Lead Left Interview – Tess Virmani

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This week we chat with Tess Virmani, SVP and Associate General Counsel of the Loan Syndications and Trading Association (LSTA). Tess works with the LSTA's Primary Market Committee and Trade Practices and Forms Committee on legal projects. She also works on advocacy and regulatory matters.

The Lead Left: Tess, thanks for joining us. I saw your excellent presentation at the Middle Market Symposium last week, and thought it would be great to pass along to our readers [link]. We have seen bank activity be impacted by the Leveraged Lending Guidance. I guess there are some reasons for banks to be optimistic about the new regulatory environment.

Tess Virmani: Yes, Randy, there is. The new administration will have the opportunity to appoint new heads at all three banking regulators. One would imagine that any appointee will share the administration's concern for burdensome regulation. Although some of what direct lenders are bringing to the table is not just a product of Leveraged Lending Guidance, but rather speed of execution. As a borrower you may be willing to paying more for certainty and speed. There may still be opportunities for direct lenders if banks get a bit more of a relaxed environment, especially if direct lenders' balance sheets continue to grow. But if regulatory change happens for the banks, it will certainly open up more of the market for them. And I would suspect we might see the share of large cap bank leveraged lending improve.

TLL: For the benefit of our readers, how long has Leveraged Lending Guidance been around?

TV: The Guidance was first released in 2013, then clarified with a list of Frequently Asked Questions that came out in 2014. So we've been living in this regulatory environment for about four years.

TLL: With the benefit of time, what kind of lessons have you learned about this regulation?

TV: There are two lessons learned. First, the Guidance is applied very much like a rule. While there are a number of guiding principles found in the Guidance, the most important seems to be demonstrating the ability of the borrower to repay its debt within a five to seven year period. Yes, leverage over six times ebitda is a concern, but for a "pass" credit the agencies are putting a lot of focus on cash flow.

Second, I would say that regulators have become well-versed in some of the flexibility that has been introduced into loan structures in recent years. Initially, they highlighted "weak underwriting" and "lack of maintenance covenants" but now we also see focus on "add-backs" and "baskets" in the credit agreement itself – the things banks live with every day. Regulators now appreciate these nuances and seem more focused there. There's a push to look at credit at a holistic level – not just the size of the capital structure when the deal is first put together, but to focus on what *could* happen to it.

TLL: Are you seeing signs of deterioration? The stats show leverage topping out, but has it?

TV: With the supply and demand imbalance in the market, we would expect to see the share of highly levered, say 7x or greater, deals grow, but that has not been the case. That being said, we're also noting more disparity between adjusted and unadjusted ebitda.

TLL: Our pet peeve!

TV: Sometimes the disparity is up to two turns! That's a substantial difference and is a natural result of competitive forces in the market. I do believe if regulators continue to focus here, we'll see more emphasis on caps to ebitda adjustments as banks reign in some of these excesses. In terms of further loosening, I was interested to hear in your presentation at the conference that 60% of middle market deals in May were cov-lite. That's surprising.

TLL: Do you think the agencies will change their messaging given the proliferation of non-banks?

TV: No. It's difficult to quantify what's happening on the non-bank side but clearly non-bank lenders are becoming a more important part of the loan market story. Presumably the regulators are also aware of the trend, but have not retreated yet.

TLL: Does LLG have a chilling effect on the market? The whole six times ebitda cap?

TV: Overall I don't know that it is. Because borrowers still want what they want and can get it elsewhere. But on the bank market, definitely.

TLL: And it's kind of a binary thing. If it's over six times, the banks can't do it. Period.

TV: Well certainly it is binary with respect to "nonpass" credits. If it wouldn't be a "pass" loan, banks aren't going to do it. Period. But that comes down largely to whether companies can repay their debt from base cash flows. Companies that are levered 6x often can show that repayment ability – that's why almost half of last year's LBOs were levered 6x or more. But the repayment ability could become harder at 7x leverage.

TLL: Are banks now confident they're all operating under the same rules? I know at the start there was concern about different rules for different folks. Kind of like two kids fighting in the back seat of the car.

TV: There certainly was. It's gotten better. Early on the Fed and OCC were taking different approaches, but that's changed. The three agencies [Fed, OCC, and FDIC] have worked to be more aligned, so there's less "regulator arbitrage". It's not perfect yet. Sometimes even across teams in the same agency you get different results. But the regulators are working on that and where there are differences they have been slowly converging with time.

TLL: What kind of possible regulatory changes are in store on the bank side?

TV: First, let's focus on the relief that's likely. The heads of agencies will change, so it's likely there will be a more commercial-friendly attitude that could permeate the agencies. Whether it will be change effected through a shift in enforcement priorities or a softening of ideology, all of this could help.

Second, there's the Congressional Review Act (CRA) question. That is, whether the Government Accountability Office (GAO) will say that LLG is really a rule so it should have been approved by Congress. Since we last saw each other, the GAO has decided that they will in fact make a determination as requested by Senator Toomey in last month's letter to them. What qualifies as a "rule" for purposes of the CRA is very broad. If it's a rule, the agencies could withdraw the guidance, then re-propose it at a later date. Or they would have to submit it to Congress for review. Congress would then have 60 days to affirm or disapprove LLG by a simple majority vote. The CRA has been used a number of times by this administration, but it's a very political environment. Ultimately, it's is very hard to forecast how this process will play out.

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