Decision of the
Supervision Appeals Review Committee

In the Matter of
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Case No. 2018-01

I. Summary

After consideration of the timely filed written submissions of the parties, the record of this case, and following the June 13, 2018 oral presentations and deliberative meeting of this Committee, the Committee upholds the decision of the Director of the Division of Risk Management Supervision ("RMS") concerning the disputed loan classification. However, the Committee notes that this appeal raised certain transparency issues relating to the process used for evaluating loans under the Shared National Credit Program. The Committee therefore directs RMS to reach out to its counterparts in the Shared National Credit Program at the other banking agencies concerning how the agencies could provide greater transparency to affected entities on the methods used by examiners in evaluating senior secured debt and intangible property.

II. Background and Procedural History

* * * ("Bank") [is] appealing a loan classification decision arising from the * * * Shared National Credit ("SNC") Review.[1] Specifically, the Bank held a participation interest in a senior secured credit facility extended to [Borrower]. The Bank argues that this loan, which was rated "Substandard" during the * * * SNC Review, should have been rated "Pass."

The [Borrower] loan was originated through * * * ("agent bank") in * * * for the purpose of financing mergers and acquisitions. The loan had a seven-year term, and at the time of the * * * SNC Review, the principal balance was approximately $* * * billion. [Borrower] was required to make quarterly payments amortizing the principal at a * * * percent annual rate, followed by a balloon payment of the remaining principal balance at maturity. The loan was secured by a first-priority lien on all of [Borrower]'s business assets. It was also secured by * * * percent of the common equity of each foreign subsidiary directly held by [Borrower]. Certain [Borrower] subsidiaries also provided guarantees.

[1] The Shared National Credit Program is an interagency initiative administered jointly by the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. Under this program, large syndicated credits are rated by interagency panels of examiners, typically during an examination of the agent bank. The assigned ratings are subsequently used during examinations of participating banks by their respective regulators, avoiding duplicate reviews of credits and promoting consistency in regulatory credit ratings.

Subsequent to the Bank's * * * purchase of a participation interest in the loan, [Borrower]'s financial performance deteriorated * * *. [Borrower] also reduced financial projections as it implemented a turnaround plan * * *. In * * *, [Borrower] and its senior secured creditors negotiated amendments to certain covenants in the loan agreement to provide [Borrower] with some relief. In addition, the amendments provided that the proceeds of any asset sales would be used to pay down the loan.

During the * * * SNC Review, examiners rated the loan "Substandard," citing [Borrower]'s high leverage, weak operating performance, and inability to deleverage in a reasonable time frame. * * *

On January 11, 2018, the Bank submitted a request for review of the classification decision to the Director of RMS pursuant to the FDIC's *Guidelines for Appeals of Material Supervisory Determinations* ("*Guidelines*").[2] The Division Director issued her decision on February 26, 2018, concluding that the classification of the loan was supported. The Division Director found that [Borrower]'s projected cash flow reflected inadequate capacity for repayment of the loan, and that collateral valuations as a secondary repayment source were insufficient to withhold the adverse classification in light of the repayment capacity weakness. The Division Director further concluded that credible findings supported the examiners' determination that the [Borrower] loan exhibited well-defined weaknesses and presented a risk of loss, consistent with the assigned "Substandard" classification.

The Bank filed an appeal with the Supervision Appeals Review Committee by letter dated March 28, 2018. In accordance with the *Guidelines*, the Committee has reviewed the appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of, and the support offered for, the positions of the parties. The Committee met to consider the appeal and to hear oral presentations from the parties on June 13, 2018.

Under the *Guidelines*, the Committee's review is limited to the facts and circumstances as they existed prior to or at the time the relevant material supervisory determination. In this case, the Bank was notified of the SNC loan classification decision on * * *. Therefore, no consideration is given to facts or circumstances that occurred after that date.

III. Analysis

The Bank disputes the "Substandard" classification assigned to the [Borrower] loan at the * * * SNC Review. The FDIC's RMS Manual of Examination policies provides the standards for loan classifications, including the following definition for the "Substandard" rating:

[2] 82 Fed. Reg. 34,522 (July 25, 2017) (available at https://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html).

> Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.[3]

The Bank argues that the classification was unwarranted due to [Borrower]'s paying capacity and the value of the pledged collateral. The Bank also asserts that the concerns cited by the examiners do not represent well-defined weaknesses jeopardizing the liquidation of the loan. According to the Bank, these concerns represent, at most, potential weaknesses.

A. Repayment Capacity

The Bank's Position

The Bank asserts that the examiners' assessment of [Borrower]'s repayment capacity was flawed because it failed to recognize the differences between senior secured creditors and unsecured creditors. In support of this argument, the Bank asserts that the examiners' write-up of the loan referenced [Borrower]'s total leverage ratio of 6.9x, rather than its senior secured leverage ratio of 2.41x. The Bank argues that as a senior secured creditor, it is not treated the same as unsecured creditors in the normal course of business and would not be treated the same if [Borrower] were to enter bankruptcy proceedings. The Bank contends that the examiners should have focused on the risk of nonpayment associated with the senior secured debt, rather than the risk of nonpayment of the total debt.

The Bank argues that as a senior secured creditor, it benefits from two additional sources of cash flow that are not available to unsecured creditors. First, the * * * amendments to the loan agreement require the proceeds of all asset sales to be applied to the loan. Approximately $* * * billion was prepaid toward the loan during * * * as a result of * * * asset sales. Second, a cash sweep provision of the loan agreement requires 50 percent of [Borrower]'s net income, with some adjustments, to be used to prepay the loan. [Borrower] prepaid * * *.

The Bank also points to [Borrower]'s improved operating results as evidence of its capacity to repay the senior secured debt. In particular, the Bank notes that [Borrower]'s net income improved * * *. All scheduled principal payments through maturity have been made, and the loan is current. In the Bank's view, the evidence with respect to repayment capacity is inconsistent with the assigned "Substandard" classification.

[3] FDIC Risk Management Manual of Examination Policies § 3.2-47 (rev. 8/16).

RMS's Position

RMS argues that the examiners differentiated [Borrower]'s senior debt from its total debt during the SNC Review, and that repayment weaknesses persist even following the asset sales and debt reductions. According to RMS, the agent bank's projections showed both senior secured leverage and total leverage increasing in the near term, indicating increasing risk. Projections provided by the agent bank showed that [Borrower]'s free cash flow would be sufficient to repay only * * * percent of its senior secured debt and * * * percent of its total debt in the next seven years.[4] Examiners' standard practice is to consider free cash flow rather than net income in evaluating repayment capacity.[5] Moreover, [Borrower] was unprofitable in * * *. RMS asserts that the forward-looking projections obtained from the agent bank, reflecting * * *, are more credible and relevant than the Bank's backward-looking assessment of repayment capacity, which relied on asset sales to reduce debt.

The Committee's Findings

We reaffirm the principle that when examiners rate loans, "[e]ach loan is appraised on the basis of its own characteristics."[6] The record here supports the determination of inadequate repayment capacity, even in light of the Bank's status as a senior secured creditor. As noted above, the agent bank's projections showed that [Borrower]'s free cash flow would be insufficient to repay its senior secured debt over the following seven years. The agent bank's projections of increasing leverage in the near term and [Borrower]'s reductions in its forward-looking revenue and earnings guidance also support the examiners' conclusion.

The examiners' consideration of total leverage as part of the analysis does not signify a failure to distinguish between senior secured creditors and unsecured creditors. [Borrower]'s senior secured creditors might enjoy priority over other creditors in bankruptcy, but they do not have the sole claim to the company's cash flow in the regular course of business. Excessive leverage, even if it consists of debts of a lower priority, reduces the borrower's flexibility and thereby increases the probability of default. Examiners should be mindful of the overall capital structure when evaluating the characteristics of a specific loan.

The prepayments appear to have benefited [Borrower]'s secured creditors, including the Bank, but do not sufficiently mitigate the concern regarding repayment capacity. The prepayments

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[4] The Bank expressed concern with certain aspects of the agent bank's analysis, but did not provide alternative projections of [Borrower]'s free cash flow as part of this appeal.

[5] See, for example, FDIC Risk Management Manual of Examination Policies § 3.2-11 (rev. 8/16) ("If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten.").

[6] FDIC Risk Management Manual of Examination Policies § 3.2-46 (rev. 8/16).

from asset sales reduced the balance of the loan, but the primary source of repayment going forward was expected to be [Borrower]'s operating cash flow. Analysis of repayment capacity is inherently forward-looking, and at the time of the determination, [Borrower]'s projected free cash flow was insufficient to repay even its senior secured debt over the relevant time frame. It is not clear that [Borrower] could rely on asset sales to repay its secured creditors indefinitely. As for the prepayments from operating cash flow, the two payments cited by the Bank took place on * * * and * * *, after the date of the loan classification. Although these payments were anticipated in projections issued prior to the date of the loan classification, the company had failed to meet its own projections in * * * and was in the midst of executing its turnaround plan at the time of the classification. Caution was therefore reasonable in considering whether those projected prepayments would in fact occur.

B. Collateral Protection

The Bank's Position

The Bank argues that even if [Borrower] lacked the capacity to repay the loan with cash, applicable regulatory guidance allows the loan to be rated "Pass" because the pledged collateral provides adequate protection. The loan was secured by first-priority security interests in all of [Borrower]'s business assets, which include * * *.

The Bank asserts that the collateral's worth substantially exceeded the total outstanding amount of [Borrower]'s senior secured credit facilities, including the loan, which totaled approximately $* * * billion at the time of the * * * SNC Review. In support of this argument, the Bank provides valuation estimates for the collateral ranging from $* * * billion to $* * * billion, resulting in senior secured loan-to-value ratios ranging from approximately 48 percent to 29 percent. The $* * * billion valuation was stated in the initial write-up of the loan provided at the * * * SNC Review, and was based on the agent bank's income or discounted cash flow analysis. The Bank also suggests applying a multiple of 6.5x earnings before interest, taxes, depreciation, and amortization ("EBITDA"), which it derives from recent asset sales, to [Borrower]'s * * * EBITDA guidance of $* * * billion, resulting in an enterprise value of $* * * billion. A third method recommended by the Bank is to use the acquisition prices of some of [Borrower]'s recent acquisitions as a proxy for their valuation, and add the book value of [Borrower]'s tangible assets, resulting in an enterprise valuation of $* * * billion.

The Bank also questions certain changes in the stated valuation of the collateral during prior SNC reviews. Specifically, the write-up of the loan from the * * * SNC Review valued the collateral at $* * * billion. The initial write-up from the * * * SNC Review contained a valuation of $* * * billion. After the Bank's SNC appeal, the revised write-up of the loan valued the collateral at only $* * * billion. The Bank seeks an explanation for this range of valuations.

The Bank also asserts that the examiners unreasonably assigned zero value to [Borrower]'s intangible assets. In support of this argument, the Bank refers to the revised write-up from the * * * SNC Review, which assigned a valuation of $* * * billion to the collateral. The Bank contends that this valuation represents the total of [Borrower]'s: (1) current assets; (2) net property, plant, and equipment; (3) and certain other assets not relevant here. Accordingly, the Bank concludes that the examiners assigned zero value to intellectual property, other intangible assets, and goodwill. The Bank argues that this approach not only misrepresents the value of the collateral with respect to the [Borrower] loan, but also generally discourages lending to businesses with sizable intellectual property holdings, such as pharmaceutical and technology companies.

RMS's Position

RMS asserts that the examiners' findings are supported, and collateral valuations as a secondary repayment source are not sufficient to withhold the "Substandard" classification in light of the repayment capacity weakness. RMS argues that enterprise value estimates obtained using even the most rigorous procedures are imprecise and ultimately may not be realized. For example, the agent bank's base case analysis employed a variety of approaches, resulting in valuations ranging from $* * * billion to $* * * billion, while its stress case analysis resulted in valuations ranging from $* * * billion to $* * * billion. RMS contends that this reflects considerable uncertainty, and caution is warranted in relying on enterprise valuation as a source of repayment.

RMS explains that the significant changes in the stated value of the collateral during recent SNC reviews resulted from an error that was corrected through the SNC appeal process. RMS asserts that the * * * SNC write-up used the *book value of [Borrower]'s tangible assets*, $* * * billion, for the collateral valuation. The * * * SNC write-up mistakenly used an estimate of [Borrower]'s *enterprise value*, $* * * billion. Following the correction of this error, the * * * SNC write-up once again used the book value of tangible assets, which was approximately $* * * billion at that time. RMS asserts that this correction made the estimates comparable.

The Committee's Findings

The value of pledged collateral can sufficiently mitigate the credit risk associated with a loan so as to warrant an improved classification. Relying upon a borrower's enterprise value as a source of repayment presents risk, however, as prevailing valuations can change substantially over time. Thus, "[i]f the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported."[7] "Evidence of well-supported value may include binding

[7] FDIC Risk Management Manual of Examination Policies § 3.2-11 (rev. 8/16).

purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions."[8]

The Bank's proposed estimates for [Borrower]'s enterprise value fail to account for potential distress or changes in business conditions. The record does not suggest that the $* * * billion valuation obtained from the agent bank's discounted cash flow analysis reflected potential distress or changes in business conditions. Similarly, application of a multiple of EBITDA from [Borrower]'s recent asset sales appears to presume that valuations will remain at current levels. As for using acquisition prices as a proxy for the value of certain businesses, such an approach would by its very nature disregard the possibility of changes in business conditions. In light of our findings with respect to repayment capacity, the record at the time the determination was made does not support an improved rating for the loan on the basis of the pledged collateral.

C. Well-Defined Weakness and Risk of Loss

The Bank's Position

The Bank argues that a "Substandard" classification is warranted only where a loan exhibits well-defined credit weaknesses. In the Bank's view, the concerns cited by the examiners do not support the assigned classification and represent, at most, potential weaknesses that could result in deterioration of the loan's repayment prospects if not corrected. Those concerns included high leverage, weak operating performance, and an inability to deleverage within a reasonable time frame.

The Bank argues that high leverage is not, in and of itself, a credit risk or weakness that requires an adverse classification. There is no bright-line rule for determining whether leverage is excessive, and examiners evaluate leverage within the context of the borrower's expected future cash flows and the condition of the borrower's industry.[9] The Bank asserts that despite [Borrower]'s high leverage, its expected future cash flows showed ample repayment capacity, while the outlook for the * * * sectors remained strong.

The Bank argues that the examiners' criticisms of [Borrower]'s operating performance were conclusory and gave too much weight to concerns regarding * * *. The Bank asserts that [Borrower]'s performance has been stable and that the examiners never showed that the cited concerns might jeopardize repayment.

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[8] *Id.*

[9] *See Interagency Guidance on Leveraged Lending: Frequently Asked Questions*, FIL-53-2014 (November 13, 2014).

With respect to [Borrower]'s ability to deleverage, the Bank argues that because the loan matures in seven years, it is due to be repaid in full within the time period cited by the examiners. In addition, the Bank contends that an inability to deleverage within five to seven years does not necessarily warrant a loan classification, as regulatory guidance requires examiners to consider whether the borrower has other compensating means of financial support that may support a "Pass" rating.[10] The Bank asserts that in this case, the strength and stability of [Borrower]'s cash flow sources support repayment of the loan.

The Bank also argues that the views of market participants reflect a lack of well-defined weaknesses with respect to the [Borrower] loan. The Bank points out that the loan traded above par value from the beginning of * * * through the time of the * * * SNC Review. The Bank contends that market participants are pricing [Borrower]'s senior secured debt with the expectation that it will be repaid in full. The Bank further notes that Standard & Poors assigned a recovery rating of * * * to [Borrower]'s senior debt, reflecting * * *.

RMS's Position

RMS argues that credible findings support a number of well-defined weaknesses consistent with the assigned "Substandard" rating. At the time of the loan classification decision, [Borrower] was operating under a turnaround plan, and covenants in the loan agreement were modified in * * * to provide the company with some relief. [Borrower] was unprofitable in * * * and * * * with declining revenue during that time frame. Debt-to-equity measures deteriorated over the same period, while leverage remained high and was expected to increase if [Borrower] could not execute its turnaround plan. RMS reiterates that [Borrower]'s free cash flow was projected to be sufficient to repay only * * * percent of its senior secured debt and * * * percent of its total debt over a seven-year time period, indicating well-defined weaknesses in repayment capacity and ability to deleverage.

RMS argues that the price of debt does not equate to credit quality, and is driven by a number of factors, including supply, demand, coupon rates, and yield. At times, those factors have affected the pricing of debt more than an assessment of risk. RMS does not take a position regarding the credit rating agencies' methods, but notes that those agencies' ratings for [Borrower]'s debt at the time of the loan classification reflected differing treatment for secured versus unsecured debt. RMS also notes that the credit rating agencies rated both [Borrower]'s senior secured and unsecured debt as sub-investment quality.

[10] *Id.*

The Committee's Findings

We find that the record here supports the determination of well-defined weaknesses consistent with the assigned classification of the loan. At the time that the material supervisory determination was made, projections of free cash flow over the remaining term of the loan indicated insufficient capacity for repayment of even the senior secured debt, meaning that repayment depended upon [Borrower]'s ability to refinance the loan. The prospects of such a refinancing could not be taken for granted, considering the company's continuing turnaround efforts and declining revenues. [Borrower] had already obtained relief from its senior secured creditors through modification of loan covenants. The company's leverage also was high and projected to increase further, limiting its flexibility going forward.

Market participants may not have shared the same concerns as the examiners, but risk appetites can vary over the course of the economic cycle. Safety and soundness supervision is intended to ensure that banks can withstand changes in business conditions, and requires a careful analysis of credit risk that may not be reflected in market pricing.

IV. Conclusion

We appreciate the collegiality of the representatives of the Bank and RMS and their presentations to the Committee. Having considered the parties' views and the record of this appeal, we conclude that at the time the loan classification was assigned, it was consistent with the policies and procedures of the FDIC, and therefore uphold the decision of the Director of RMS. However, we are mindful of the importance of transparency and believe that institutions should have sufficient information to understand the analysis underlying loan classifications. We therefore direct RMS to reach out to its counterparts in the SNC Program at the other banking agencies concerning how the agencies could provide greater transparency to affected entities on the methods used by examiners in evaluating senior secured debt and intangible property.

This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, dated July 27, 2018.