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Banks Enriched by Junk Resist U.S. Regulator Standards

By Caroline Salas Gage and Kristen Haunss - Mar 6, 2014

More than five months ago, the Federal Reserve and Office of the Comptroller of the Currency told some of the biggest banks to improve underwriting standards for non-investment-grade loans. The market is showing few signs of tightening as lenders chase lucrative fees.

Banks are arranging junk-rated deals that leave companies with debt levels exceeding guidelines set by regulators. Among them: the $1.7 billion of loans led by UBS AG and Deutsche Bank AG last month to finance KKR & Co.'s purchase of a majority stake in Sedgwick Claims Management Services Inc., and the $700 million loan Credit Suisse Group AG arranged in January for Applied Systems Inc., a maker of software for insurance companies.

Bank supervisors are insisting on minimum standards as they seek to avoid a repeat of the losses that occurred during the credit crisis, which sent the global speculative-grade default rate to more than 13 percent in 2009, the highest since the Great Depression. The persistence of deals with questionable terms shows that, so far, regulators are having trouble deterring excessive risk-taking simply by asking.

"Jawboning rarely works if there's money to be made," said Mark Calabria, director of financial regulation studies at the Washington-based Cato Institute, a research group that espouses limited government. "History doesn't repeat itself but sometimes it rhymes -- I certainly have those concerns."

Urging Prudence

Starting last September, the Fed and the OCC sent letters to banks giving them 30 days to come up with a plan for tighter policies, according to four people familiar with the missives. Recipients included Barclays Plc, Citigroup Inc., Deutsche Bank, Goldman Sachs Group Inc., JPMorgan Chase & Co., Morgan Stanley and UBS.

The Fed and OCC are urging restraint in a market that has been one of the bright spots for banks hobbled by narrow profit margins.

Debt-underwriting revenue at eight of the largest U.S. and European investment banks, including JPMorgan and Deutsche Bank, rose 9.1 percent to about $18.7 billion in 2013. That was the highest total since at least 2008, according to Bloomberg Industries. Much of the increase last year was driven by high-yield lending, industry analytics firm Coalition Ltd. said in its annual report in February.

Underwriting Fees

Fees for underwriting leveraged loans can be about two percentage points, or $20 million on a $1 billion credit, according to two people familiar with such deals, who declined to be identified because they're not public. That compares with an average of about 50 basis points, or 0.5 percentage point, for arranging investment-grade bonds last year, according to data compiled by Bloomberg.

While banks will often use their balance sheets to commit to financing a leveraged loan, they typically sell them to investors such as mutual funds, hedge funds or collateralized loan obligations. CLOs are a type of collateralized debt obligation that pool high-yield loans and slice them into securities of varying risk and return.

Leveraged loans, also called high-yield or junk-rated loans, are made to companies rated below Baa3 by Moody's Investors Service or lower than BBB- by Standard & Poor's.

"The big banks are crawling all over here" to make loans, and terms are "hyper-competitive," Federal Reserve Bank of Dallas President Richard Fisher said Feb. 12 in an interview at the district bank. Because interest rates are low, "everyone is reaching to take advantage of this environment."

Covenant-Light

For the first time, more than half of the junk-rated loans made in the U.S. during the fourth quarter and so far this year lacked standard protections for lenders such as limits on debt relative to cash flow, Bloomberg data show. Such so-called covenant-light loans amounted to a record $84 billion in the fourth quarter. That was followed by another $57 billion since December.

The exclusion of "meaningful maintenance covenants" is a sign that "prudent underwriting practices have deteriorated," the Fed, OCC and Federal Deposit Insurance Corp. said in a March 21 statement accompanying the release of their underwriting guidelines.

The advisory said debt levels of more than six times earnings before interest, taxes, depreciation and amortization, or Ebitda, "raises concerns." Underwriting standards should also consider a borrower's ability to repay and "delever to a sustainable level within a reasonable period," the regulators said.

Dialing Up

"The issuer community has continued to press the envelope," said Jason Rosiak, head of portfolio management at Newport Beach, California-based Pacific Asset Management, the Pacific Life Insurance Co. affiliate that oversees about $4.5 billion in assets. "Some deals" are "dialing up leverage a bit more, and covenant light has become the norm."

Meredith Coffey, an executive vice president at the Loan Syndications and Trading Association, declined to comment. The New York-based LSTA is the leveraged-loan market's main trade group.

Fed officials have singled out leveraged loans as an example of excessive risk-taking as they scan the financial horizon for signs of asset-price bubbles fueled by a benchmark interest rate that's been near zero for more than five years.

Strong Inflows

High-yield corporate-bond and leveraged-loan funds "have seen strong inflows, reflecting greater investor appetite for risky corporate credits, while underwriting standards have deteriorated, raising the possibility of large losses going forward," Daniel Tarullo, the Fed governor in charge of bank supervision, said in a speech in Arlington, Virginia, on Feb. 25.

Inflows into U.S. mutual funds that invest in bank loans swelled to a record $61.3 billion last year, from $11.2 billion in 2012, according to data from Morningstar Inc. The debt has seen unprecedented demand because, in addition to yielding more than safer securities, floating rates offer a shield from rising borrowing costs.

Investors have been "very sanguine regarding certain types of exposure and modest in their demands for compensation to assume such risk," Tarullo said.

Demand has allowed U.S. speculative-grade companies to lower their borrowing costs. The average yield on new loans in 2013 was 5.2 percent, down from 8.5 percent in 2009, according to S&P Capital IQ Leveraged Commentary and Data.

'Criticized' Loans

When regulators conducted their annual review of bank credit last year, they found the March guidance had gone unheeded. Of $429 billion of leveraged loans they sampled, 42 percent were "criticized," or classified as having a deficiency that might lead to a loss.

They then followed up with letters to individual banks starting in September.

"It is a bit too soon to judge precisely how effective" supervisory actions such as last year's leveraged-lending guidance have been, Tarullo said in his speech last month.

Fed and OCC regulators have been meeting with bankers during the past several weeks to discuss their responses to the letters, according to five people who participated in the meetings.

One obstacle regulators face: as they succeed in deterring firms from some risky deals, competitors snap them up.

Texas Chipmaker

JPMorgan, for example, didn't arrange a refinancing this month of a portion of Freescale Semiconductor Inc.'s more than $5 billion of debt -- even though the New York-based bank helped put together earlier facilities, according to three people familiar with the deal and regulatory filings. The Austin, Texas-based chipmaker is levered 6.8 times, according to high-yield research firm KDP Investment Advisors Inc.

JPMorgan's abstinence hasn't stopped the deal from getting done. Citigroup, Barclays, Credit Suisse, Deutsche Bank, Goldman Sachs and Morgan Stanley arranged the deal, according to data compiled by Bloomberg. Tasha Pelio, a JPMorgan spokeswoman, declined to comment. Kendrid Rodriguez, a Freescale spokeswoman, didn't respond to requests for comment.

Citigroup's decision to stand back from a debt package that included a $735 million covenant-light term loan for KKR's buyout of Brickman Group Ltd. didn't stop the landscaping company's deal either, two people familiar with knowledge of the matter said. Kristi Huller, a KKR spokeswoman, declined to comment.

Brickman Leverage

Brickman's B2 rating -- five levels below investment-grade -- reflects the company's debt-to-Ebitda of 6.8 times, "low profitability and weak interest-coverage metrics, relatively small revenue size and limited business diversity," Moody's said in a Dec. 3 report. Morgan Stanley, Credit Suisse and Goldman Sachs are among the banks that helped arrange Brickman's loan.

Rob Julavits, a spokesman for Citigroup, and LaNella Hooper-Williams, a spokeswoman for Brickman, declined to comment.

One challenge banks face as they seek to comply with regulators' guidance is its sweeping nature, said Beth MacLean, an executive vice president and bank-loan investment manager at Newport Beach, California-based Pacific Investment Management Co., which oversees $1.9 trillion in assets, including $15 billion of loans.

The maximum debt-to-cash-flow ratio "doesn't distinguish between an industrial company that should maybe have four times leverage and a media company that historically has been able to support six to eight times leverage," MacLean said.

Deficient Loan

Banks also have varying internal definitions of what constitutes a deficient loan. Underwriters determine themselves whether the loan is considered criticized or not at inception. Then, during an annual review of bank credit, supervisors examine a sample of those deals and assign their own ratings.

Regulators are concerned the amount of debt companies are piling on exceeds their ability to repay it. Low-rated companies can borrow even after indicating they "will have to be reorganized, or are in bad shape," the Fed's Fisher said.

Sedgwick, the Memphis-based claims processor in which KKR bought a majority stake, has "substantial" leverage of about eight times Ebitda after taking out covenant-light loans to fund the purchase, Moody's said in a Feb. 10 report. Banks marketed the deal with 7.1 times leverage based on "adjusted Ebitda," according to a deal document obtained by Bloomberg News.

Catherine Bennett, a spokeswoman for Sedgwick, didn't respond to e-mails seeking comment. Megan Stinson, a UBS spokeswoman, and Mayura Hooper, a Deutsche Bank spokeswoman, both declined to comment.

Software Maker

Applied Systems is also saddled with debt of about nine times Ebitda after taking out its covenant-light term loan led by Credit Suisse to finance the insurance-management software maker's purchase by private-equity firms Hellman & Friedman LLC and JMI Equity, according to Bloomberg data and a Jan. 10 Moody's report.

"The leverage burden leaves Applied Systems virtually no room for operational error to respond effectively to competitive pressures or changing market conditions," the Moody's report said. The University Park, Illinois-based company is rated B3, six levels above default.

Matt Fogt, a spokesman for Applied Systems, didn't respond to requests for comment. Drew Benson, a Credit Suisse spokesman, declined to comment.

Leon Black, founder of private-equity firm Apollo Global Management LLC, said regulators' proposals to clamp down on debt levels in leveraged buyouts are micromanaging.

'Blanket' View

"To have a blanket number like that is micromanaging too much from a regulatory point of view," Black said Feb. 28 at a conference in New York. "Different industries have different growth rates."

Tighter credit could curb profits for private-equity firms like Apollo, if they are forced to put up more cash for their takeovers or are restricted from piling additional debt onto their portfolio companies for purposes such as paying themselves dividends.

The Fed, OCC and the FDIC soon will undertake their annual review of bank credit, which is usually conducted in May and June, according to the Fed's website.

Martin Pfinsgraff, senior deputy comptroller for large bank supervision at the OCC, said in a November interview that regulators have a "whole array" of tools available if banks ignore their directives, including cease-and-desist orders and lowering the supervisory scores that regulators give to banks. A lower rating can affect a bank's flexibility to buy back stock, pay dividends, engage in mergers and expand branches.

Tarullo, in his speech last month, said central bankers must preserve the option of using interest rates to lean against dangerous financial bubbles. They may have to do that, said Cato's Calabria.

"It's all well and good for the regulators to say 'You need to be aware of this risk,'" he said. "You also have to be aware that interest-rate environments create such strong incentives to do some things."

"I'm a believer you have to do this monetary wise."

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