines the diligence and management requirements for institutions arranging and underwriting leveraged loans. For example, "A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors." *Id*. at 17774.

91. *See supra* notes 48 through 52, and accompanying text.

92. *See* William W. Land & Julapa A. Jagtiani, *The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance*, 38 ATL. ECON. J. 295, 296–305 (describing first phase of the Financial Crisis and noting, with the respect to financial institutions investment in Residential Mortgage-backed Securities, "[w]ith this market collapsing and because of doubts about counterparties' creditworthiness due to large but unquantified exposure to the mortgage market, many large financial firms faced a severe liquidity squeeze that threatened their survival.").

93. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. at 17773.

committing financing for too many deals could also certainly affect a bank's liquidity rating.

While the Guidance does not have the force and effect of agency regulation, let alone a statutory mandate, not complying with the Guidance can have a wide range of consequences for banks. Banks have already seen regulators take informal measures during their CAMELS rating examinations, including the MRIA letter to Credit Suisse.[94] As of January 2016, it appears unlikely that any formal enforcement action, such as a cease and desist order, will result from issuing criticized loans.[95] Bank regulators appear to generally approve of the most recent changes in underwriting standards.[96] However, issuing loans that warrant regulatory criticism can still adversely affect a bank's CAMELS rating in several ways ranging from lower CAMELS scores to MRIA or MRA letters. While these are regarded as effective regulatory remedies to ensure compliance, the opacity of the Guidance's requirements poses a challenge to implementation.

IV. EFFECTIVENESS OF THE GUIDANCE

Despite the fact that regulators have a myriad of regulatory tools at their disposal to implement the Guidance, it took nearly two years for the volume of leveraged loans and average leverage ratios to drop in the syndicated loan market, and regulators continue to express concern about leveraged lending practices generally. The Guidance, although issued in March 2013, generally had little impact on bank lending practices until late 2014,[97] and after a brief correction in 2015 there is renewed concern

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94. *See* Tan & Racy, *supra* note 69; Walsh & Harrison, *supra* note 71.

95. The reaction to the Credit Suisse MRIA letter suggests that it was considered a dramatic step. *Id.* Still, the SNC Leveraged Loan Supplement suggests that regulators will be looking more closely at banks' leveraged lending activity. *See* Shared National Credits Program Review 2014, *supra* note 16 ("The agencies believe that an institution unwilling or unable to implement strong risk management processes will incur significant risks and should cease their participation in this type of lending until their processes improve sufficiently. As a result of the recent SNC leveraged lending findings, supervisors will increase the frequency of reviews around this business line to ensure risks are well understood and well controlled.")

96. *Shared National Credits Program Review 2015, supra* note 16, at 3 ("Examiners noted improved compliance with underwriting expectations with regard to the 2013 leveraged lending guidance and subsequent frequently asked question documents. However, gaps between industry practices and the guidance remain."

97. *See, e.g.*, Sean Jones, *U.S. Bank Regulators to Enforce Stricter Discipline on*

regarding underwriting standards.[98] This section takes a closer look at how individual banks and the market as a whole have responded to the Guidance since its issuance.

A. *Inconsistent Application of Guidance By Different Regulators*

Since the Guidance did not provide bright line rules defining, prohibiting, or even classifying leveraged loans, many banks struggled to understand and implement the Guidance,[99] and leveraged lending continued to grow well into 2014.[100] In addition, enforcement of the Guidance was uneven across the various bank regulators. According to industry insiders, "the OCC . . . more frequently contact[ed] banks about the issue and . . . OCC-regulated banks also received more verbal warnings as well as official letters demanding fixes than banks that are regulated just by the Fed."[101] It seemed, for a time, that leveraged lenders might exploit agency differences in implementation through regulatory arbitrage and take advantage of the Fed's more lax enforcement.[102] Finally, the lack of clarity may have led many banks to decline making loans that may have been appropriate, thus pushing borrowers toward less regulated non-bank lenders.[103] As a result, some leveraged lending may have moved into other sectors of the financial markets like "shadow

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Leveraged Lending, MOODY'S INVESTOR SERVICE (Aug. 12, 2014) ("There is no sign yet of a reversal in the general trend towards weaker covenants, larger credit lines, narrower pricing and other indications of slacker underwriting . . .").

98. *See* Craig Torres & Nabila Ahmad, *Wall Street Listens as Fed Wards on Risky Loans*, BLOOMBERG (Feb. 19, 2015); *Shared National Credits Program Review 2015*, *supra* note 16, at 3 (Nov. 2015); Sridhar Natarajan, *Wall Street Regulators Said to Step Up Leveraged-Loan Focus*, BLOOMBERG (Nov. 20, 2015).

99. *See* Coffey, *supra* note 15; Kristen Haunss, *Fed Said to Work with OCC to Clarify Leveraged-Loan Guidance*, BLOOMBERG (Mar. 12, 2014).

100. *See* Gillian Tan, *Debt Rises in Leveraged Buyouts Despite Warnings*, THE WALL ST. J. (May 20, 2014) ("Wall Street banks are financing more private-equity takeovers with higher levels of debt, despite warnings by regulators to reduce the amount of risky loans they make.")

101. Lauren LaCapra & Greg Roumeliotis, *Update 1 -Insight- Fed, OCC Differ in Enforcing Leveraged Lending Guidelines*, THOMSON REUTERS (Apr. 25, 2014).

102. *See id.* ("Some sources said that it could create conditions that could eventually push risky lending entirely out of the regulated banking sector and into the lightly-regulated realm of shadow banking, consisting of firms such as private equity and hedge funds.")

103. *See* Tom Braithwaite et al., *Leveraged Loan Crackdown Drives Borrowers to 'Shadow Banks,'* FIN. TIMES (Apr. 29, 2014); *see also* Kelly Thompson, *Leveraged Loans: Banks' Share of Middle Market Pie Shrinks Further in 2013*, FORBES (Jan. 29, 2014).

banks" including Jeffries and other financial institutions not subject to the same regulatory oversight as nationally or state chartered banks.[104] While such a shift would reduce leveraged lending risk to chartered banks, it would also entail reduced regulation of the market as a whole, at least by bank regulators.[105]

One indication of the confusion caused by the Guidance is the number of client alerts published by Wall Street law firms, which as of January 2016 include no less than five devoted entirely to the Guidance.[106] Anecdotal evidence suggests that bank managers and directors continued to ask counsel to review the application of the Guidance as late as July 2014, over a year after its publication.[107] *The Wall Street Journal*, *Bloomberg*, *Reuters*, and other news outlets also published numerous articles and commentaries on the meaning and significance of the Guidance.[108]

B. Shared National Credits Review: A Report Card For Leveraged Lending

The clearest indication of the Guidance's effectiveness, however, is the number and volume of leveraged loans issued by banks. An examination of the 2014 Shared National Credits Review ("2014

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104. *See* Walsh & Harrison, *supra* note 71 (referring to the tightening of credit and noting that "[t]his could force some borrowers into the shadow banking market."). Jefferies, for example, is a pure investment bank and not a commercial bank, and therefore largely regulated by the SEC and not the Fed, OCC or FDIC.

105. *See* Walsh & Harrison, *supra* note 71.

106. *See* Bank Regulators *Issue Guidance on Leveraged Lending*, CAHILL GORDON & REINDEL LLP (Apr. 12, 2012); David A. Brittenham et al., *What's New: Leveraged Lending Guidance*, 14 DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT No. 1 (2014); *Federal Banking Agencies Revamp Guidance on Leveraged Lending*, SIMPSON THATCHER & BARTLETT, LLP (Mar. 27, 2013); David C. Reamer et al., *Bank Regulators Eye Leveraged Lending*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (Jan. 16, 2014) Cephas, Derrick and Dimia Fogam, *Bank Regulators Tackle Leveraged Lending*, WEIL FINANCIAL REGULATORY REFORM CENTER (Mar. 2013).

107. At one firm, additional research into the Guidance was assigned as a project to summer associates as late as July 2014.

108. *See, e.g.*, Pedro Nicolaci de *Costa, Fed Wants Better Compliance on Leveraged Loan Guidelines, Report Says*, WALL ST. J., (July 15, 2014); Haunss, *supra* note 99; Coffey, *supra* note 15; Greg Roumeliotis, *U.S. Fed Warns of More Bank Scrutiny Over Leveraged Lending*, THOMSON REUTERS (May 13, 2014).

Review"), a thorough annual analysis of outstanding credits, published by the Fed, the FDIC, and the OCC, revealed that leveraged lending continued to grow in the year following publication of the Guidance.[109] The 2014 Review noted that the deficiencies in underwriting and risk management standards, implementation, and controls persisted in the leveraged lending market, and that the volume of higher risk loans had increased substantially and continuously since 2009.[110] Part 33 of the 2014 Review concisely summarized the trends in syndicated loan underwriting:

> The SNC examination noted weak underwriting standards in 31 percent of the loan transactions sampled. This percentage compared unfavorably to 2012, 2011, 2010 and 2009 percentages of 24 percent, 19 percent, 16 percent and 13 percent, respectively. Leveraged lending transactions were the primary driver of this deterioration. The most frequently cited underwriting deficiencies . . . were minimal or no loan covenants, liberal repayment terms, repayment dependent on refinancing, and inadequate collateral valuations. The weak underwriting structures were in part attributable to aggressive competition and market liquidity.[111]

The 2014 Review even included a "Leveraged Loan Supplement" ("Supplement"), as regulators paid particular attention to leveraged loans in the 2014 SNC Review specifically to measure the effectiveness of the

109. *Shared National Credits Program Review 2014*, *supra* note 16, at 4–5; *see also* Joint Press Release by the Board of Governors of the Federal Reserve, Federal Deposit Insurance Company, Office of the Comptroller of the Currency, *Credit Risk in the Shared National Credits Portfolio is High; Leveraged Lending Remains a Concern* (Nov. 17, 2014) (noting "serious deficiencies in underwriting standards and risk management of leveraged loans.").

110. *Shared National Credits Program Review 2014*, *supra* note 16, at 4. Note that while the SNC Review does not specifically define the term, "syndicated loans" generally refers to loans underwritten by multiple banks, while "leveraged loans" refers to a subset of syndicated loans that are considered more risky due to the debt burden on the borrower. *See* LEVERAGEDLOAN.COM, http://www.leveragedloan.com/primer/#!how-are-loans-syndicated (last visited Apr. 10, 2015).

111. *Shared National Credits Program Review 2014*, *supra* note 16, at 9. The Review also includes a more detailed chart of classified and criticized loan percentages from 1989 to 2014 at page 10.

2013 Guidance.[112] Bank regulators concluded that the Guidance had not been fully heeded and expressed concern at the level of risk persisting in the leveraged loan market.[113] The Supplement concluded that banks had merely reduced interest rates and extended maturities to accommodate overly-leveraged borrowers. This meant that banks were receiving reduced returns on higher-risk loans, although these measures did ease the debt burden on borrowers, making default less likely only for the short term..[114] Instead, regulators would have preferred to see banks take more substantive steps to require or assist borrowers in de-levering their balance sheets.[115] These might include "implementation of new covenants or tightening existing covenants; equity injections; line reduction; step-ups to a term loan A structure with increased amortization; the addition of collateral; [and] restrictions on new acquisitions or issuance of additional debt."[116] The Supplement also noted that banks should more diligently document their efforts to support the credits they issue.[117]

Finally, the quantitative analysis in the 2014 SNC Review and the Supplement showed continued growth in the leveraged loan market, and particularly in more leveraged and risky credits.[118] "[O]nly 77 percent of borrowers are projected to repay 50 percent of total debt within seven years, compared to 83 percent prior to June 1, 2013. . . [and] 15 percent of [leveraged loan] transactions showed leverage in excess of 8.0X."[119] The final paragraph of the Supplement noted that the increasing volume

112. *Shared National Credits Program Review 2014*, *supra* note 16, at 9.

113. *Shared National Credits Program Review 2014*, *supra* note 16, at 6 ("While institutions have formally addressed many of the risk management issues noted in the guidance, execution and full implementation has not been achieved.").

114. *Shared National Credits Program Review 2014*, *supra* note 16, at 5 ("Steps taken by institutions to strengthen non-pass credits were generally limited to a reduction in interest rate or an extension of maturity, which are insufficient for meeting supervisors' expectations for such credits.").

115. *Shared National Credits Program Review 2014*, *supra* note 16, at 5 ("The agencies expect a strategy that actively pursues and executes meaningful improvements in structure or controls during the refinancing of a non-pass borrower.")

116. *Shared National Credits Program Review 2014*, *supra* note 16, at 5.

117. *Shared National Credits Program Review 2014*, *supra* note 16, at 5 ("[E]xaminers noted that institutions frequently did not identify and document efforts to strengthen these [special mention] credits.").

118. *See Shared National Credits Program Review 2014*, *supra* note 16, at 6–7.

119. *See Shared National Credits Program Review 2014*, *supra* note 16, at 6–7.

of poor quality loans increased systemic risk in credit markets as a whole,[120] and regulators indicated that they would step up their monitoring efforts in leveraged lending and might even try to prevent institutions from participating in the market if they did not meet the expectations outlined in the Guidance.[121]

It was unsurprising that the 2014 SNC Review finally clarified the Guidance. As Meredith Coffey of the Loan Syndications and Trading Association ("LSTA") pointed out in May of 2014, over a year after the Guidance was issued:

> [M]ost market participants say that the banks need to go through another SNC exam to determine just how much they are punished for underwriting or holding criticized loans. Once that cycle has ended in summer 2014, the market may have more clarity on just what is expected from the Leveraged Lending Guidance.[122]

This perspective reflects not only the lack of clarity regarding regulators' expectations for implementation of the Guidance, but also a sense that market participants still needed to know what was at stake for noncompliance.

The 2014 SNC Review provided a report card of sorts for the leveraged lending market, and banks have since responded by reducing leveraged lending to comply with the Guidance.[123] During the fourth quarter of 2014, "[d]ebt levels for companies funding takeovers in the leveraged-loan market fell . . . for only the second time since 2012."[124] In the first quarter of 2015, the leveraged loan market was down 69

120. *See Shared National Credits Program Review 2014*, *supra* note 16, at 7.

121. *See Shared National Credits Program Review 2014*, *supra* note 16, at 7 ("The agencies believe that an institution unwilling or unable to implement strong risk management processes will incur significant risks and should cease their participation in this type of lending until their processes improve sufficiently. As a result of the recent SNC leveraged lending findings, supervisors will increase the frequency of reviews around his business line to ensure risks are well understood and well controlled.").

122. Coffey, *supra* note 15.

123. *See* Matthew Heller, *Leveraged Lending Pullback Tied to Regulatory Scrutiny*, CFO (Oct. 23, 2014) http://ww2.cfo.com/credit/2014/10/leveraged-lending-pullback-tied-regulatory-scrutiny/.

124. *Id*.

percent from 2014, and the drop has been at least partially attributed to the Guidance.[125] Standard & Poor's also noted that the average debt-to-EBITDA ratio for large leveraged buyouts dropped below the 6X threshold, from a high of 6.3X in September 2014 to 5.6X in March 2015.[126] Thus, although it took over 18 months from the publication of the Guidance, it appeared that the Guidance was beginning to effectively moderate banks' leveraged lending activities and perhaps even improve the quality of commercial credit and thus moderate risk in the financial system as a whole.

The more recent Shared National Credits Program 2015 Review ("2015 SNC Review") presented only marginally improved market conditions, noting "36.1 percent of leveraged transactions originated within the past year exhibited structures that were cited as weak by examiners."[127] The 2015 SNC Review included a smaller cross-section of the leveraged lending market and noted that while underwriting standards seemed to improve in the latter half of the year, many of the same troubling characteristics of leveraged loans have continued to persist, including borrowers' inability to de-lever and reduce financial covenants.[128] Incremental facilities and other "accordion features" which contemplate additional post-closing borrowings were also a principal concern, though much of the report is devoted to challenges facing the oil and gas sector due to dramatic drop in oil prices following years of rapid expansion in the industry.[129]

Following the 2015 SNC Review, federal regulators have renewed their focus on leveraged lending, which suggests that the Guidance and other regulatory measures have failed to adequately

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125. Christine Idzelis, *Leveraged-Loan Sales Slump To Worst Since 2010 on Fed Scrutiny*, [2015] BANKING DAILY (BNA) NO. 67 (Apr. 8, 2015).

126. *Id*.

127. *Shared National Credits Program Review 2015*, *supra* note 16, at 3.

128. *Shared National Credits Program Review 2015*, *supra* note 16, at 9.

129. *Shared National Credits Program Review 2015*, *supra* note 16, at 9 ("Incremental facilities have been included in loan agreements for a number of years, but are drawing attention because of their increased usage in conjunction with relaxation of other structural elements such as covenants and restricted payments."); *Id.* at 10 (noting challenges that oil and gas companies face and that "the significant decreases in [oil and gas] market prices have impaired many [oil and gas] companies' ability to pay interest and principal, and has led to some defaults.")

improve underwriting standards.[130] Regulators now plan to conduct the Shared National Credits Review biannually, instead of annually, and several major commercial banks are already facing renewed scrutiny of their leveraged lending and underwriting practices.[131] In addition, some signs indicate that the market itself is losing its appetite for riskier loans.[132] This suggests that even if bank underwriting standards improve going forward, it will be due to market pressure, rather than regulatory cajoling.

V. SYNDICATION ISSUES

The commercial banking and financial services industry has evolved in a number of ways over the last several decades and syndicated lending is just one example of innovation in the industry. This section describes the convergence of syndicated lending and high-yield bond products and goes on to describe the market conditions that have driven this evolution. Finally, the section describes some parallels between syndicated lending and the sub-prime lending markets.

A. Convergence of Bond and Credit Agreement Structures

Banks generally syndicate large leveraged loans, meaning the loans are underwritten and held by multiple banks and investors rather than issued and held exclusively by the arranging bank or banks. This has several important implications in today's economic climate and interconnected financial market structure. Over the last two decades, non-banks have started to play a much more significant role in the syndicated lending market.[133] Non-banks can participate in both the initial syndicate of lenders and purchase participations in a syndicated loan from an initial lender.[134] Furthermore, banks and other financial institutions can buy and

130. Natarajan, *supra* note 98 (describing trends in the leveraged lending market from 2009 to Q3 of 2015).

131. Natarajan, *supra* note 98.

132. *See* Natarajan, *supra* note 98 (noting that "a group of lenders led by Bank of America Corp. and Morgan Stanley postponed a $5.5 billion debt package backing the biggest leveraged buyout of the year after struggling to sell the debt to investors.").

133. Wight, *supra* note 45.

134. *See generally*, Loan Syndication and Trading Association website:

sell participations in syndicated loans on a fairly active market.[135] Thus, the syndicated loan market has begun to resemble the corporate bond market and leveraged lending has become an alternative to high-yield bond issuance.

Similarly, the documentation and features of many syndicated loans, specifically term loans,[136] has begun to resemble high-yield bond indentures.[137] For example, borrowers began negotiating more flexible lender protections through mechanisms like "baskets," which allow certain uses of cash flow or additional debt, dividend payments by the borrower, and the designation of unrestricted subsidiaries (subsidiaries which are not obligors under the loan documents).[138] Credit Agreements have become more heavily negotiated contracts, like bond indentures, and in some ways the primary difference between high-yield bonds and leveraged loans is merely that bonds trade in much smaller denominations and are therefore more liquid. Over time, the increased participation of non-bank entities on the lender side of the syndicated lending market has both increased lender-side demand for the instruments while also eroding lender protections, which has also caused a convergence in terms for bank and bond debt.[139]

B. Low Interest Rates Have Driven Investors into Riskier Investments

In the aftermath of the 2008 financial crisis, interest rates remained at or near historic lows for over six years with the Fed announcing only a one quarter of a percent increase above the near-zero Federal Funds Rate on December 16, 2016.[140] With only modest growth

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http://www.lsta.org/about (last visited Nov. 17, 2015) (the LSTA's website includes a wealth of current information regarding the U.S. syndicated loan market)

135. *Id*.

136. Wight, *supra* note 45, at 7–8. Syndicated loans take many forms, from revolving credits that function much like a corporate credit card to amortizing term loans (historically "tranche A" loans). *Id*. Historically, non-banks have invested in "tranche B" loans with feautres like nominal amortization and longer maturity. *Id*.

137. *See, e.g.*, Maura O'Sullivan and Benjamin Cheng, TERM LOANS AND HIGH YIELD BONDS: TRACKING THE CONVERGENCE, Practical Law 60, 62–63 (July/Aug. 2012).

138. *Id*.

139. *See id*.; Wight, *supra* note 45, at 7–8.

140. *See, e.g.*, John Carney, *The Fed's Rate Increase: A New Test Looms*, WALL ST. J.

in the U.S. economy and anemic growth and recession fears elsewhere in the world, the Fed still seems hesitant to raise interest rates dramatically following the December 2015 increase.[141] Low interest rates generally encourage individuals and businesses to invest, as low yields on bank deposits discourage saving.[142] However, "[e]xcessively low rates help to create bubbles because they allow investors to ignore the cost of financing and concentrate on the capital gains if their strategy works; they let people forget risk and focus too much on reward."[143]

The extended period of low interest rates has resulted in concentrated risk in a lower range of rates of return.[144] For example, *The Economist* noted in 2013 that "[c]ompanies with a junk-bond rating are able to borrow at a rate that is four percentage points below the post-2000 average, according to Citigroup . . . whereas a typical investment-grade company, ranked A, can borrow at 2.4% compared with an historical norm of 5.1%."[145] Investors, particularly large institutional investors like public and private pension funds that must keep pace with their pensioners' entitlements, must meet target rates of return that necessarily reflect more risky today than ten years ago. Thus, while an investor could hit its target rate of return in A-rated debt in 2004, that investor must now invest in lower-rated (and thus riskier) debt to make the same return.

C. Parallels With the Subprime Mortgage Crisis

Today banks are acting, as they always have, as intermediaries between parties that have liquid capital and those that need liquid capital. As arrangers of syndicated loans, banks are able to match institutional investors with corporate borrowers in need of financing. In the extended period of low interest rates, however, *both* corporate borrowers *and* institutional investors are clamoring for more loans—investors because

(Dec. 16, 2015); *Six Years of Low Interest Rates*, *supra* note 14.

141. *See* Jon Hilsenrath & Ben Leubsdorf, *Fed Divided on June Rate Increase, but Soft Data May Prove Deciding Factor*, WALL ST. J. (Apr. 8, 2015) ("While 'several' officials thought June would be the right time to raise rates, others thought it would be better to wait longer and some thought the Fed might need to wait until 2016.").

142. *Id.*

143. *Id.*

144. *Id.*

145. *Six Years of Low Interest Rates*, *supra* note 14.

they have fewer options for even modest returns,[146] and borrowers because borrowing at a low rate of interest can facilitate expansion, as well as improve return on equity by increasing the amount of debt (and thus leverage) in a capital structure.[147] Furthermore, banks are even more directly incentivized to issue leveraged loans because they are able to collect higher fees and interest for arranging and underwriting the loans, particularly riskier loans.[148]

Structurally, at least, the current market dynamic is alarmingly similar to the mortgage-backed securities market prior to the 2008 financial crisis.[149] In the early-to-mid 2000s, mortgage originators wrote mortgage loans to borrowers without a demonstrated ability to repay the loan, depending instead on such borrowers' ability to refinance or the lender's ability to recover their value through foreclosure and resale.[150] Originators were not concerned with whether the loans were eventually paid in full because of their ability to sell the loans to banks, who could package and re-package many loans together in special purpose vehicles and instruments, and then sell off the payment streams as mortgage-backed securities into the capital markets.[151] Then, as now, the market for the downstream products created with the mortgages sought higher and higher returns without controlling, structuring, or taking into account, the added risk that necessarily accompanied those higher returns.[152]

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146. *Six Years of Low Interest Rates*, *supra* note 14. ("[T]he expectation of prolonged low real rates is, as policymakers hoped, edging investors down riskier paths.").

147. *Six Years of Low Interest Rates*, *supra* note 14. ("This demand for fixed-income investment has lowered borrowing costs for businesses. . . . Low rates have not just made life easier for some consumers and businesses by reducing borrowing costs. They have also allowed firms to substitute debt for equity. This usually boosts earnings per share, which makes it an attractive choice for executives motivated by share options.").

148. Greg Roumeliotis, Lauren Tara LaCapra & Soyoung Kim, *Wall Street Banks Take Heart from Leveraged Loan Exams*, REUTERS (Aug. 5, 2014) ("Making junk-rated loans to companies is a lucrative, high-margin business for major Wall Street banks. Last year leveraged loans generated $1.47 billion in fees in the United States alone.").

149. *See* Antoine Gara, *JPMorgan Sees Parallel to Subprime Bust at Regional Banks*, THE STREET (Apr. 8, 2014) ("'The boom in these loans has been fed by continued surge in leveraged loan funds. The genesis of this voracious interest is the search for yield, similar to the strong growth in subprime mortgages in 2006-2007,' Juanuja [of JPMorgan] said.").

150. *See, e.g.*, Robin Paul Malloy, *U.S. Mortgage Markets: A Tale of Self-correcting Markets, Parallel Lives and Other People's Money*, THE FUTURE OF FIN. REG. (Eds. Iain MacNeil & Justin O'Brien) 40–50, Hart: 2010 (describing the pre-crisis mortgage lending market and the effects of government subsidies).

151. *See id*.

152. *See id*. at 48 ("From top to bottom, the housing and the primary and secondary

Today, many banks are themselves behaving similar to the subprime mortgage originators that issued subprime mortgages to less-qualified borrowers without fearing default, as the loans can be syndicated among banks or loan participations can be sold in an active and rapidly growing market to investors other than banks.[153] Leveraged loans are generally arranged by one or a few banks, but the arrangers merely negotiate the terms of the loans on behalf of a syndicate of investors that actually underwrite the loans.[154] Banks therefore have every incentive to arrange leveraged loans, as they can collect the arrangement fees and then sell off or hedge their own exposure, removing some of their skin from the game, just as mortgage originators found creative ways to sell off questionable mortgage products that they never planned to hold.[155]

Market trends suggest that demand by investors for high-yielding participations in leveraged loans, and not the credit quality of the borrowers, is driving the rapidly growing market.[156] For example, Fifth Third Bank, N.A. "has grown its leveraged loan syndication volume to $5.3 billion in 2013 from $1.2 billion in 2011," and Regions Financial Bank "grew volumes to $4.5 billion from $1.9 billion over the same period."[157]

> Among the nation's largest banks, Citigroup has stepped up its leveraged loan issuance the fastest, with volumes

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mortgage markets operate on using other people's money . . . .Consequently, no one has any 'skin' in the game.").

153. Mortgage originators are now required to retain some exposure to the mortgages that they issue unless the mortgage terms and borrowers meet specific underwriting standards. *See* 15 U.S.C. 1639c (2015); Jeffrey R. Favitta, Comment, *The Exception that Ate the Rule: Why QRM Should Not Equal QM*, 18 N.C. BANKING INST. 363, 364–70 (2014). A similar retention requirement for leveraged loans, though not included in Dodd-Frank or the Guidance, would further encourage banks to limit high-risk loan issuance.

154. *See* LEVERAGEDLOAN.COM, http://www.leveragedloan.com/primer/#!how-are-loans-syndicated (last visited Apr. 10, 2015).

155. *See id*. ("The 'retail' market for a syndicated loan consists of banks and, in the case of leveraged transactions, finance companies and institutional investors such as mutual funds, structured finance vehicles and hedge funds.").

156. *See* Gara, *supra* note 149 ("For some regional banks, leveraged loan volumes have risen three-to-fourfold over the past few years, while the nation's largest banks have also rapidly increased their issuance amid booming LBO markets.").

157. *See* Gara, *supra* note 149.

> rising 74 percent from 2011 to 2013, and LBO [leveraged buyout] underwriting fees the fastest among large banks. Bank of America and Wells Fargo have also seen issuance rise 30 percent year over year, with leveraged loan fees accounting for 33 percent to 38 percent of their underwriting fees.[158]

Leveraged lending fees and interest are, therefore, becoming a significant source of income for banks, as the pool of loans grows rapidly deeper.[159] In addition, increasing activity in mergers and acquisitions, including leveraged buyouts, has fueled additional leveraged lending.

In sum, extended low interest rates have created an economic environment in which investors must accept more risk for the same level of returns when compared to the period before the 2008 financial crisis.[160] Leveraged loans allow banks to offer higher returns to investors, while also allowing companies and their owners the prospect of higher return on equity through increased debt in their capital structures.[161] Finally, banks are willing to arrange more leveraged loans because they are confident that they will be able to syndicate the loans to other investors and thus leave themselves only minimaly exposed to default and loss risks.[162] Given the volume of leveraged loans in the market and the parallels with the subprime mortgage-backed securities market leading

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158. *See* Gara, *supra* note 149. Leveraged buyouts are transactions whereby an acquiring company (often a private equity-backed company) purchases a target company using mostly debt raised by pledging the target company or its assets as collateral. *See, e.g.*, Josh Kosman, *Why Private Equity Firms Like Bain Really Are the Worst of Capitalism*, ROLLING STONE (May 23, 2012). "For the most part, issuers undertake leveraged loans for four reasons: [t]o support an M&A-related transaction; [t]o back a recapitalization of a company's balance sheet; [t]o refinance debt; [t]o fund general corporate purposes or project finance." LEVERAGEDLOAN.COM, http://www.leveragedloan.com/primer/#!definingleveraged (last visited Apr. 10, 2015) ("Debt as a share of total sources of funding for the LBO can range from 50% to upwards of 75%.").

159. *See* Gara, *supra* note 149; *see also* Rob Tricchinelli, *Corporate Debt Liquidity Problems Pose "Systemic Risk," Gallagher Says*, [2015] BANKING DAILY (BNA) NO. 41 (Mar. 3, 2015) ("Liquidity problems in corporate debt markets pose a 'systemic risk' to the financial system, Securities and Exchange Commissioner Daniel Gallagher said March 2. Growing issuances of corporate debt paired with a drop in many dealers' inventory will cause widespread trouble if interest rates rise.").

160. *See supra* notes 140 through 145, and accompanying text.

161. *See, e.g.*, *Six Years of Low Interest Rates*, *supra* note 14.

162. *See, e.g.*, Roumeliotis, *supra* note 148.

up to the 2008 financial crisis, it is no surprise that regulators have paid increasing attention to bank underwriting standards.[163] The Guidance itself, however, seemed to have little effect on the market until regulators began enforcing it with a stern warning to the industry in general and issuing MRIA letters for noncompliance during bank examinations.[164]

VI. PARTICIPATORY REGULATION – A POSSIBLE SOLUTION

While the Guidance and bank regulators' subsequent actions now seem to be finally reducing risk in the leveraged lending market,[165] such a delayed response by the market seems risky and unacceptable. This section briefly describes how a self-regulatory body might be more effective at shaping banks' lending practices than external regulatory measures like the Guidance.

A. Regulatory Challenge

Although not required by the Dodd-Frank Act, the Guidance was similar to many of the regulatory overhauls since the Dodd-Frank Act in that it evolved in a delayed, fragmented, and generalized regulatory fashion.[166] It is worth noting that the Guidance was issued by all three bank regulatory agencies,[167] although some regulators sought to enforce it more aggressively than others.[168] Furthermore, regulators issued the Guidance as a mandate without clear metrics, bright line rules or clear safe harbors.[169] It caused "considerable confusion" regarding

163. *See, e.g.*, Malloy, *supra* note 150.

164. *See, e.g.*, Nicolaci de Costa, *supra* note 105; Tan & Racy, *supra* note 69; Harrison et al., *supra* note 72.

165. *Shared National Credits Program Review 2015*, *supra* note 16, at 3.

166. *See* Saule Omarova, T*he Dodd-Frank Act: A New Deal for a New Age*, 15 N.C. BANKING INST. 83, 88 (2011) ("The Dodd-Frank Act failed to eliminate the structural basis for regulatory arbitrage by retaining the fundamental principle of regulatory fragmentation.").

167. The Guidance was issued by the Fed, the OCC, and FDIC. *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar. 22, 2013).

168. Several news articles and certain changes in league tables (tracking the number and volume of loans made by major banks) suggest that the OCC was somewhat more zealous in implementing the Guidance than the Fed, placing nationally chartered banks at a regulatory and market disadvantage. *See e.g.*, LaCapra, *supra* note 98.

169. Despite several concerns over the proposed Guidance's definition of leveraged lending, regulators made no changes to the definition in the final version. Interagency

expectations and implementation.[170] As leveraged lending continued apace into 2014, perhaps the most troubling result initially was its migration into "shadow banks," less regulated financial entities beyond the bailiwick of the FDIC, OCC, or the Fed.[171]

These difficulties in implementation point to a more fundamental problem with the present regulatory framework of the Dodd-Frank Act. Reliance on a fragmented regulatory approach with a sometimes adversarial relationship between regulators and market players is very much a product of twentieth century regulatory thinking,[172] and unsuitable for the complexity of modern U.S. and global financial markets.[173] Modern markets require "active participation in the regulatory process" by the market participants to be regulated, as "a purely unilateral command-and-control [regulatory] manner will inevitably encounter the fundamental problem of regulatory arbitrage, whereby financial institutions find new ways to get around government rules."[174] While regulatory arbitrage was, and is, a serious concern, in the case of the Guidance, banks were initially incapable of compliance because regulators did not make their expectations clear.[175]

B. Self-regulation as a Potential Solution

Instead of issuing the Guidance and waiting over eighteen months for the Shared National Credits Review to give it scope and substance,

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Guidance on Leveraged Lending, 78 Fed. Reg. at 17768.

170. *See, e.g.*, Coffey, *supra* note 15.

171. *See, e.g.*, Braithwaite, *supra* note 103.

172. *See* Omarova, *supra* note 167 ("Contrary to popular expectations, the Dodd-Frank Act largely retained the existing regulatory structure in the financial services sector . . . Congress opted against large-scale structural reform.").

173. *See* Omarova, *supra* note 167, at 92–94 (describing the Volcker Rule and noting "these new statutory prohibitions rest on an old fiction . . . that the key sources of financial risk to banks can be effectively controlled through imposing certain formalistic, institution-based restrictions . . . . These assumptions tend to over-simplify the dynamics of modern financial services businesses.").

174. *See* Saule Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 416 (2011) (noting that such arbitrage creates "a never-ending spiral of rulemaking and rule evading" (citing Victor Vleischer, *Regulatory Arbitrage* (U. of Colo. Law Sch. Studies Research Paper Series, Paper No. 10-11, 2010, available at http://papers.ssrn.com/abstract_id=1567212.)).

175. *See, e.g.*, Coffey, *supra* note 15; Braithwaite, supra note 103.

regulators should have involved market participants more directly to secure and leverage their expertise and thus tailor market-stabilizing solutions in a more collaborative and effective way. A more cooperative but supervised form of self-regulation would allow market participants and regulators to escape the cycle of regulatory arbitrage and provide greater and more timely responsiveness and stability in complex financial markets.[176] Similar systems have been effective in the securities and commodity markets (e.g., the New York Stock Exchange, the Chicago Mercantile Exchange, the Financial Industry Regulatory Authority, and the National Futures Association), but no similar self-regulatory organization ("SRO") currently exists for the banking industry.[177]

The most immediate and perhaps simplest solution may be to expand the responsibilities and powers of the LSTA to include a self-regulatory function.[178] The LSTA currently "foster[s] cooperation and coordination among all loan market participants, facilitating just and equitable market principles," and also serves as an industry advocacy group.[179] A more robust and empowered version of the organization, with government mandates and regulatory oversight, could expand its role to become an industry self-regulator. While a thorough discussion of precisely how a more participatory system of "embedded self-regulation" would work is beyond the scope of this article, it is worth exploring why such a system would be particularly well-suited to deal with the regulatory challenge of leveraged lending.[180]

First, the relatively limited number of banks engaged in leveraged lending already possess the best available information regarding the credits they arrange and underwrite. Moreover, they have the most

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176. *See* Omarova, *supra* note 175, at 417 ("[T]he dynamics of the twenty-first century global financial market demand a new approach to industry self-regulation, which has the potential to be much more comprehensive and systemic in its scope and operation.").

177. *See* Omarova, *supra* note 175, at 464–65.

178. *See* LOAN SYNDICATIONS AND TRADING ASSOCIATION, http://www.lsta.org/about.

179. *Id*.

180. For a thorough discussion of "embedded self-regulation" and "New Governance" theory, *see* Omarova, *supra* note 175. *See also* John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466 (1982); Michael Douglas, *Federal Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN L. REV. 171 (1995); Christodoulos Stefanadis, *Self-Regulation, Innovation, and the Financial Industry*, 23 J. REG. ECON. 5 (2003).

current and sophisticated understanding of the leveraged lending market as a whole. Both of these factors place them in the best informational position to understand the individual risk and the collective risk posed by any individual loan or set of credits.[181] Second, a self-regulatory body would not face the communication challenges that the present adversarial and patchwork regulatory structure has created. As lenders were only peripherally involved in the creation and drafting of the Guidance, they also had great difficulty in interpreting and implementing it.[182] Finally, an SRO would be in a position to force participating banks to accept and acknowledge responsibility for market failures and the prospect that government bailouts and other risk reducing and market stabilizing programs are no longer a viable solution to market failures.[183] This would incentivize market participants to not only establish sound rules and guidelines for individual and systemic stability, but also incentivize compliance with those guidelines, as opposed to rewarding successful avoidance through arbitrage.

The almost two-year lag between the issuance of the Guidance and a measurable reduction of leverage ratios in the leveraged lending market reflects the lack of clarity in the market regarding precisely what regulators intended or required, as well as the consequences for non-compliance.[184] A more open and collaborative dialogue including both regulators and market participants representing both lenders and borrowers, or their counsel, might have yielded a clearer understanding of regulators' expectations and a greater appreciation for the basis of their concern. Such a process might also incentivize the development and implementation of best practices for th market and foster a more level playin fields. For example, instead of leaving banks to define leveraged lending individually, regulators might have facilitated an industry discussion to craft a uniform definition and thereby provided clearer guidelines with industry input, thus eliminating the uncertainty of

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181. *See* Omarova, *supra* note 175. (discussing the informational advantages that can be leveraged by embedded self-regulatory systems in the financial industry).

182. *See supra* notes 99 through 108, and accompanying text.

183. *See* Omarova, *supra* note 175. (discussing the establishment of a "community of fate" in the financial industry, whereby each participant understands that the survival of each participant is dependent on the viability of the system as a whole).

184. *See supra* Part III.

whether or not a particular credit would be criticized.

In addition to providing clearer guidance to banks, an established industry SRO could also implement uniform standards and compliance. A failure to comply with industry guidelines could be corrected both more informally and more effectively by other market participants, since the major banks generally rely on one another when syndicating both leveraged loans and investment grade loans. If a bank earned a reputation for pushing the envelope in leveraged deals, a SRO might have the ability to discourage other banks from helping the offending institution to syndicate such deals, and even the threat of such a sanction would have to be taken at least as seriously as the MRIA letter that Credit Suisse received in September 2014.

Finally, an established SRO would function with more accurate and current information than external regulators. By definition, an external regulator must expend significant resources to understand and react to the market from the outside looking in, while a self-regulatory body would already have a sophisticated understanding of the lending market. Market trends in lender protections and borrower flexibility can change relatively quickly, and it makes little sense to have regulators duplicate the work that market participants must do to negotiate and syndicate the loans in the first place. In the case of the Guidance, an SRO could have monitored leveraged lending internally on a real time and ongoing basis without having to wait for an annual Shared National Credits Report. Arguably, such a regulator would also act more proactively out of an interest in preserving the market's autonomy and vibrancy, especially if it were clear that the options for market participants were to either effectively regulate themselves or be excluded from or restricted in the market and thus lose substantial influence and market share.

VII. CONCLUSION

While there are some indications that the Guidance is beginning to curb risk in the syndicated leveraged loan market, the process has not been a smooth or timely one. The Guidance provided some insight into regulators' expectations, but it was not until the subsequent publication of the 2014 Shared National Credits Review that banks had any real

clarity regarding how the Guidance was to be implemented and applied. Furthermore, significant market forces continue to incentivize the kind of risky lending practices that the Guidance was intended to discourage. This problem is symptomatic of the present regulatory structure, and a self-regulatory framework could provide more effective individual bank and systemic risk management.