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**Proposed Leveraged Lending Guidance;
Docket No. OCC-2011-0028; Federal Reserve Docket No. OP-1439**

Dear Ladies and Gentlemen,

I appreciate the opportunity to comment on the Agencies' Proposed Guidance on Leveraged Lending, published in the Federal Register on March 30, 2012.¹

My concern about the issues raised in your proposed rulemaking dates back to the mid 1990's when I authored an article that was used as the cover story in the Washington Monthly Magazine titled "Very Risky Business."

The article expressed my concern then about banks whose deposits were insured by the American taxpayers trading in derivatives on their own proprietary accounts. Over the years, my concerns about the amount of risk these banks were taking proved to be well founded. The bank bailouts that were required beginning in late 2008 and 2009 were evidence of the substantial danger to the taxpayers when banks engage in activities that, in other circumstances, would be called "gambling."

¹ Proposed Guidance on Leveraged Lending, 77 Fed. Reg. 19,417 (Mar. 30, 2012).

Since writing that article, I have published a book titled “Reckless” on the general subject and have been engaged both in the U.S. Senate and outside of it, in support of effective regulatory oversight of this type of banking practice.

Although the article I wrote in the mid 1990’s focused on the banks’ proprietary trading in derivatives, the very same issues now present themselves in the concerns surrounding highly leveraged lending. These risky loans can express the same jeopardy for the taxpayers and the same concerns about safety and soundness. That is the reason I believe the action proposed by the Agencies is both necessary and prudent and why I welcomed the opportunity to submit supporting comments and to suggest an additional safeguard to help manage such risks.

Large Banks and Moral Hazard

Large banks occupy a unique position among market participants due to their size and systemic importance and the competitive position they enjoy in the lending markets. As the events of recent years have reminded us, banks do not internalize all risks they take. Rather, they hold deposits that are backed by federal insurance, they have special access to loans on advantageous terms from the Federal Reserve, and they receive extraordinary government assistance (e.g., TARP funds) to ensure their viability at times of intense stress. Leveraged loans—particularly the “covenant-lite” variety that has become more prevalent—entail risk that removes them from the realm of traditional banking. In light of the implicit and explicit taxpayer support (and the potential for “moral hazard” that this public support implies) and the high-risk nature of leveraged lending, the Agencies have a responsibility to ensure that these risks are prudently managed.

The Nature of Leveraged Lending

Leveraged lending may carry considerable risk for banks, as regulators have acknowledged in a variety of contexts in recent years as such lending activity has increased. For example, the FDIC’s recently proposed guidelines for large bank assessments would employ specific guidelines to identify certain leveraged loans as “higher-risk assets” and therefore subject to inclusion in the formula for calculating assessments due to the FDIC.²

Indeed, leveraged loans may involve proprietary risk levels comparable to those the Volcker Rule is intended to address. As commentators have pointed out, bank activity need not involve trading in order to impose substantial proprietary risk.³ “Covenant-lite” loans lack many of the typical covenants intended to protect the lender against certain risks. Leveraged lending

² Assessments, Large Bank Pricing, 77 Fed. Reg. 18,109 (Mar. 27, 2012). *See also, e.g.,* See Office of the Comptroller of the Currency, SURVEY OF CREDIT UNDERWRITING PRACTICES 2011, at 8, available at <http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/pub-survey-cred-under-2011.pdf> (describing increasing risk-taking in leverage lending).

³ Benn Steil, Senior Fellow and Director of International Economics, Beyond the Volcker Rule: A Better Approach to Financial Reform, Council on Foreign Relations, Policy Innovation Memorandum No. 18, available at <http://www.cfr.org/financial-crises/beyond-volcker-rule-better-approach-financial-reform/p27894> (“In short, proprietary risk taking is the issue to be concerned with. Proprietary trading may not involve taking much risk, and proprietary risks can be large without much trading.”).

involves proprietary risk-taking on a scale that is not traditional—even if lending is a traditional bank activity. Covenant-lite loans to firms with high debt levels are frequently as risky as other proprietary activity.⁴

The Agencies' proposal reflects their recognition that the nature of the risk, rather than the particular label attached to an activity or product, is of key importance.⁵ This point also is highlighted by the Volcker Rule's reference to "high-risk assets." In the context of the Volcker Rule, an activity that otherwise is permitted under the rule is prohibited if it involves material exposure of the banking entity to a "high-risk asset." A "high-risk asset" is "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail."⁶

Simply put, leveraged lending carries substantial risk. At a time when legislators' and regulators' attention has focused so keenly on monitoring and mitigating risk at large banks, the Agencies should move forward with their proposed risk management measures for leveraged lending.

The Expansion of Leveraged Lending and Covenant-Lite Loans

Leveraged lending in general, and covenant-lite lending in particular, has expanded in recent years.⁷ The OCC has observed that banks are taking increasingly larger risks in connection with leveraged lending, as credit risk increases and banks ease underwriting standards, lower pricing, and demand fewer covenants.⁸ The OCC found that pricing is the primary means by which banks ease underwriting standards for commercial products.⁹ The risks

⁴ See, e.g., Raghuram G. Rajat, *FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY* 173 (2010) (arguing that inherent riskiness is an insufficient basis for banning proprietary trading, though this is commonly presented as the rationale for the Volcker Rule, and stating "In truth, if banks want to take risk, they can simply go further down the spectrum of risk in any of the activities permitted to them. For example, so long as they can lend, they can freely make unsecured, long-term, 'covenant-lite' loans to heavily indebted firms.").

⁵ It is notable, for instance, that the proposal takes a policies-and-procedures approach to risk management and would have banks define "leveraged lending" in the context of their own activities and risk parameters, rather than, for instance, imposing a universal definition or leverage ratio restrictions.

⁶ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,950 (Nov. 7, 2011) (§ __.8(c)(2) of proposed Volcker Rule).

⁷ See, e.g., Theresa A. Einhorn, *Annual Review of Developments in Business Financing: Current Trends in the Corporate Credit Markets*, 41 No. 2 THE LAWYER'S BRIEF 2 (May 31, 2011) ("In 2007, \$96 billion of covenant-lite loans were issued, mostly to finance private equity buyouts. In contrast, in 2010 only \$5 billion were issued. In the first two months of 2011, \$17 billion of covenant-lite loans had already been issued."); Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 662 (2009) ("Before the subprime loan meltdown in 2007, private equity sponsors saw a substantial rise in 'covenant-lite' (or 'cov-lite') loans—which, as the name suggests, had substantially fewer covenants than most commercial loans -- jumping from four in 2005 to over 100 in 2007. Market participants attributed a portion of the decline in covenant levels to the increased ability to hedge risk in the credit market and the weakening incentives of banks to screen and monitor borrowers.").

⁸ See Office of the Comptroller of the Currency, *SURVEY OF CREDIT UNDERWRITING PRACTICES 2011*, at 8, available at <http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting-practices-report/pub-survey-cred-under-2011.pdf>.

⁹ See OCC *SURVEY OF CREDIT UNDERWRITING PRACTICES 2011*, at 4.

posed by covenant-lite loans may be underestimated in the current markets, magnifying their potentially negative impact.¹⁰

Large Banks as Lenders

Large banks are different from other lenders because they are backed by federal deposit insurance and because their size and systemic importance gives the government a special interest in preventing their collapse. During and after the recent credit crisis, large banks were bailed out by TARP funds and billions of dollars in emergency loans on advantageous terms.¹¹ The bailout experience has increased the potential for moral hazard in bank lending. One study about risk-taking by banks found that banks that received TARP funds engaged in riskier lending, although their total lending amounts remained stable.¹² This finding counters arguments that federal funds increase lending and therefore promote broad economic recovery. The market will not naturally account for all risk. To the contrary, regulators need to address risky activities with specificity in order to combat banks' disincentives to account fully for these risks.¹³

Competitive Pressures in Leveraged Lending

According to the OCC's Handbook on Leveraged Lending, corporate borrowers "often require banks to participate in their credit facilities before purchasing other corporate treasury products."¹⁴ As the OCC has observed, competitive pressures are one of the key reasons banks lower their underwriting standards, thereby increasing risk to the banks and hence to taxpayers.¹⁵ The OCC's National Risk Committee ("NRC") will soon release its *Semi-Annual Perspective on Risk* that will describe systemic threats, the data that evidences them, and measures the OCC is

¹⁰ See, e.g., Theresa A. Einhorn, *Annual Review of Developments in Business Financing: Current Trends in the Corporate Credit Markets*, 41 No. 2 THE LAWYER'S BRIEF 2 (May 31, 2011) ("Moody's cautions that covenant-lite structures 'may be laying the groundwork for painful fallout from the next credit downturn.' With covenant-lite terms, companies avoid default for a longer time, which means that by the time a default occurs, the company will be in weaker financial condition.").

¹¹ See, e.g., Bob Ivry, Bradley Keoun and Phil Kuntz, *Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress*, Bloomberg Markets Magazine (Nov. 27, 2011), available at <http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html> ("The Fed says it typically makes emergency loans more expensive than those available in the marketplace to discourage banks from abusing the privilege. During the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008, according to data from the central bank and money-market rates tracked by Bloomberg.").

¹² See San Duchin and Denis Sosyura, *Safer Ratios, Riskier Portfolios: Banks' Response to Government Aid*, dated Sept. 2011, available at http://www.fdic.gov/bank/analytical/cfr/2011/sept/BRC_2011_51_Sosyura.pdf.

¹³ See Testimony by David K. Wilson, Deputy Comptroller, Credit and Market Risk, Office of the Comptroller of the Currency, before the Subcomm. On Fin. Institutions and Consumer Protection, Sen. Comm. On Banking, Housing, and Urban Affairs, at 4 (June 15, 2011), available at <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-72-written.pdf> ("[R]egulators need to take steps to restore greater transparency and accountability by all market participants – lenders, borrowers, and investors – to facilitate market discipline on excessive risk taking and dispel reliance on potential or perceived government backstops.").

¹⁴ LEVERAGED LENDING, Comptroller's Handbook, Comptroller of the Currency, at 3 (2008), available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/leveragedlending.pdf.

¹⁵ OCC SURVEY OF CREDIT UNDERWRITING PRACTICES 2011, at 7 ("When banks were easing standards, increased competition, risk appetite, and market liquidity were the main reasons for easing.").

taking to address them.¹⁶ Martin Pfinsgraff, co-chair of the NRC, recently cited competitive pressures as one of the themes that emerged in the NRC's recent meetings: "Fee income is down as is loan demand, creating competitive pressures to lower underwriting standards, price or both. We are seeing that trend in high yield, cards, and commercial and industrial loans at present."¹⁷

As might be expected, the OCC has addressed the "slippage" of standards by directing examiners to criticize risky credits they encounter in examinations.¹⁸ Such measures are a sensible starting point for addressing risks as their scope becomes more apparent and problematic. Having identified a risky trend, however, mitigation at the point of examination is inadequate for the longer term. Risk management must be imposed at the time the loan is made. Clear regulatory guidance is needed to promote responsible and effective internal risk management at banks.

Below-Market Loans

As noted above, leveraged lending is one aspect of competitive pressure and bargaining between banks and corporate clients. The anti-tying restriction applicable to banks, which reflects concern about banks' unusual market power, prohibits banks from conditioning the availability or price of a product or service to the customer's purchase of another product or service.¹⁹ Even if practices do not constitute tying, however, the competitive landscape raises concerns about whether banks are using their market power to unfair advantage. To the extent that banks offer loans at below-market rates, measured by price or other terms, their lending practices are anti-competitive, high risk, and proprietary in nature, and must therefore be addressed.

The Financial Accounting Standards Board ("FASB") proposed in 2010 to expand mark-to-market accounting to include loans and other financial instruments historically subject to other accounting methods.²⁰ The breadth of the FASB proposal elicited many objections, and the FASB eventually backed away from key elements of its initial proposal. As the FASB's

¹⁶ Martin Pfinsgraff, OCC Deputy Comptroller for Credit and Market Risk, Remarks before the Risk Magazine Credit Risk Conference, New York, NY (May 22, 2012), *available at* <http://www.occ.treas.gov/news-issuances/speeches/2012/pub-speech-2012-81.pdf>.

¹⁷ *Id.*

¹⁸ See Testimony by David K. Wilson, Deputy Comptroller, Credit and Market Risk, Office of the Comptroller of the Currency, before the Subcomm. On Fin. Institutions and Consumer Protection, Sen. Comm. On Banking, Housing, and Urban Affairs (June 15, 2011), *available at* <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-72-written.pdf>. Wilson told the Subcommittee: "[W]e have admonished national banks not to compromise their underwriting standards due to competitive pressures. Where we see signs of such slippage, we are intervening at an early stage. For example, last June in response to signs of slippage that examiners were seeing in some leveraged loan facilities, we issued guidance to our examiners that reinforced our supervisory expectations for this type of lending and directed them to criticize or classify credits that exhibit minimal repayment capacity, excessive leverage or weak/nonexistent covenants, even when the credits had been recently advanced." *Id.*

¹⁹ Bank Holding Company Act Amendments of 1970, § 106.

²⁰ FASB Exposure Draft, Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments (Topic 825) and Hedging Activities (Topic 815), File Reference No. 1810-100 (May 26, 2010) ("Exposure Draft").

deliberations have continued, however, one aspect of the proposal that remains is a concern for off-market transaction prices. The current summary of the FASB's positions states in part, "In certain circumstances, an entity would be required to evaluate whether the consideration given or received at recognition for a financial instrument that is not otherwise required to be initially measured at fair value indicates that an element other than the financial instrument is included in the transaction."²¹

The initial FASB proposal was more specific in how it addressed situations in which transaction price differs significantly from the fair value of a financial instrument, indicating the presence of "other element(s)" in the transaction.²² The proposal, which aimed to promote transparency in disclosures about financial instruments, would have required a bank to acknowledge and account for a loan's divergence from market terms. Evidence of such difference could be found in, among other things, "[t]he price that a third-party buyer would be willing to pay to acquire a financial asset or to assume a financial liability"—in other words, in the case of leveraged lending, evidence that the loan was made off-market and would trade at a discount to par.

The FASB deliberations are a reminder that certain types of transactions—such as leveraged loans, especially the covenant-lite variety—may not be readily transparent and, in any event, unquestionably involve proprietary risks and incentives that require accountability, management, and mitigation. Particularly where there are safety and soundness concerns, and where risks impact banks' balance sheets and capital (and, therefore, taxpayer funds), adequate risk management controls are essential. A key aspect of effective risk management in this context is a system that allows risk managers to identify the actual substance of the transaction and thus the actual risks involved. In other words, when "relationship lending" occurs, risks

²¹ See FASB's Accounting for Financial Instruments, Summary of Decisions Reached to Date During Redeliberations, at 2 (dated May 21, 2012), *available at* http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156422130. The "initial measurement principle" is stated in paragraph 12 of the initial proposal. Exposure Draft, at 32-33.

²² Exposure Draft, at 33-34, ¶¶14-17. The proposed guidance called for "reliable evidence" that there is a significant difference between transaction price and fair value. Such evidence may be found in any of the following:

- "a. The terms of a financial instrument, such as upfront and ongoing fees, duration, collateral, and restrictive covenants
- b. Prevailing rates offered to other borrowers or offered by other lenders for similar financial instruments that are not influenced by unstated or stated rights and privileges
- c. Prevailing rates of other financial instruments with the same borrower or lender that are not influenced by unstated or stated rights and privileges
- d. The price that a third-party buyer would be willing to pay to acquire a financial asset or to assume a financial liability
- e. If noncash items are exchanged, the current cash price for the same or similar items exchanged in the transaction."

Exposure Draft, at 67-68. One example given of such a situation is "a credit facility offered at an off-market rate in exchange for goods or services at off-market prices." In this example, the lender would recognize the loan at fair value, and the difference between the transaction price and fair value would be recognized in net income. Exposure Draft, at 68.

cannot be adequately identified and managed unless the complete economic substance of the transaction is transparent, including, for example, any discounts and incentives.

Good Faith Par Standard

At base, though, the most effective risk mitigant as it pertains to leveraged lending is to prohibit banks from making off-market loans. While banks should, as the FASB has recommended, account for the economic substance and inherent risk of their lending transactions, banks at the outset should not be permitted to take undue risks with depositor funds or compromise safety and soundness by engaging in excessively risky long-term lending activity for the sake of near-term ancillary fee income. In the case of leveraged lending, a bank should not make a leveraged loan unless there is a good-faith belief that the loan is made at market-clearing terms and will trade at par immediately after origination (or would trade at par, even if immediate sale is not intended). Imposing this simple standard would reinforce accountability and serve as an important gauge of whether the risk involved is reasonable: the absence of such a good-faith belief indicates that the loan is being made at below-market terms and, as such, carries undue risk, creates proprietary exposure, and constitutes anti-competitive behavior.

Conclusion

Regulators have been following the rise in leveraged lending for several years and have recognized the risks involved. I applaud the Agencies' efforts in identifying and analyzing the various dimensions of these risks. As we learned from the credit crisis, action must not wait for substantial identified risks to materialize—especially at the expense of taxpayers and investors who are still feeling the effects of the last government bailout. I urge the Agencies to heed this lesson of the credit crisis.²³ Regulatory guidance is needed now to create robust and effective risk management and eliminate undue risk-taking and anti-competitive behavior. I therefore urge the Agencies to adopt its Proposed Guidance on Leveraged Lending and to add the simple par standard suggested above.

Sincerely,



Byron L. Dorgan

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Deputy Comptroller Wilson stated it well in testimony last year:

“One of the lessons we learned is the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. This is one reason why we are working to develop better tools that will enable us to identify signs of accelerating risk taking at an earlier stage when our actions can be more modulated.”

Testimony by David K. Wilson, Deputy Comptroller, Credit and Market Risk, Office of the Comptroller of the Currency, before the Subcomm. On Fin. Institutions and Consumer Protection, Sen. Comm. On Banking, Housing, and Urban Affairs, at 16 (June 15, 2011), available at <http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-72-written.pdf>