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SNC exam nuggets

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My theory on markets, like much of life, is that things are never as bad as they seem when events are going south and never as good as they seem when all appears to be headed higher. One standard deviation on either side of the mean is where most of the action occurs. The 2014 Shared National Credit exam, I think, falls within the two standard deviations confidence interval. I did not see any big surprises in the examiners' comments, which for the second consecutive year focused on leveraged lending commitments ($767 billion) within the context of the overall SNC exam ($3.4 trillion of commitments). That said there were some instructive comments that may point to how the market will evolve. As a result, the 2015 exam may be more useful for investors provided the economy does not change dramatically.

Some background. An interagency regulatory task force published guidance for leverage lending in March 2013 that updated the 2001 guidance. For the most part, the guidance was just that, guidance rather than a series of dos and don'ts and multiple bright-lines. Since the regulations were published in the Federal Register, regulator and investor angst has emerged that some banks have flouted the guidance given a booming market for leveraged lending that has been characterized with rising enterprise valuations of borrowers and rich fees for lenders. I noted in a prior post on leverage lending that if investors are viewed as ducks, they are quacking to be fed income.

One of the bright-lines, rightly or not, is that borrowers with leverage greater than 6x earnings before interest, taxes, depreciation and amortization (EBITDA) "raise concerns for most industries." The guidance does not absolutely say banks should not participate in deals where the borrower is levered above 6x, but the lean in the guidance, press reports this year and the SNC exam results is that deals above 6x should be avoided or at the least be very infrequent.

What is infrequent? The 2014 exam notes that 27% of originations after June 1, 2013, reflected leverage of 6x or greater. Maybe there is an issue of interpretation, such as whether leverage should be measured on a gross basis as regulators prefer or net of unrestricted cash as is the more typical investor convention.

The guidance also notes that borrowers should demonstrate an ability to retire at least 50% of the debt within five-to-seven years. According to this year's exam, 77% of borrowers could do so, down from 83% of levered credits originated before June 1. If regulators are successful in containing the market, highly levered deals should be lower in next year's exams, and deals that do not meet the amortization test should decrease.

Examiners did not think much of the levered credits; they rated 33% as criticized, and the more adverse "classified" subset was very high at 19%. I am modestly surprised that banks are originating a "large" amount of non-pass credits, whether to be retained or distributed like bonds. It seems like credit committees would flag this, though maybe the divide reflects a different view of the world between the bankers and regulators.

Dividend recaps, where private equity sponsors recap a portfolio company by borrowing to finance dividends, were criticized conceptually because the borrowing does not increase a firm's cash flow capacity. Regulators fingered "aggressive competition and market liquidity" as a reason for weak underwriting structures. Here I have to point to years of the impact of the Fed's zero interest rate policy (ZIRP) as a culprit. Why wouldn't PE firms substitute debt for equity when debt is dirt cheap and the banks are willing to lend? Plus, a recap should be much easier to execute than a sale or IPO.

As a former sell-side analyst, one area of the exam in the leveraged loan supplement was funny to me. Examiners criticized the banks for an "overreliance on borrowers/sponsor base case projections when evaluating performance." It was noted EBITDA used to measure leverage and repayment ability included "difficult-to-support adjustments, such as unrealized cost savings from mergers and acquisitions." Also, growth assumptions were viewed as being "optimistic" and different (i.e., better) than the borrower's history. My interpretation is that the projections may have a tendency to have a gap-up in EBITDA at the inception of the levered transaction and then exhibit a strong southwest to northeast bias as time passes. Street EPS estimates for many companies look the same, especially when a merger is announced.

Regulatory scrutiny of the leveraged lending market may take the edge off what some view as an increasingly risky market. How much is unknown. The performance of the economy will be the ultimate arbiter as to how most of these credits perform. Examiners, like lenders (and analysts), do not always get it right when looking forward. One comment from the 2006 exam caught my attention. The review noted a small increase in problem loans overall as SNC lending was then expanding with a robust M&A market, though more pronounced weakening trends in manufacturing, primarily the automotive industry, were noted. A little over two years later the federal government bailed-out General Motors and Chrysler.

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