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The war on judgment

By Jeff K. Davis

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I recently attended a conference for business development companies (BDCs). One of the panelists used the phrase "war on judgment" as it related to increasing regulatory scrutiny about how BDCs and other (public) funds assign values to level two and level three assets. Commercial banks, Goldman Sachs Group Inc. and Morgan Stanley can relate to the war on judgment too. Many of their traditional activities are being second-guessed by regulators.

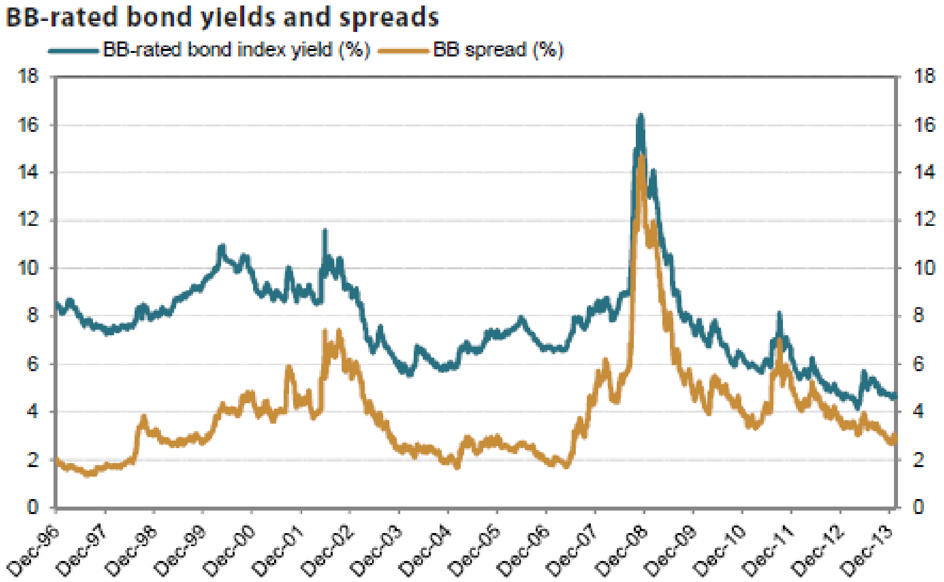
Aside from asset marks, leveraged lending is an area that is being subjected to increased scrutiny as banks and investors clamor for yield in the sixth year of the Fed's zero interest-rate policy (ZIRP). On March 22, 2013, the OCC, Federal Reserve and FDIC published Interagency Guidance on Leveraged Lending in the Federal Register. The new guidance replaced guidance that was issued in April 2001.

The guidance was provided in time for a record year for leveraged lending. According to Thomson Reuters, U.S. leveraged loan issuance totaled a record $1.1 trillion in 2013, though 67% represented refinancing volume. A little over half of the issuance was purchased by CLOs, mutual funds, insurance companies and other institutional investors. Leverage lending has grown dramatically since the 1980s when Mike Milken popularized — and I would argue, proved — that high yield bonds were an efficient capital source. After all, the tax code favors debt because interest expense is tax deductible. Dividends that are paid by C-corporations from after-tax income are subject to a second layer of taxation if the recipient is not a tax-exempt entity.

The regulators have left it up to the banks to define leveraged lending; though the guidelines imply companies with total debt that exceeds 4.0x EBITDA is one threshold test, subject to industry conventions. Likewise, lending for acquisitions, buy-outs and dividend recapitalizations is another criterion. The bright-line test of what is off limits for the banks may be murky. A recent *Wall Street Journal* article on the issue suggested deals in which the borrower's debt exceeds 6.0x EBITDA should be avoided. The regulatory guidance notes that leverage after asset sales that exceeds 6.0x EBITDA "raises concerns."

Thomson Reuters puts debt-to-EBITDA for broadly syndicated LBOs at 6.2x in 2013. If one were comparing multiples to the pre-crisis years, 2013 would look like 2006. And 2010 to 2012 with debt-to-EBITDA multiples of 5.0x to 5.5x would like 2003 to 2005. Regulatory scrutiny may pre-empt 2007 multiples (7.0x), though I would argue ZIRP is a countervailing force on multiples. Posing less risk are LBOs, dividend recaps and acquisitions of middle market companies that entail less leverage, though the borrowers' loans and bonds generally are less liquid than those of large corporate issuers.

The pronouncement is clear that leveraged transactions should show "a borrower's capacity to repay and de-lever to a sustainable level over a reasonable period, whether underwritten to hold or to distribute." High-yield bonds seem to be outside this pronouncement, so a bank presumably could underwrite bonds without running afoul of regulators for a highly levered transaction.



Data as of Feb. 14, 2014.
Source: Bank of America Merrill Lynch BB High Yield Index per St. Louis Federal Reserve

The market for high-yield bonds is not signaling any imminent danger, though when it does it is usually too late to do anything about it. The chart shows spreads on BB rated bonds (equivalent to Ba for Moody's), which is a couple of notches below the lowest investment grade rating. Inflection points can only be seen looking back. One was August 1998 when LTCM nearly created a Lehman-event that Alan Greenspan was able to defuse. Spreads widened until October 2002 when the then-shallow recession was coming to an end. The next inflection point was in mid-2007 following the failure of several subprime originators and the Bear Stearns hedge funds. The tightening of spreads since late 2008 peak was only meaningfully interrupted in 2011 when many European banks were struggling with funding issues and S&P downgraded the U.S. government.

While the absence of widening may signal no pending issues, the index yield and spread imply there is limited value and margin of safety. As of Feb. 14, the yield on the BofA Merrill Lynch High Yield BB Index was 4.61%, not far from the all-time low since 1996 of 4.13% and well below the 7.72% average. Likewise, the 2.84% option adjusted spread to equivalent U.S. Treasuries was below the 17-year average of 3.91%. The same value math may apply to leveraged loans, but the zero rate environment is distorting pricing and risk taking, in my view.

So is there a (regulatory) war on judgment? FDIC Vice Chairman Thomas Hoenig, in a letter to *The Wall Street Journal* in response to the Jan. 22 article on leveraged lending, argued that the guidelines are flexible, yet reasonable, given the public backstop that commercial banks receive and the leverage that it encourages. That seems like a reasonable response to me, though all bank lending is subsidized indirectly via deposit insurance. Regulatory guidance that was put forth in December 2006 warning banks that CRE lending that exceeded certain thresholds of capital was a problem proved to be prescient, though like widening spreads was too late to change most banks' fate.

As large as the leverage lending market is, it proved not to be a major problem as an asset class for U.S. banks during the financial crisis. Most banks remain wed to real estate-related lending, an asset that is highly sensitive to prevailing interest rates. I assume regulators tacitly or explicitly would like to push as much of the leverage lending — at least that above 4x EBITDA — to non-banks. BDCs would be among the beneficiaries, and pending legislation if passed would allow BDCs to increase their leverage. Still, it seems to me that modest exposure to leverage lending may provide diversification and yield benefits to many banks. And whenever the next market crisis occurs, I suspect leverage issues will be found in structured products sold to yield-starved retail investors and elsewhere rather than in bank portfolios unless the current lending cycle expands unchecked for many years.

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