

Pest Control

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Cutting through Central Park on our way to a meeting recently, we encountered a worker fiddling with what looked like a centrifuge for uranium enrichment. Somewhat alarmed, we slowed our pace.

“What is that?”

“It’s to keep armadillos away.”

“Didn’t think there were any armadillos in Central Park.”

With a grin, he said: “Well, then, I guess it’s working.”

We fell for this old joke in broad daylight, and it reminded us of the 2014 Shared National Credit (SNC) Review that hit bankers’ desks last year with a .

This document (and its companion, the Leveraged Lending Supplement) was a gift from the Gang of Three: the Fed, OCC and FDIC. This year, they have a special message for buyers and sellers of syndicated loans: “We’re not kidding.”

The gang’s pique began with March 2013’s Interagency Guidance on Leveraged Lending. This missive outlined the gang’s expectations for regulated banks in the new world order. Specifically, these risky loans should fully repay within the term of the deal on base case projections. Also, any loan over six times debt-to-ebitda risks being criticized. Finally, current market standards, such as covenant-lite structures, will not necessarily be accepted as appropriate.

Further screw tightening came with last November’s SNC review – the first since the guidance was issued. It was critical of underwriting practices, including “material widespread weaknesses ... excessive leverage, inability to amortize debt over a reasonable period and lack of meaningful financial covenants”. But banks were left thinking that this feedback was meant for other, less responsible types.

This complacency was shattered with the latest review. It cited “serious deficiencies in underwriting standards and risk management” with 31% of leveraged loans having “weak” structures. Having observed no improvement since 2013, the report added helpfully, “financial institutions should ensure borrowers can repay credits when due”.

Of course, the gang’s stated target is reducing “systemic risk”. It is their response to the banks’ argument that US taxpayer’s losses during the crisis were caused by sub-prime mortgages, not “risky loans”. (The review acknowledges that almost 75% of buyers of all SNC classified credits – rated substandard, doubtful or loss – weren’t banks at all.)

That brings us to centrifuges. The gang thinks scary machines will keep critters away from leveraged loans. Yes, there are no armadillos in Central Park: S&P Capital IQ data shows only 4.4% of highly leveraged loans are held

by US banks.

What about underwritten, but not distributed, LBO financings by those banks? When the music stopped back in July 2007, roughly \$300 billion of unsold paper was held by agents. Despite doomsday predictions, that overhang was eventually absorbed into the market; not without pain and losses, but without “systemic risk”. Syndicators learned their lesson. Today the overhang is barely 10% of that number.

This is not to make light of all the report’s findings. One eyebrow-raising chart shows 45% of all leveraged SNC transactions after 1 June 2013 sported leverage over six times. As one seasoned risk officer is known to observe, nothing good happens over six times leverage.

This column first appeared in the weekly newsletter of [Creditflux](#), a leading global information source for the credit trading and investment market.