Fed Loan Warning May Hurt Riskiest Borrowers, Trade Group Says

Kristen Haunss - Oct 25, 2013

Recommendations by top banking regulators that lenders strengthen underwriting standards for leveraged loans may decrease funding to the neediest borrowers, according to Loan Syndications and Trading Association.

The Federal Reserve and the Office of the Comptroller of the Currency sent letters to some of the biggest U.S. banks asking them to avoid arranging debt that may be classified by regulators as having some deficiency that may result in a loss, according to nine people with knowledge of the communication.

Regulators are seeking to cut down on excessive risk taking as typical lender protections have been stripped from credit agreements at a record pace. Speculative-grade borrowers have raised $239.6 billion of covenant-light loans this year, more than double the amount in 2012, Bloomberg data show. The LSTA, whose almost 350 members consist of banks, investors and corporate law firms, said the regulators' request will hurt the least-creditworthy companies.

"This does not help the availability of credit to non-investment-grade borrowers," Meredith Coffey, executive vice president at the trade association for the U.S. corporate loan market, said in a telephone interview.

Covenant-light loans give companies more leeway to avoid a default as they don't contain financial-maintenance provisions requiring the borrower to meet such restrictions as a set level of debt relative to earnings before interest, tax, depreciation and amortization.

Leveraged loans and high-yield, high-risk bonds are rated below Baa3 by Moody's Investors Service and lower than BBB- at Standard & Poor's.

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High-yield, high-risk loans are used to help troubled companies as well as back buyouts, such as the $3 billion financing that helped real-estate lender Istar Financial Inc. avoid bankruptcy and the debt package for the $48 billion purchase of Energy Future Holdings Corp. by KKR & Co., Goldman Sachs Capital Partners and TPG Capital.

The debt is booming, with issuance at $839.6 billion this year in the U.S., within 7 percent of the record $899 billion set in 2007, according to data compiled by Bloomberg.

The Fed, the Federal Deposit Insurance Corp., and the OCC issued guidelines in March for junk-rated loans citing deteriorating underwriting conditions. The update was the first since 2001.

“The concerns they are expressing are not something we are seeing reflected in an increasing default rate,” Elliot Ganz, general counsel at the LSTA in New York, said in a telephone interview.

Moody’s forecasts the global speculative-grade default rate will rise to 3 percent this year from 2.8 percent in September. The measure peaked at 13.73 percent in November 2009.

“If the agencies prevent the banks from underwriting leveraged loans, it’s pretty clear that some deals won’t get done,” Ganz said.