Bauerle's Bank Notes

Jawboning

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According to Wikipedia, the default knowledge base of the Internet age, "jawboning" is "an unofficial technique of public and private discussions and arm-twisting, which may work by the implicit threat of future legal regulation." Americans of a different age remember President Kennedy in April 1962 publicly jawboning the steel industry. In a bid to contain inflation, Kennedy's team had brokered a deal with the United Steelworkers Union not to seek higher wages if the industry did not raise prices. When U.S. Steel hiked prices anyway, Kennedy went public with his anger. On national television he charged, "the American people will find it hard, as I do, to accept a situation in which a tiny handful of steel executives, whose pursuit of private power and profit exceeds their sense of public responsibility, can show such utter contempt for the interests of 185 million Americans. " U.S. Steel reduced its prices and jawboning entered the American political lexicon.

The Federal Reserve Board of Governors has lately engaged in its own form of jawboning, repeatedly signaling its displeasure with loans to highly leveraged companies. The first shot across the financial markets' bow came in 2012 when the Fed, the OCC and the FDIC jointly published proposed Interagency Guidance on Leveraged Lending. In March 2013, the regulators issued their Guidance in final form. (Legally, federal agencies issue "guidance" as a way to publish their views on a subject without going through the process of issuing regulations that are codified in the Code of Federal Regulations.) Earlier this year, the OCC's annual Shared National Credit Examination served as a bully pulpit from which the message was rebroadcast. In mid-November, the regulators spoke again, issuing Frequently Asked Questions for Implementing March 2013 Interagency Guidance on Leveraged Lending.

The FAQ Guidance is short on prescriptive measures like those published in 2006. One of the lessons learned in 2008 was that regulators waited too long to sound the alarm about the systemic risk posed by the sharp increase in real estate-backed debt. When they did act by limiting banks' exposure to commercial real estate loans to 300% of capital, most banks were already above the limit. So the regulators' action closed the credit spigot abruptly, throttled the real estate industry and helped precipitate the crisis.

Determined not to miss their mark again, federal regulators have begun earlier in this business cycle and pressed harder to contain the growth of financial leverage. They have avoided prescriptive measures (so far), preferring nuanced cautions designed to appear measured but deliberate. Typical is the following q&a:

> Q3. Are all loans that meet any one of the common characteristics, such as exceeding 3 times senior debt or 4 times total debt divided by earnings before interest, taxes, depreciation, and amortization (EBITDA), automatically considered leveraged?
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> > No. Leverage is an important indicator, but it should be considered in relation to other loan characteristics. It is generally appropriate to exclude certain loans secured by tangible collateral (for example, accounts receivable, inventory, property, plant and equipment, and real estate) that do not rely on enterprise valuations for repayment, even where leverage exceeds 3 times senior debt or 4 times debt divided by EBITDA, because the lender has additional sources of repayment beyond the cash flow from the operations of the borrower. Accordingly, the agencies would not expect most loans secured by commercial real estate and small business loans to be included in an institution's definition of a leveraged loan. Many of the risk management principles in the guidance for leveraged lending also apply to these loans, and management should have underwriting, monitoring, structure, and repayment expectations for these credits that reflect the characteristics of the collateral and the unique risks of these loans.

The words are measured, but the meaning is clear: "We will not tolerate concentrations of loans to highly leveraged companies." In Fed-speak,

> The supervisory expectation is that institutions establish sound underwriting and risk management processes for a broad range of credits to leveraged borrowers. Management should consider each of the common characteristics discussed in the guidance individually to identify leveraged loans for the institution's definition.

The message has not been lost on the market. Banks responded first. Private equity funds have fallen into line lately. The Wall Street Journal on Dec. 4 noted that private equity funds are framing financing proposals for companies they sponsor so as not to run afoul of the six times equity boundary that the Interagency Guidance and FAQ has established as the trip wire for heightened scrutiny.

Shadow banking providers are not escaping attention this time around either. The Guidance says its restrictions apply with equal force to banks' credit exposure to business development companies (BDCs) and Collateralized Loan Obligation funds (CLOs). These types of entities have been a favorite Wall Street tactic to circumvent bank regulatory constraints on leveraged lending. BDCs issue equity in the public market and then use bank borrowings to leverage their capital, including by making leveraged loans to nonfinancial companies. BDCs and CLOs have funded approximately ¾ of the leveraged loans booked in the last several years.

An important consequence of the regulators' campaign is likely to be moderation of the prices being paid in merger and acquisition transactions. Buyers typically base their bids for companies on the amount they can finance in the capital markets, just as home buyers do when purchasing residential real estate. Pent-up demand of private equity buyers and high levels of bank capital seeking a home in the market for commercial and industrial loans have led to steep prices being paid for companies that have quality earnings (or even the prospect of attaining them). Application of the 6x equity boundary will inevitably drive down deal pricing. Would-be sellers need to act while market conditions remain conducive to getting optimal prices.

The economic recovery since 2009 has occurred at a snail's pace as companies have hoarded cash, consumers have de-leveraged their balance sheets, bankers have been reluctant lenders, and regulators have jawboned the financial industry frequently and intensively. Whether that serves the nation well or poorly remains to be seen. What is evident is that the jawboning is likely to continue, and price hikes, whether on steel, loans or other commodities, will remain hard to come by.

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