

#### ***XIV. The Growth of Bank Exposure to Private Market Risks***

##### **A. Introduction**

In 2013, the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (Fed), and the Federal Deposit Insurance Corporation (FDIC) joined in their collective desire to curb the practice of leveraged lending, and issued the Interagency Guidance on Leveraged Lending (2013 Interagency Guidance) to provide banks with clear guidelines for controlling their runaway use of high-risk, leveraged loans.<sup>1</sup> Yet, where the intent of the 2013 Interagency Guidance was to reduce bank exposure to the risk inherent in loans to highly leveraged companies, this practice of financing risky loans merely shifted to private nonbank financial institutions—which often used bank loans to finance their activity.<sup>2</sup> The 2013 Interagency Guidance coincided with shifting practices in private equity firms and U.S. Business Development Companies (BDCs) to stimulate demand for leveraged loans and fuel the market for debt-backed financial instruments, the like of which contributed to the 2008 Financial Crisis (Financial Crisis).<sup>3</sup> Influential parties have taken both sides of the

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<sup>1</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, BD. OF GOVERNORS OF THE FED. RESERVE SYS. & FED. DEPOSIT INS. CORP., INTERAGENCY GUIDANCE ON LEVERAGED LENDING 1 (2013), <https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf> [<https://perma.cc/V3KG-XRTD>] [hereinafter 2013 Interagency Guidance] (“The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively the “agencies”) are issuing this leveraged lending guidance to update and replace the April 2001 Interagency guidance [footnote omitted] regarding sound practices for leveraged finance activities . . . . Since the issuance of the 2001 guidance, the agencies have observed periods of tremendous growth in the volume of leveraged credit and in the participation of unregulated investors.”).

<sup>2</sup> See SOOJI KIM et al., FED. RESERVE BANK OF N.Y., MACROPRUDENTIAL POLICY AND THE REVOLVING DOOR OF RISK: LESSONS FROM LEVERAGED LENDING GUIDANCE 1, 4–6, 20–24 (2017) [hereinafter FED STAFF REPORT] (discussing the “migration of leveraged lending to nonbanks” using bank funds following the 2013 Interagency Guidance, despite aiming to have banks “conduct leveraged lending activities in a safe and sound manner” to reduce risk).

<sup>3</sup> See Paul J. Davies, *Banks and Private Markets: Making Fresh Connections*, WALL ST. J. (Aug. 8, 2018, 6:01 AM),

issue—advocating both for and against the lenders contributing to this situation—making the path to a potential solution unclear.<sup>4</sup> If recent history is any indication, altering the regulatory landscape will only shift leveraged lending between banks and their nonbank financial institution counterparts,<sup>5</sup> though actively including market participants in any new regulatory scheme may improve results.<sup>6</sup>

This article will discuss the rise of bank exposure to private market risks. Section B will provide an overview of some of the primary ways in which banks are exposed to private market risks. Section C will then review the regulatory landscape as it relates to bank exposure to private market risk. Sections D and E discuss the implications of that changing regulatory landscape and the concerns raised for banks. Section F will provide some reasons for optimism related to bank exposure. Finally, Section G will preview a few potential regulatory solutions to this issue and discuss why they could be more effective than past efforts.

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<https://www.wsj.com/articles/banks-and-private-markets-making-fresh-connections-1533722346>; Stephen Gandel, Opinion, *CLOs Are the New Hedge Funds. Plan Accordingly*, BLOOMBERG (Aug. 15, 2018, 10:13 AM), <https://www.bloomberg.com/view/articles/2018-08-15/clos-are-the-new-hedge-funds-plan-accordingly>.

<sup>4</sup> *Compare* INSTITUTIONAL LTD. PARTNERS ASS'N, CONSIDERATIONS AND BEST PRACTICES FOR LIMITED AND GENERAL PARTNERS 1, 1–5 (2017), <https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf> [<https://perma.cc/9Z9P-DAK7>] [hereinafter ILPA Considerations] (establishing a set of best practices designed to impact the use of subscription lending in private equity), with Robert J. Raymond & David W.S. Yudin, *ILPA Subscription Best Practices—A Step Too Far (Cleary Gottlieb)*, AM. INV. COUNCIL (Aug. 29, 2017), <https://www.investmentcouncil.org/ilpa-subscription-best-practices-step-far/> [<https://perma.cc/6Q72-KJ2F>] (describing the ILPA's recommendations as “overbroad and misguided” in expressing their support for leveraged lending).

<sup>5</sup> FED STAFF REPORT, *supra* note 2, at 5.

<sup>6</sup> Peter Webb, *Leveraged Lending Guidance and Enforcement: Moving the Fulcrum*, 20 N.C. BANKING INST. 91, 122–23 (2016) (“Instead of issuing the Guidance . . . regulators should have involved market participants more directly to secure and leverage their expertise and thus tailor market-stabilizing solutions in a more collaborative and effective way.”).

### B. Bank Links to the Private Market

Since 2014, banks have been exposed to private market risks largely through leveraged loans provided to private equity firms, BDCs, and funds that buy securitized leveraged loans.<sup>7</sup> The practice of leveraged lending lacks a consistent definition across industries and regulators, but has generally been described as lending where the borrower is “rated as a non-investment-grade company with a high debt to net worth ratio.”<sup>8</sup> Leverage is used to fund a wide variety of transactions,<sup>9</sup> including private equity’s utilization of subscription or “bridge” loans: loans used to “cover the gap between calling for investors’ commitments and receiving funds.”<sup>10</sup> Subscription loans are especially attractive because they often carry lower interest rates than portfolio loans, thus allowing fund managers to quickly assemble the funds needed to execute a transaction without paying excessive fees for the convenience.<sup>11</sup>

Once this leverage is provided to risky lenders with high debt ratios, it can be repackaged into “derivative debt investment[s]” known as Collateralized Loan Obligations (CLOs).<sup>12</sup> Observers have referred to these investments as “a cousin of the type of funds that blew up in the housing bubble,” but their popularity has continued to grow.<sup>13</sup> CLO issuance rose sixty-five percent from 2016 to 2017, bringing in \$120 billion worth of new issuances.<sup>14</sup> The same private equity firms

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<sup>7</sup> Davies, *supra* note 3.

<sup>8</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER’S HANDBOOK: LEVERAGED LENDING 2 (2008), <https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/leveraged-lending/pub-ch-leveraged-lending.pdf> [<https://perma.cc/U26S-4AHK>] [hereinafter COMPTROLLER’S HANDBOOK].

<sup>9</sup> *Id.* at 1 (“Leveraged lending is 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.”).

<sup>10</sup> Max Bower, *Booming Fund Financing Poses Risks for Banks*, REUTERS (Feb. 22, 2018, 06:17 AM), <https://www.reuters.com/article/us-fundfinance-loans/booming-fund-financing-poses-risks-for-banks-idUSKCN1G61BA> [<https://perma.cc/2NQW-94MS>].

<sup>11</sup> *See id.*

<sup>12</sup> Gandel, *supra* note 3 (alteration in original) (describing how CLOs are formed and what category of investment they are).

<sup>13</sup> *Id.*

<sup>14</sup> Lisa Lee et al., *Wall Street’s Hot CLO Machine Freed from Post-Crisis Rules*, BLOOMBERG (Feb. 9, 2018, 11:05 AM),

that created the leveraged loans packaged into these investments also manage CLOs.<sup>15</sup> Floating interest rates and historically strong returns have raised demand to levels that bond graders and potential buyers have struggled to keep up with, as Moody's is reportedly "taking around a month more to rate the securities than it needed before."<sup>16</sup>

### C. Attempted Regulation of Private Market Risk

By 2013, U.S. private equity buyouts exceeded \$60 billion in total volume.<sup>17</sup> Thus, the OCC, Fed, and FDIC saw the need to update and replace their April 2001 Interagency Guidance,<sup>18</sup> which aimed to "describe more fully supervisory expectations regarding sound practices for leveraged financing activities."<sup>19</sup> The 2013 Interagency Guidance was "designed to assist financial institutions in providing leveraged lending to creditworthy borrowers" in a manner that did not "unnecessarily heighten risks by originating poorly underwritten loans."<sup>20</sup> The 2013 Interagency Guidance outlined minimum expectations for financial institutions in areas such as the definition of leveraged lending, valuation standards, risk rating leveraged loans, and underwriting standards, which stated that a leverage level above "6X

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<https://www.bloomberg.com/news/articles/2018-02-09/clo-managers-exempt-from-risk-retention-regulations-court-rules> ("CLO issuance was around \$120 billion last year, up 65 percent from 2016, according to data compiled by Bloomberg.").

<sup>15</sup> Gandel, *supra* note 3.

<sup>16</sup> Sally Bakewell, *CLO Machine Is Approaching Full-Tilt, and Credit Quality Suffers*, BLOOMBERG (May 25, 2018, 6:00 AM), <https://www.bloomberg.com/news/articles/2018-05-25/clo-machine-is-approaching-full-tilt-and-credit-quality-suffers>.

<sup>17</sup> Gillian Tan, *Buyout Firms Feel Pinch from Lending Crackdown*, WALL ST. J. (Mar. 25, 2015, 7:40 PM), <https://www.wsj.com/articles/buyout-shops-feel-pinch-from-lending-crackdown-1427304125>.

<sup>18</sup> 2013 Interagency Guidance, *supra* note 1, at 2 ("This guidance updates and replaces the 2001 guidance in light of the developments and experience gained since the time that guidance was issued.").

<sup>19</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. DEPOSIT INS. CORP. & OFFICE OF THRIFT SUPERVISION, LEVERAGED FINANCING I (2001), <https://www.federalreserve.gov/boarddocs/press/general/2001/20010409/attachment.pdf> [<https://perma.cc/W62J-DNSS>].

<sup>20</sup> 2013 Interagency Guidance, *supra* note 1, at 1.

Total Debt/EBITDA raises concerns for most industries.”<sup>21</sup> A supplemental report was issued in 2014 to provide clarity and “promote consistent application of the guidance.”<sup>22</sup> Initially, the market reaction was as intended: highly leveraged buyouts fell as banks conformed to the new guidelines and limited the amount of leverage available to buyout firms.<sup>23</sup> However, market appetite for new deals did not dissipate as quickly, and soon, nonbank lenders were stepping in to fill the void left by banks.<sup>24</sup> A Staff Report from the Federal Reserve Bank of New York found that the number of nonbank loans increased by more than fifty percent following the 2013 Interagency Guidance, and that banks were still the parties funding this increase in lending as “loan financing increased by 125%” thereafter.<sup>25</sup> The Fed Staff Report concluded, “this migration was not accompanied by a similar reduction in risk in the banking sector.”<sup>26</sup>

Additionally, following the collapse of mortgage-backed securities in the 2008 Financial Crisis, legislators sought to protect investors from the deterioration of underlying loan quality in CLOs<sup>27</sup> through its requirement that securitizers retain at least five percent of the credit risk of any asset distributed to a third party.<sup>28</sup> Regulators reasoned that forcing securitizers to have “skin in the game” would provide them with a stronger “incentive to monitor the quality of the assets they purchase from originators, package into securities, and

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<sup>21</sup> *Id.* at 7.

<sup>22</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, BD. OF GOVERNORS OF THE FED. RESERVE SYS. & FED. DEPOSIT INS. CORP., FREQUENTLY ASKED QUESTIONS (FAQ) FOR IMPLEMENTING MARCH 2013 INTERAGENCY GUIDANCE ON LEVERAGED LENDING 1 (2014), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20141107a3.pdf> [<https://perma.cc/9F9B-PAKR>].

<sup>23</sup> Tan, *supra* note 17 (“After resisting at first, banks have lately been falling in line with guidance regulators set in 2013, which sought to limit how much debt banks could extend for corporate takeovers.”).

<sup>24</sup> FED STAFF REPORT, *supra* note 2, at 5.

<sup>25</sup> *Id.* at 3, 21 (“Nonbank lenders appear to have been the main beneficiaries of this response, as their market share based on the number of loans increased by more than 50 percent while their market share based on the volume of lending more than doubled over that period of time.”).

<sup>26</sup> *Id.* at 23.

<sup>27</sup> S. REP. NO. 111-176, at 36–37 (2010) (outlining the securities issues addressed by new legislation, including the “deterioration in credit and loan underwriting standards” in complex and opaque securitization markets).

<sup>28</sup> 15 U.S.C. § 78o-11 (2012).

sell.”<sup>29</sup> However, the recent decision in *Loan Syndications & Trading Ass’n v. SEC* determined that CLO managers are not subject to these five percent retention requirements, thus removing a crucial part of CLO risk reduction policy.<sup>30</sup>

Finally, U.S. BDCs are now allowed to increase their leverage after the March 2018 Small Business Credit Availability Act (SBCA) reduced asset coverage requirements for BDCs from 200% to 150%.<sup>31</sup> This change effectively allows BDCs to double their leverage-equity ratios from 1:1 to 2:1, subject to board and shareholder approval requirements provided in the SBCA.<sup>32</sup>

#### D. Primary Sources of Risk

##### 1. Private Equity Risk

Some observers believe that a private equity firm’s use of subscription loans inflates the funds’ internal rate of return (IRR), making funds even more attractive for potential investors.<sup>33</sup> Accordingly, the price for unwanted stakes in private equity funds has increased significantly in recent years as potential investors use leverage to drive up sale prices; this trend stands in sharp contrast to previous selloffs, which often occurred at discounts to relieve

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<sup>29</sup> S. REP. NO. 111-176, at 129.

<sup>30</sup> See *Loan Syndications & Trading Ass’n v. SEC*, 882 F.3d 220, 227–29 (D.C. Cir. 2018) (determining that requiring CLO managers to retain a portion of the CLO credit risk was unreasonable as CLO managers never held the underlying loans).

<sup>31</sup> Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, § 802, 132 Stat. 348, 1138–40 (individually referred to as the Small Business Credit Availability Act) (providing an amendment to the Invest Company Act of 1940 where the 200% asset coverage requirements of business development companies is reduced to 150%).

<sup>32</sup> Memorandum from Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Michael K. Hoffman et al., *New Legislation Will Benefit Business Development Companies While Closed-End Funds Remain in Limbo* (Apr. 9, 2018), <https://www.skadden.com/insights/publications/2018/04/new-legislation-will-benefit-business-development> [<https://perma.cc/M7TX-NDP7>].

<sup>33</sup> See Paul J. Davies, *Private Equity’s Trick to Make Returns Look Bigger*, WALL ST. J. (Mar. 9, 2018, 5:10 PM), [https://www.wsj.com/articles/private-equitys-trick-to-make-returns-look-bigger-1520600579?mod=article\\_inline&mod=article\\_inline](https://www.wsj.com/articles/private-equitys-trick-to-make-returns-look-bigger-1520600579?mod=article_inline&mod=article_inline).

distressed investors of their stakes in a fund.<sup>34</sup> Furthermore, with banks restricted by regulatory guidelines such as the 2013 Interagency Guidance, private equity firms have stepped in to fill the lending gap and further diversify their financial activities.<sup>35</sup> After originating debt, “firms have also created funds that invest in and trade debt instruments,” yet another financial activity private equity firms have undertaken.<sup>36</sup> Private equity’s unique mix of financial activity has led some observers to compare these firms to pre-Financial Crisis investment banks.<sup>37</sup> Where investment banks formerly relied upon short-term instruments such as repos and commercial paper to fund long-term assets, private equity firms utilize short-term subscription loans to fund leveraged buyouts, creating a potential maturity mismatch that makes these funds susceptible to runs.<sup>38</sup>

## 2. *Increased Leverage for BDCs*

BDCs are investment funds that are statutorily required to invest at least seventy percent of their capital in small and medium sized companies<sup>39</sup> and to provide those companies with “significant managerial assistance.”<sup>40</sup> However, the positive effect BDCs can have on small businesses often requires bank capital, and banks have specifically chosen not to invest in the companies BDCs are funding since the Financial Crisis.<sup>41</sup> Upon learning of expanded BDC leverage limits via the SBCA’s passage in the Consolidated Appropriations Act,

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<sup>34</sup> See Paul J. Davies, *Private Equity: So Hot Even Second-Hand Funds Can Sell at a Premium*, WALL ST. J. (June 25, 2018, 7:00 AM), <https://www.wsj.com/articles/private-equity-so-hot-even-second-hand-funds-can-sell-at-a-premium-1529924400>.

<sup>35</sup> See FED STAFF REPORT, *supra* note 2, at 3 (reporting on the rise in nonbank loans following the 2013 Interagency Guidance).

<sup>36</sup> Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 343–47 (2017).

<sup>37</sup> See *id.* at 340–42 (comparing the activity mix and other qualities of private equity firms with major investment banks).

<sup>38</sup> See *id.* at 330–31.

<sup>39</sup> 15 U.S.C. § 80a-54 (2012).

<sup>40</sup> 15 U.S.C. § 80a-2 (2012).

<sup>41</sup> See Industry Commentary from William Blair & Company, L.L.C., J.P. Young, *New Law Could Spur the Next Wave of BDC Capital Raising* (May 9, 2018), <https://www.williamblair.com/News-Items/2018/May/09/New-Law-Could-Spur-the-Next-Wave-of-BDC-Capital-Raising.aspx> [<https://perma.cc/MD3U-XPGF>].

credit-rating agency Standard & Poor's (S&P) changed its outlook on BDCs to negative.<sup>42</sup> Despite S&P advising BDCs that pursuing higher leverage would result in downgrades to their creditworthiness, many BDCs have already moved to increase their leverage ratios via board approval;<sup>43</sup> thus, banks that increase their lending to BDCs will see greater risk in their loans.

### 3. CLO Demand

In addition to the possibility that increased market appetite for CLOs will generate a push for more leveraged loans, banks may be impacted by CLOs in more direct ways. With the issuance of leveraged loans lagging slightly behind 2017's pace, riskier loans are being provided by both bank and nonbank lenders to help meet the demand for bundled loan investment instruments.<sup>44</sup> Demand is still high, and CLO managers have begun to offer fewer protections to investors.<sup>45</sup> Fund managers have touted how "[m]ore regulation means less risk"<sup>46</sup> in regard to the five percent retention rule overturned in

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<sup>42</sup> *The Impact of New Leverage Rules on BDC Ratings*, STANDARD & POORS (Apr. 4, 2018, 1:48) (available via S&P website at [https://www.spratings.com/en\\_US/webcasts-events?p\\_p\\_id=122\\_INSTANCE\\_pDEwUjLxpNYr&p\\_p\\_lifecycle=0&p\\_p\\_state=normal&p\\_p\\_mode=view&p\\_p\\_col\\_id=column-1&p\\_p\\_col\\_count=1&p\\_r\\_p\\_564233524\\_categoryId=event;88377,delim,88208,delimDateRangeNames,dummyDate,past,delimDateRangeValues,20131018040000,20181017040000&p\\_r\\_p\\_564233524\\_resetCur=true](https://www.spratings.com/en_US/webcasts-events?p_p_id=122_INSTANCE_pDEwUjLxpNYr&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&p_p_col_id=column-1&p_p_col_count=1&p_r_p_564233524_categoryId=event;88377,delim,88208,delimDateRangeNames,dummyDate,past,delimDateRangeValues,20131018040000,20181017040000&p_r_p_564233524_resetCur=true) by scrolling down to the April 4, 2018 event).

<sup>43</sup> Leela Parker Deo, *BDCs Move to Boost Leverage*, REUTERS (Apr. 17, 2018, 10:34 AM), <https://www.reuters.com/article/bdc-leverage/bdcs-move-to-boost-leverage-idUSL1N1RT21M> [<https://perma.cc/MBX7-G36E>].

<sup>44</sup> See Bakewell, *supra* note 16 (describing how an increased demand for CLOs and decline in leveraged lending has resulted in more favorable lending terms); see also Tim Cross, *Covenant-Lite Credits Continue to Dominate U.S. Leveraged Loan Market*, FORBES (Feb. 8, 2018, 5:18 PM), <https://www.forbes.com/sites/spleverage/2018/02/08/covenant-lite-credits-continue-to-dominate-u-s-leveraged-loan-market/#11ffb1904400> [<http://perma.cc/95UQ-CE3N>].

<sup>45</sup> *Id.* ("Covenant-lite loans, an issuer-friendly feature that offers less protection for lenders and investors than traditionally structured credits, now account for a record 75% of the roughly \$970 billion in outstanding U.S. leveraged loans, according to LCD.")

<sup>46</sup> Laila Kollmorgen & Steven Oh, *Seeing Beyond the Complexity: An Introduction to Collateralized Loan Obligations*, PINEBRIDGE INVS. (Aug. 8,



*Loan Syndications & Trading Ass'n.*<sup>47</sup> However, repealing this rule could see issuers reduce the quality of their CLOs without having to retain the risk created as the market seeks to meet rising CLO demand, thus increasing risk in the leveraged loans issued.<sup>48</sup> These developments not only expose banks to the riskier leveraged loans provided to meet CLO demand, but also to the risk of CLOs defaulting, as there are reports that banks both invest in and hold CLOs during the repackaging and sales process.<sup>49</sup>

### E. Concerns for Banks

When combined, the above factors create risks for banks on multiple levels. First is the systemic risk created by the growing importance of private equity firms.<sup>50</sup> The interconnectedness and wide-ranging activity levels within private equity firms creates the possibility that “[r]isks created in one market sector could migrate to another market and be amplified there.”<sup>51</sup> In his examination of the most prominent financial panics in U.S. history, Hugh Rockoff found that financial intermediaries that rely heavily on short-term liabilities for funding and are subject to little if any regulation were responsible for the final failure in eleven of the thirteen major panics examined.<sup>52</sup> According to Rockoff, the two primary reasons these institutions

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2017), <https://www.pinebridge.com/insights/investing/2017/08/clo-beyond-the-complexity> [<https://perma.cc/USP4-QZXU>] (alteration in original).

<sup>47</sup> *Loan Syndications & Trading Ass'n v. SEC*, 882 F.3d 220, 227–29 (D.C. Cir. 2018) (overturning the five percent risk retention requirement placed on CLO managers).

<sup>48</sup> Bakewell, *supra* note 16.

<sup>49</sup> See, e.g., Paul J. Davies, *The Big Weakness in the Buyout Funding Chain*, WALL ST. J. (Aug. 7, 2018, 06:18 AM), <https://www.wsj.com/articles/the-big-weakness-in-the-buyout-funding-chain-1533637105> (discussing how banks hold CLO bonds to earn a greater yield on their liquid assets).

<sup>50</sup> Tuch, *supra* note 36, at 365.

<sup>51</sup> *Id.* (alteration in original).

<sup>52</sup> Hugh Rockoff, *It is Always the Shadow Banks: The Regulatory Status of the Banks that Failed and Ignited America's Greatest Financial Panics*, in COPING WITH FINANCIAL CRISES 77, 78, 100 (Hugh Rockoff & Isao Suto eds., 2018) (describing a shadow banks as “a financial intermediary that relies heavily on short-term liabilities for funding . . . [and] . . . is not subject to close scrutiny and regulation by a government authority” and finding “[i]n the thirteen cases examined here, there were only two in which the final failure was not a shadow bank”).

contribute to financial panics are the fact that their strategies sometimes focus on “a narrow range of risky long-term assets” that are closed off to banks and the presence of increased demand for capital from private investors.<sup>53</sup> Reliance on short-term subscription lending and a lack of formal regulation place private equity firms in the category of financial institutions of which Rockoff warns.<sup>54</sup> Furthermore, both the risky long-term strategy and demand for private capital responsible for shadow banks’ contributions to financial crises<sup>55</sup> are reflected in the massive leveraged buyouts and lending to private companies now common in private equity funds. If these funds fail, banks with insufficient collateral in these massive loans could follow, further deteriorating market confidence.<sup>56</sup>

The second level applies directly to banks via the leveraged loans they underwrite and pool before selling as CLOs.<sup>57</sup> This practice of issuing, arranging, and underwriting leveraged loans has been compared to the market dynamics of the Financial Crisis, where mortgage originators dismissed concerns about the quality of loans “because of their ability to sell the loans to banks, who could package and re-package many loans together in special purpose vehicles and instruments, and then sell off the payment streams as mortgage-backed securities into the capital markets.”<sup>58</sup> In the event that an economic downturn impacts the ability of companies and investment funds to pay off their substantial debt loads, banks themselves could be stuck holding onto billions of dollars in loans, just as they were in the lead-up to the Financial Crisis.<sup>59</sup> Given that the terms and quality of these loans have decreased significantly as demand for CLOs has stimulated

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<sup>53</sup> *Id.* at 100.

<sup>54</sup> *See id.* at 78 (describing the shadow banks responsible for the examined crises as financial intermediaries that rely on short-term liabilities for funding and subject to less regulation).

<sup>55</sup> *Id.*

<sup>56</sup> *See* Tuch, *supra* note 36, at 364 (positing that the failure of private funds could create systemic collapse within the financial system).

<sup>57</sup> *See* Davies, *supra* note 3.

<sup>58</sup> Webb, *supra* note 6, at 118 (“Structurally, at least, the current market dynamic is alarmingly similar to the mortgage-backed securities market prior to the 2008 financial crisis.”).

<sup>59</sup> Henny Sender, *Debt on Sale: Banks Grease the Leveraged-Loan Machine*, WALL ST. J. (Oct. 10, 2007, 12:01 AM), <https://www.wsj.com/articles/SB119197749870054211> (discussing falling investor demand for loans that banks had previously issued for private equity deals, which left banks with roughly \$400 billion of debt).

the secondary market, banks could end up suffering significant financial losses in the event that borrowers fail to meet their repayment obligations.

#### F. Reasons for Optimism

Not all analysts are as pessimistic about the supposed risk increase. Writing for the American Investment Council, attorneys from Cleary Gottlieb Steen & Hamilton LLP emphasized how subscription lending has no impact on a variety of performance metrics, such as Multiple of Money, that investors use in addition to IRR when evaluating funds—a fact they use to soothe concerns that evolving lending habits have inflated the value of private equity stakes.<sup>60</sup> Additionally, subscription lending helps streamline transactions by allowing funds to call upon all of the necessary capital in a single swoop, rather than in “piecemeal fashion.”<sup>61</sup> Observers also tentatively believe that private equity firms “are less financially vulnerable than the former investment banks,” in part because modern private equity funds do not face the same “asset liability-maturity mismatch that afflicted the investment banks” during the Financial Crisis.<sup>62</sup> Private equity funds also have much lower leverage ratios than their private fund counterparts, such as hedge funds, and carry long-term capital commitments from investors.<sup>63</sup> This combination reduces the risk of

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<sup>60</sup> Raymond & Yudin, *supra* note 4 (“While it is true that the use of subscription lines could increase a fund’s IRRs, in our experience, any such increase would generally not be material over the life of the fund . . . subscription line borrowing would not have any effect on other commonly used performance metrics such as Multiple of Money.”).

<sup>61</sup> *Id.*; see also Frederick C. Fisher IV et al., *Benefits of Fund-Level Debt in Acquisition Finance*, FUND FIN. MKT. REV. (Mayer Brown LLP), Sept. 18, 2017, at 8–10, <https://www.mayerbrown.com/files/Publication/f2524ce7-6683-44ef-a501-88883334c3d2/Presentation/PublicationAttachment/02a264adb721-47cd-8bb1-901136d3da36/Benefits-of-Fund-Level-Debt-in-Acquisition-Finance.pdf> [<http://perma.cc/Y3E6-RDKR>] (outlining the benefits of fund-level financing, including subscription lending, for private equity and other investment funds).

<sup>62</sup> Tuch, *supra* note 36, at 356.

<sup>63</sup> David C. Johnson & Francis A. Martinez, *Form PF Insights on Private Equity Funds and Their Portfolio Companies* 3 (Office of Fin. Research Brief No. 18-01, 2018), [https://www.financialresearch.gov/briefs/files/OFRBr\\_2018\\_01\\_Form-PF.pdf](https://www.financialresearch.gov/briefs/files/OFRBr_2018_01_Form-PF.pdf) [<https://perma.cc/HGF7-4RJR>].

runs on individual funds.<sup>64</sup> Overall systemic risk may be limited by the unique structure of private equity funds, where “the separation of funds and managers limits the spillage of risks across funds and between funds and other business lines,” thus limiting the potential for multiple firms to fail in the fallout of a fund collapse.<sup>65</sup> Finally, lenders can reduce the risk involved in leveraged lending by syndicating leveraged loans, thus allowing them to “serve client needs while at the same time ensuring appropriate risk diversification in their permanent loan portfolios.”<sup>66</sup>

### G. Potential Regulatory Solutions

Early in 2018, Comptroller of the Currency Joseph Otting signaled the decline of the 2013 Interagency Guidance by declaring that banks can “do what [they] want” with leveraged lending, “as long as it does not impair safety and soundness.”<sup>67</sup> When Otting’s comments are combined with suggestions that regulators could return to the more subjective standards seen in the 2001 Interagency Guidance, it appears that regulators may soon develop a new set of guidelines for leveraged lending.<sup>68</sup> One potential solution applicable to the private equity industry is the Institutional Limited Partners Association’s (ILPA) release of its considerations and recommendations for

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<sup>64</sup> See *id.* (positing that the duration of private equity investments limits the risk of runs).

<sup>65</sup> John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1260 (2014).

<sup>66</sup> COMPTROLLER’S HANDBOOK, *supra* note 8, at 3.

<sup>67</sup> Eleanor Duncan, *Banks can ‘do what they want’ in leveraged lending: Otting*, REUTERS (Feb. 27, 2018, 10:06 PM), <https://www.reuters.com/article/us-usa-banks-lending-otting/banks-can-do-what-they-want-in-leveraged-lending-otting-idUSKCN1GC0B5> [<https://perma.cc/B9UR-9L86>] (alteration in original) (quoting Comptroller of the Currency Joseph Otting).

<sup>68</sup> See *id.* (highlighting Comptroller of the Currency Joseph Otting’s criticism of the current guidelines and apparent willingness to give banks more deference); Eric Leicht, Jake Mincemoyer, Kevin Petrasic & Duane Wall, *Banking Regulators Signal Movement away from Leveraged Lending Guidance*, WHITE & CASE (Mar. 15, 2018), <https://www.whitecase.com/publications/alert/banking-regulators-signal-movement-away-leveraged-lending-guidance> [<https://perma.cc/H2L8-P77D>] (discussing the potential for an updated set of guidelines based on more subjective standards of review, such as those found in the 2001 Interagency Guidance).

subscription lending.<sup>69</sup> The release issued nine specific recommendations for limited partners to adopt that could curb the practice of leveraged lending via subscription loans; these recommendations include additional disclosure requirements for managers, consideration of subscription lines in analyzing fund performance, and designating thresholds for subscription line usage.<sup>70</sup> As evidenced by banks' initial noncompliance with the 2013 Interagency Guidance and the need for additional clarity, it is possible that the ILPA's considerations need clarification and substance before they begin to impact private equity lending habits.<sup>71</sup> Another potential solution could come in the form of a self-regulatory organization (SRO) for the banking industry, as suggested by Peter Webb.<sup>72</sup> Notably, such a system would place regulatory authority in the hands of those most knowledgeable about leveraged lending and remove potential communication roadblocks that slowed the effectiveness of the 2013 Interagency Guidance.<sup>73</sup> Criticism of both of the 2013 Interagency Guidance and the ILPA's considerations highlight the importance of inclusive regulatory frameworks that clearly explain how parties can demonstrate compliance, issues that a SRO may be ideally suited to address.<sup>74</sup>

## H. Conclusion

U.S. bank exposure to private market risk is on the rise due to changing private market practices and an altered regulatory framework. Despite unified regulatory efforts to minimize this risk and

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<sup>69</sup> See ILPA Considerations, *supra* note 4, at 1–5 (providing a set of considerations and best practices for limited partners to consider).

<sup>70</sup> *Id.* at 3–4.

<sup>71</sup> Michael I. Zinder, David Tarr & Christopher E. Giorgione, *Leveraged Lending Guidelines—2013 to 2015 Impact*, WILLKIE FARR & GALLAGHER LLP 1–4 (Feb. 18, 2016), [https://www.willkie.com/~media/Files/Publications/2016/02/Leveraged\\_Lending\\_Guidelines\\_2013\\_to\\_2015\\_Impact.pdf](https://www.willkie.com/~media/Files/Publications/2016/02/Leveraged_Lending_Guidelines_2013_to_2015_Impact.pdf) [http://perma.cc/J2WB-GQEP] (reviewing the impact of the 2013 Interagency Guidance and the initial lag in bank compliance).

<sup>72</sup> See Webb, *supra* note 6, at 122–25.

<sup>73</sup> See *id.*

<sup>74</sup> *Id.* (suggesting creation of a SRO would be more effective than guidelines). See generally Raymond & Yudin, *supra* note 4, at 1–5 (criticizing ILPA's considerations and recommendations).

restrict leveraged lending,<sup>75</sup> funding needs have necessitated the acquisition of leverage from other sources, and it was not long before private actors stepped in to fill the void created by the withdrawal of bank financing.<sup>76</sup> Past regulatory efforts have demonstrated that industry-focused barriers merely produce shifts in lending habits as other financial institutions adapt to evolving market needs.<sup>77</sup> However, a more inclusive regulatory system that incorporates the knowledge of and works with the parties most involved in the leveraged lending market could produce more effective results that can help prevent another financial crisis.<sup>78</sup>

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<sup>75</sup> See generally 15 U.S.C. § 78o-11 (2012) (providing regulation for credit risk retention), and 2013 Interagency Guidance, *supra* note 1.

<sup>76</sup> FED STAFF REPORT, *supra* note 2, at 5.

<sup>77</sup> See *id.* at 4.

<sup>78</sup> See Webb, *supra* note 6, at 122–25 (recommending the use of a self-regulatory organization in crafting future leveraged lending regulations to leverage the expertise of market participants).

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