to hold more capital against a PLS asset than the maximum economic loss on that asset. At a minimum, regulators should calibrate standards to resolve this type of counterintuitive result.

Amend Reg AB II

The SEC should amend Reg AB II as it applies to registered securitizations to reduce the number of required reporting fields. It is essential to provide loan-level disclosures on the quality of underlying collateral to maintain transparency and promote investor confidence. However, fewer fields and standardized definitions may provide sufficient transparency without placing excessive burden on the issuer.

Evaluate Impact of Liquidity Rules on the PLS Market

U.S. banking regulators should consider the impact that capital and liquidity rules implementing Basel III standards would have on secondary market activity and calibrate them to reduce complexity and avoid punitive capital requirements.

Leveraged Lending

Overview

One significant type of lending provided by banks and other financial institutions is leveraged loans. Leveraged loans are a type of corporate finance used for mergers and acquisitions, business recapitalization and refinancing, equity buyouts, and business or product line build-outs and expansions.[218] For companies that do not have an investment-grade credit rating, and therefore have limited access to the public capital markets, leveraged loans play a significant role in supporting their business growth and increasing returns to investors. Banks play a critical role in arranging, originating, and administering funding for leveraged loans to these borrowers.[219]

The leveraged loan business has existed since at least the early 1980s, when issuance was less than $50 billion. [220] From 2004 to 2007, there was significant leveraged buyout business activity, leading to growth in leveraged loans, and a peak in issuance of more than $500 billion in 2007.[221] During the financial crisis in 2008 and 2009, leveraged loan issuance dried up.[222] Since the financial crisis, leveraged loan issuance has recovered, reaching record levels in 2013.[223] Today, the leveraged loan business remains fairly robust.[224]

218. OCC Leveraged Lending Comptroller's Handbook (Feb. 2008).

219. The Clearing House. *Submission to the U.S. Treasury Department: Aligning the U.S. Bank Regulatory Framework with the Core Principles of Financial Regulation.* (May 2, 2017), available at: *www.theclearinghouse.org/~/media/TCH/Documents/TCH%20WEEKLY/2017/20170502_TCH_Submission_to_UST_re_Core_Principles_Study.pdf.*

220. *Recent Developments in Corporate Finance*, 76 Fed.Res.Bull. 593, 595, 1990 WL 319954, at *2.

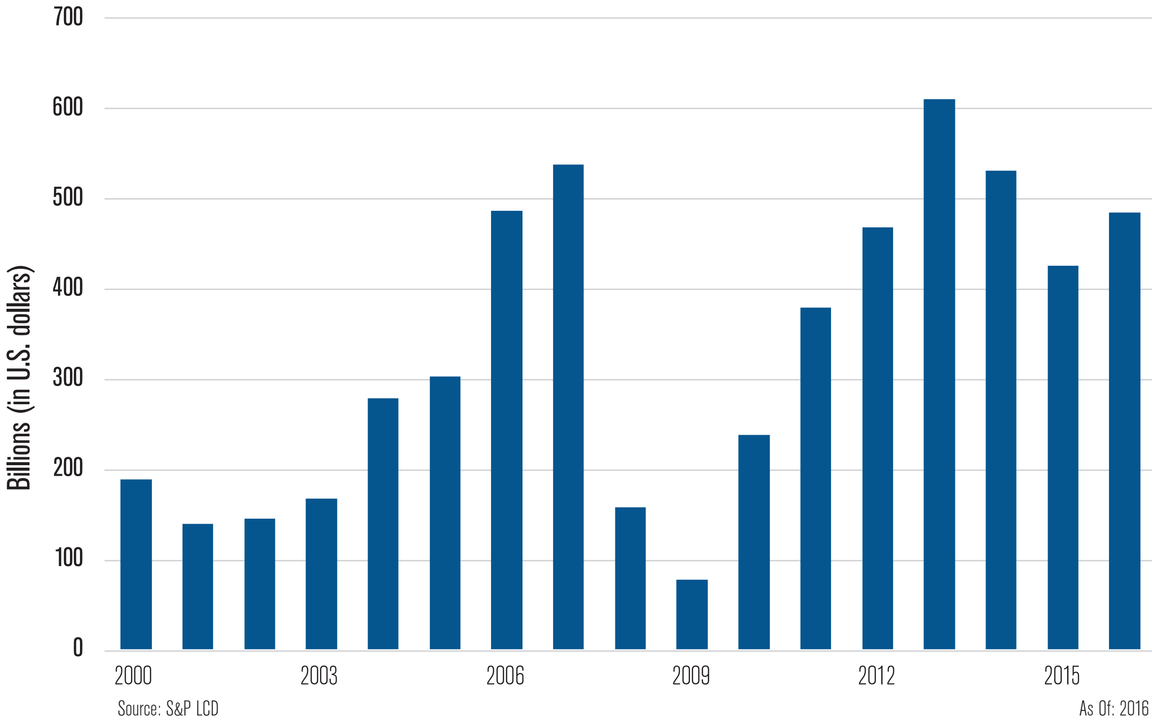
221. GAO. *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention* p. 46. Sept. 2008, available at: *www.gao.gov/new.items/d08885.pdf*.

222. Ivashina, Victoria, Scharfstein, David, *Bank Lending During the Financial Crisis of 2008*, Harvard Business School (Nov. 5, 2008) at 5, available at: *http://www.people.hbs.edu/dscharfstein/Lending_During_the_Crisis.pdf*.

223. Doherty, Colm (CJ.), Pereia, Hugo, *Leveraged Loan Monthly*, Thomson Reuters LPC (Dec. 2016), at 7, available at: *http://lipperalpha.financial.thomsonreuters.com/wp-content/uploads/2017/01/Leveraged-Loan-Monthly-Year-end_2016.pdf*.

224. Id.

Figure 11: Leveraged Loan Issuance



Regulatory Guidance on Leveraged Lending

In conjunction with the surge in leveraged lending, standards for credit agreements became murkier, and participation by unregulated investors increased. For example, credit agreements for many leveraged loans relied on aggressive estimates of borrower repayment capacity, and they provided limited protections for lenders, for example by omitting meaningful maintenance covenants.[225] Additionally, many financial institutions lacked satisfactory systems to monitor loan credit exposures, particularly during periods when buyer demand for risky assets weakened.[226]

Driven by this dynamic, in March 2013, the OCC, the Federal Reserve, and the FDIC issued updated supervisory guidance on leveraged lending to banks, which outlined principles for leveraged lending activity.[227] In response to additional inquiries, the agencies issued responses to frequently asked questions on November 7, 2014.[228] Together, the guidance and frequently asked

225. Maintenance covenants require the borrower to maintain its credit quality by adhering to predetermined ratios at specified intervals.

226. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013); see also Federal Reserve SR 13-3, Interagency Guidance on Leveraged Lending (Mar. 21, 2013), available at: *https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf*.

227. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013).

228. Federal Reserve, FDIC and OCC. *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending*. November 2014, available at: *www.occ.treas.gov/news-issuances/news-releases/2014/nr-ia-2014-153c.pdf*.

questions outlined expectations on a range of topics related to leveraged lending. Those topics included underwriting and valuation standards, loan pipeline management, credit risk ratings, and managing problem credit exposures.

The 2013 guidance attempted to set forth the regulators' expectations for banks' risk management of leveraged lending. It emphasized the importance of structuring leveraged loans based on a sound business premise. It also highlighted the importance of a clear and consistent definition of leveraged lending, well-defined underwriting standards, appropriate credit limits and credit concentration parameters, sound systems to monitor credit exposures, and coherent guidelines for portfolio stress tests. The guidance further stated that leveraged lending credit agreements should contain covenant protections, including financial performance covenants such as debt to cash flow, interest coverage, or fixed charge coverage. It also stated that the agreements should include provisions related to compliance reporting and monitoring.[229]

Key Issues with Regulatory Guidance

Both experts and market participants have provided mixed feedback on the 2013 leveraged lending guidance. One of the primary concerns expressed with the guidance was the level of ambiguity left in the definition of leveraged lending. For example, while the guidance specifically expressed concern with loans exceeding six times (6x) leverage (defined as the ratio of total debt to EBITDA), the regulators simultaneously said the 6x limit is not a "bright line" so long as other "compensating factors" make up for the amount of leverage.[230] Additionally, the guidance gave banks the opportunity to adopt their own definitions of leveraged lending – such as to identify leveraged loans based on the borrower's leverage, based on the borrower's credit rating, based on the purpose of the loan, or based on the spread of the loan at origination.[231] Notwithstanding subsequent clarifications to the guidance, this ambiguity left banks unsure how to satisfy regulatory demands while also providing credit to clients. In essence, banks were left to wait until ex post facto regulatory review to get clarity on whether a leveraged loan would pass or fail supervisory review.

In addition to the ambiguity around the definition of leveraged lending, the guidance lacked clear penalties for noncompliance, which fueled further questions about its usefulness. As a general matter, failure to comply with guidance can result in increased supervisory scrutiny and potentially even a downgrade in the bank's supervisory rating. [232] Because the guidance lacked specificity, it led to uncertainty in the leveraged lending market, and ultimately, resulted in fewer leveraged loans by banks. [233] However, the reduction in leveraged lending by banks did not necessarily lead to a reduction in risk in the financial system. Instead, a recent Federal Reserve staff paper found that leveraged lending migrated to less regulated nonbanks – a dynamic which makes it far less clear

229. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar 22, 2013).

230. Some industry engagement participants informed Treasury that bank regulators sometimes utilized leverage definitions of 3x or 4x senior debt divided by EBITDA.

231. Kim, Sooji, Plosser, Matthew, and Santos, Joao, *Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance*, Federal Reserve Bank of New York Staff Reports, Report No. 815, May 2017, at 2.

232. Id.

233. Id at 4.

that the guidance actually diminished risks to financial stability, since nonbank lenders often originate leveraged loans using more aggressive and riskier credit structures. [234] What is clear, however, is that the reduction in leveraged loans available from banks reduced access to credit by businesses.

Recommendations for Regulatory Reform

To address the concerns noted above, Treasury recommends the following:

- The 2013 leveraged lending guidance should be re-issued for public comment. Following the public comment process, the guidance should be refined with the objective of reducing ambiguity in the definition of leveraged lending and achieving consistency in supervision, examination and enforcement.
- Banks should be encouraged to incorporate a clear but robust set of metrics when underwriting a leveraged loan, instead of solely relying on a 6x leverage ratio discussed in the 2013 leveraged lending guidance. Encouraging banks to do so will help maximize the role that leveraged lending plays in the provision of capital to business.

Small Business Lending

Overview

Small businesses are an integral engine of economic growth and job creation in the United States.[235] They employ almost half of the private sector workforce and create three out of five net new jobs in the United States as small businesses are typically more labor intensive than their larger peers.[236] Ensuring adequate access to capital for this segment of the economy is critical to supporting robust and lasting growth.

Unlike large and medium-sized businesses, small businesses typically do not have access to capital markets to attract retail or institutional investors. As a result, small businesses rely heavily on personal savings, business profits, home equity loans, and friends and family as initial sources of capital. Financial institutions are the primary source of outside credit to small businesses. Among financial institutions, community banks issue 43% of small business loans.[237]

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234. Sooji Kim, Matthew Plosser and João Santos, "Did the Supervisory Guidance on Leveraged Lending Work?" *Liberty Street Economics*. May 16, 2016, available at *http://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html*. See also: Kim, Sooji, "Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance," at 4.
235. Traditionally, a small business is defined as an enterprise with fewer than 500 employees. Financial institutions tend to define small businesses as a client which produces between less than $10-$50 million in revenues per year.
236. Karen Mills & Brayden McCarthy. *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (State of Small Business Lending), Working Paper 15-004. Harvard Business School, (June 22, 2014) available at: *http://www.hbs.edu/faculty/Publication%20 Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf*.
237. *FDIC Quarterly 2017*. Vol. 11. No. 1. available at: *www.fdic.gov/bank/analytical/quarterly*. (FDIC Quarterly)