# Syndicated Leveraged Loans for Community and Regional Banks: Formulating Strategy and Policy

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## Building Portfolios on Time-Tested Credit Principles and a Regulatory Foundation

Increasingly, commercial banks are entering or expanding into the leveraged lending market as the risk/reward benefits of the asset class become better known and understood. Regulator reaction is understandable. Such a move is both material and strategic and examiners expect it to be treated as such. In particular, regulators will want to review the bank's documented strategy and credit policy and will assess the content relative to the 2013 Interagency Guidance on Leveraged Lending ("Guidance").

The bank's leveraged lending credit policy will govern the risk exposure taken by the bank on these assets and will ultimately determine the success of the strategy. The importance of the policy cannot be understated. While the regulators require its existence, what they really require is the discipline it will and should mandate.

The regulators have favorably considered loan acquisition programs that demonstrate a balanced proportion, credit structures compliant to the bank's policy, thorough risk identification, risk mitigation, and aggressive monitoring. And those are just the elements they will be looking for in the bank's policy statement.

Banks exhibiting those disciplines in managing leveraged lending portfolios have successfully navigated their safety and soundness exams.

There are multiple routes by which a bank can acquire leveraged loans:

1. Acquire a participation from a bankers' bank or correspondent bank that is selling down from a larger loan acquired. The pro to this approach is that the bank can start on a limited scale. The cons include a) a typically poor selection of loans available, b) the usual acquisition vehicle being a participation as opposed to an assignment, c) the bank incurs participating bank risk and d) the bank may shortcut the full analytical process
2. Build a strategically designed portfolio of leveraged loans, usually through the affiliation with a well placed third party provider. The portfolio can be customized by any number of parameters. The pros to this approach are a) accessing the risk management experience of the partner and b) broad market access and customized portfolio capability. These programs typically charge a fee based on assets under management
3. Leveraged loans come along as part of the acquisition of another institution
4. Build a leveraged lending team from scratch. While this is likely the most expensive and time consuming option, it also provides the most control

Regardless of how a bank acquires leveraged loans, the regulators approach' and expectations are the same.

And that is what we will discuss in this paper.

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### What does the Guidance Say about the Bank's Leveraged Lending Policy?

The following topics need to be included in a bank's policy statement as components of a leveraged lending risk management framework:

- Your bank's definition of leveraged lending
- Underwriting standards and credit analysis
- Enterprise valuations
- Reporting and analytics
- Risk rating expectations
- Portfolio management processes
- Independent credit review
- Allowance for Credit Losses (ACL) and capital

Pipeline risk is not included in this list even though it is discussed in detail in the Guidance. Pipeline risk is specific to syndicating agent banks and should not be a risk undertaken by community or regional banks building a proprietary portfolio.

## It's All Local

If there is a recurrent theme on leveraged lending conveyed by the regulatory agencies, it is local ownership. Local ownership means local understanding of the risks, local work product, and local management of the loan throughout its life (but not necessarily local borrowers!). About the worst thing to say to a regulator is, "Gee, I don't know. That wasn't in the package they sent me."

And that starts with the policy. No off-the-shelf approach here. The bank needs to show evidence that the bank has thoroughly considered the strategy and all of its implications for the bank and structured its policy accordingly.

**Definition**: What is a "leveraged loan" as the bank would define it? Sure, you can lift the regulators' definition out of the guidance, but the bank should consider that definition in light of its local circumstances and priorities. For example, perhaps quick deleveraging is significant to a bank, such that acceptable loans achieve X.X cash flow leverage in year 2 and/or restrict dividends and/or have minimum X% excess cash flow recapture (ECR).

**Appetite**: Considering the bank's capital and liquidity positions, what size portfolio does the bank want to acquire? And at what pace can the bank safely identify, underwrite and book these credits?

**Portfolio Composition**: What type of loans are included?

**Local Resources**: There should be a candid evaluation of local talent and experience. With that assessment, are there training or recruitment needs to be addressed?

**Local Process**: Assess and upgrade local human and technology resources to optimize reaction time, underwriting quality and risk tracking.

**Third Parties:** Analyze and determine when and where to engage a third party provider to fill gaps in the process.

**Why are regulators increasing their oversight of leveraged lending?**

*"Financial institutions … should be able to demonstrate they understand the risks and potential impact of stressful events and circumstances on a borrower's financial condition."*

*-Federal Reserve Guidance on Stress Testing For Banking Organizations (2012)*

*"Financial institutions that purchase loans or participations should perform the same degree of independent credit and collateral analysis as if they were the originator."*

*-FDIC Advisory on Effective Risk Management Practices for Purchased Loans (2015)*

## ACL and Capital

For most banks, the loss experience in leveraged lending is somewhat of a surprise...a good surprise. It is usually a good measure lower than typical commercial and industrial (C&I) lending. Often, the data and experience can justify a lower provision rate.

For example, per Moody's one-year migration analysis for 2020, the expected default rate for a Ba3 average portfolio is 1.23%.[1] The Moody's Ultimate Recovery Database of 3,500 leveraged loans and bonds indicates ultimate recoveries for senior secured loans to be >80%.[1] That would indicate a net loss experience of <30 bp. A defensible ACL methodology should be in the policy. With CECL reporting now current or imminent, banks should develop a solution that includes the increased data requirements and computational nuances needed for this requirement.

A similar, measured approach can be taken on capital allocation. Leveraged lending is not a place to be greedy. For banks in an early phase of leveraged lending, capital commitment of 25% of general risk based equity capital is appropriate. As a bank gains experience and cements its underwriting and management processes, that level can rise. The bank's policy should reflect its capital allocation strategy.

## Underwriting – Getting it Right

Leveraged loans are cash-flow oriented C&I credits with unique characteristics in how they are underwritten and managed. The size, number and longevity of this asset class means that funding banks, rating agencies, independent analyts and regulators have developed an established approach to assessing and managing risk. For that reason, the credit policy needs to reflect those established and proven practices.

**Free cash flow**: Bankers are fond of saying "EBITDA does not repay loans, free cash flow does." Accurate and consistent calculations of cash flow are important.

**Free Cash Flow Common Definition**

**EBITDA**
- **Less**: Interest Expense
- **Less**: Capital Expenditures
- **Less**: Cash Taxes
- **Less**: Change in Working Capital
- **Less**: Common Dividend
- **Less**: Required Amortization
- **Equals**: Free Cash Flow

In addition to these common components, when applicable, synergy and add-back adjustments should also be considered as well as restructuring costs and pension contributions. Cash flow should be able to pay off senior debt and the majority of total debt over the medium term. Bank credit policy should be consistent with these expectations.

**Debt leverage**: Debt Leverage is tracked under two calculations: Senior Debt / EBITDA and Total Debt / EBITDA. The former calculation is not specifically identified in the Guidance but is accepted in the industry as an upper limit, with some exceptions, at 4X. The latter value is specified in the Guidance as an upper limit as 6X, with some exceptions. The bank's policy document will need to be specific in these calculations.

**Sector analysis**: Borrowers in the leveraged lending industry are typically larger scale entities subject to broader regional, national and global factors that require assessment to monitor sector exposure. This may require access to new information sources at this level and move the bank to more anticipatory posturing in its sector exposures. A third party provider can be instrumental in assisting to make these assessments.

**Structure**: Several structural elements come into play when determining leveraged loan policy: term loan A vs. term loan B, revolver, covenant lite and ECR. The principal difference between TL-A and TL-B is the amortization rate. In our view, TL-B is the better value, as the difference in coupon is not justified since both structures have essentially the same risk of loss. Acquiring a portion of a revolving credit is not a good value.

A bank will need to assess its comfort with covenant lite loans. This structure is becoming more common in the market and accounts for over 70% of new loan issuance, most of which are within the risk grades appropriate for commercial banks.

[1] Source: Moody's one year alphanumeric rating migration rate tables, 1983-2020.

Mitigants include continuation of affirmative and negative covenants, ECR and the ability to divest into the secondary market. Banks are increasingly comfortable with these features.

It's important to keep track of cross-portfolio maturities as well as individual loan call protection (time to call date) to assure the bank does not incur a situation where the call date could negatively impact the bank's ability to sell the loan at an acceptable price.

**Target portfolio risk grade**: In our view, optimal relative value lies in a portfolio in the Moody's Baa3—Ba3 risk grade range. The preferred portfolio based approach to leveraged lending allows for employment of advanced portfolio theory for further risk mitigation. Individual loans are acquired and managed within the target risk grade range and sector constraints.

**Third parties**: Third parties can provide valuable services to a bank in leveraged loans.

**Enterprise value**: Enterprise value (EV) is commonly recognized as the secondary source of repayment for leveraged loans. Therefore, a bank will calculate both EV / senior debt and EV / total debt as additional tools to track repayment risk. These values should be part of the policy document.

EV is not a typical analytical tool for middle market C&I lending but is a standard component of leveraged loan analysis. The calculation of EV is not to be taken lightly as the regulators will fully dig into the calculations and assumptions made by the bank in its EV analysis.

The calculation of EV requires knowledge of economic trends, capital markets, interest rate movements and sector trends. If a bank does not have this skill set in-house, then a training / mentoring process needs to be established to put it in place. Importantly, to quote the Guidance, "…enterprise valuations should be performed by qualified persons independent of an institution's origination function." EV is another area where a third party provider can add value. The bank's commitment and approach to completing EV, both an initial underwriting element as well as an ongoing, updated risk consideration is an important policy addition.

**Stress testing**: Stress tests have long been part of loan underwriting. It is no surprise the regulators expect a robust stress test component in leveraged loan underwriting. What components should be stressed? That will depend on the operating pivot points of the borrower. Candidates for consideration include revenue, margins, interest rates, supply chain interruption, technology, commodity price risk, covenant violation or combinations of the above. The bank's policy should assure that stress tests are completed upon underwriting and updated quarterly thereafter unless trends are down, then as needed to track risk.

## Third Party Providers

Leveraged loans have evolved to their own asset class and with over $1 trillion in loans outstanding and now constitute a major component of the U.S. financial industry. Third party providers have a large and increasing role in this segment.

With priorities around risk management and efficiency, there are several areas where a third party can add substantial value to a bank's leveraged loan strategy:

- **Market access**: A well-established third party can provide a portal to both the primary and secondary markets to build a fully diversified loan portfolio
- **Underwriting**: An experienced third party risk manager can share risk management expertise in underwriting and portfolio management. This does not relieve the bank of full responsibility for the loan portfolio and will generally enhance a bank's overall staff risk experience level that can be utilized with the bank's local C&I portfolio
- **Loan review**: A third party can verify risk grades, policy compliance and ACL / CECL methodologies

*"The FDIC recognizes that the use of third parties can assist management in attaining strategic objectives by increasing revenues or reducing costs. The use of a third party also commonly serves as a vehicle for management to access greater expertise or efficiency for a particular activity."*

*-FDIC FIL-2008*

- **Accounting**: Accounting processes for leveraged loans can be difficult. Most banks in this market utilize a third party loan servicing specialist to relieve the back office particularly since in many cases the core processor can be overmatched with the processing requirements. The third party provides daily entries, adjustments and reconciliations directly to the bank's general ledger cost-effectively
- **Loan divest**: When appropriate, a third party can assist the bank to divest a loan into the secondary market when the risk profile exceeds bank appetite or liquidity needs arise
- **Information access**: A third party may have access to industry information sources or even direct borrower access that the bank may not have

Use of third parties is a strategic decision and their inclusion in the process is a component of the overall strategy and policy document. Risk assessments are required for all third parties engaged in the leveraged loan strategy.

## Portfolio Management

One of the keys to a successful leveraged loan portfolio is the discipline of managing each loan in the portfolio throughout its life. The following would be considered minimum requirements in the process:

- Review borrower performance against plan quarterly
- Review risk grade and ACL quarterly
- Update enterprise valuation quarterly
- Update stress tests quarterly
- Annual portfolio review
- Annual loan review
- Ongoing review of borrower, sector, micro/macro economic news and reports
- Quarterly reporting to executive management board and regulators

Approaching a leveraged lending strategy from a portfolio standpoint allows the bank to employ portfolio theory to further mitigate risk. Portfolio theory would include the following elements:

- The portfolio has to be large enough to reach a meaningful diversification of assets
- Target loans with high relative value; i.e., loans where the risk/reward balance is more favorable (third parties are helpful here)
- Set appropriate limits: max loan per borrower, max exposure per sector, weighted averaged risk grade, max % covenant lite loans, etc.
- Utilize Moody's Weighted Average Rating Factor to monitor risk drift (or similar tool)
- Track loans with cyclical risk
- Pro-active outlook for sectors moving into higher vulnerabilities. Move out of sectors trending negatively
- Sell loans when needed to meet internal guidelines

Additionally, the bank should have a standardized process to deal with any loan whose risk profile evolves to exceed the bank's appetite. That process would include an assessment of the alternatives: a) sell the loan into the secondary market (is the increased risk reflected in the loan price?) or b) manage the workout process internally, possibly in conjunction with a third party provider.

These practices and process triggers should be described in the bank's credit policy.

## Risk Ratings

Because leveraged loans are specifically structured around the borrower's cash flow and not toward the value of assets, banks will typically have separate risk rating definitions applicable to leveraged loans. The bank will develop its internal definitions with an eye on the Guidance to ensure compatibility.

Essentially, all loans in the leveraged loan market also have public debt ratings from one or more of the established rating agencies, which are updated periodically and provide a useful benchmark.

Additionally, all leveraged loans are in the Shared National Credit (SNC) program and are reviewed annually at the agent bank. The SNC ratings are shared with every bank that is a direct lender to the borrower. When a loan receives a criticized rating, that rating must be mirrored by all direct lenders.

The bank's risk rating practices are an essential part of the bank's leveraged loan credit policy and will be reviewed by regulators at the time of the safety and soundness exam.

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**Disclosures**

This paper deals with required themes in a leveraged loan credit policy but due to the breadth of the topic and space limitations, the treatment herein is not exhaustive.

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