Enforceability of OCC Reserve-Based Lending Guidelines

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A discussion of the implications that the pullback by federal banking regulatory agencies from enforcing the Leveraged Lending Guidance may have on the enforceability of the OCC Handbook for Examination of Oil and Gas Exploration and Production Lending.

In 2016, right after crude oil prices hit rock bottom in the middle of the worst downturn for US producers since the 1980s, the Office of the Comptroller of the Currency (OCC) revised its Handbook for Examination of Oil and Gas Exploration and Production Lending (E&P Handbook). The E&P Handbook introduced new metrics by which bank examiners were supposed to evaluate the repayment risks on bank loans secured by oil and gas reserves.

The changes announced by the OCC added to the angst and consternation among energy lenders and their oil and gas borrowers as it called into question the viability of E&P loan portfolios and availability of bank loan financing. For more information on the E&P Handbook, see Article, The New OCC Oil and Gas Lending Guidelines and Their Implications for Bank Lending in the Oil and Gas Sector (w-001-8221).

A few years before the E&P Handbook was issued, the OCC, along with other agencies responsible for oversight of national banks, the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (collectively, the Agencies), issued a similar guidance for the evaluation of leveraged loans under the Interagency Guidance on Leveraged Lending (Leveraged Lending Guidance) (see Legal Updates, Banking Agencies Issue New Proposed Guidance on Leveraged Lending (8-518-6635) and US Bank Regulators Release Supervisory Guidance on Leveraged Lending (9-525-4153)).

However, the Agencies issued their guidance without first submitting it to Congress for review and approval under the Congressional Review Act (CRA) of 1996, which raised questions about enforceability of this guidance (5 U.S.C. § 802).

LEVERAGED LOAN GUIDANCE ENFORCEABILITY ISSUES

In the fall of 2017, following an inquiry by Senator Toomey, the General Accounting Office (GAO) reviewed whether the Agencies' action complied with the CRA and concluded that it did not. Following the GAO's decision, officials at the Federal Reserve and the OCC have publicly stepped back from enforcing the Leverage Lending Guidance (see Legal Updates, OCC Will Not Enforce Leveraged Lending Guidance (w-013-5518) and Federal Banking Agencies, SEC Clarify That Supervisory Guidance Does Not Have Force and Effect of Law (w-016-5859) and Article, Expert Q&A on US Loan Market Hot Topics (w-016-8185)).

Although the GAO's decision relates to the Leveraged Lending Guidance, the same analysis should apply to the E&P Handbook. This is because:

- It is similar in scope and purpose to the Leveraged Lending Guidance.
- It has a similar effect on banks to the Leveraged Lending Guidance.
- The OCC also failed to submit the E&P Handbook for review under the CRA.

It appears, therefore, that the binding nature of the E&P Handbook may be similarly questioned.

SCOPE OF REVIEW UNDER THE CONGRESSIONAL REVIEW ACT

The CRA was enacted in 1996 to "create a special mechanism for Congress to review new rules issued by federal agencies ... before they go into effect and to disapprove any rule to which Congress objects." (see The Loan Syndication Trading Association (LSTA): The Congressional Review Act and the Leveraged Lending Guidelines: Questions and Answers (May 23, 2017) (the LSTA Q&A). The CRA requires all federal agencies to submit to the GAO and Congress new rules before they can become effective (see the LSTA Q&A). From its enactment in 1996 through 2016, the CRA was invoked only once to invalidate an agency rule (see the LSTA Q&A). However, since President Trump's inauguration in 2017, 15 rules have been overturned by joint congressional resolution under the CRA (see US General Accounting Office Congressional Review Act FAQs).

The threshold question regarding whether the CRA applies to an agency publication is whether or not such pronouncement is considered a "rule" (see Peter Weinstock and Marysia Laskowski, "If it Walks Like a Duck ...": The Demise of the Guidance Masquerade, 135 The Banking Law Journal at 215, 217 (Apr. 2018)). The CRA adopted the Administrative Procedure Act's (APA) broad definition of a "rule" (see 135 The Banking Law Journal at 215, 217).

The APA defines a rule as "the whole or part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency" (Congressional Review Act, 5 U.S.C. § 804(3) (citing the Administrative Procedure Act, 5 U.S.C. § 551(4)). This definition encompasses all types of agency pronouncements, including notice-and-comment procedures, regulations not requiring these procedures, agency interpretive rules, and, of particular significance, general statements of policy (see 135 The Banking Law Journal at 218-19).

Once a rule has been submitted to Congress under the CRA, members of Congress have a limited period of time to initiate the formal review process. To successfully invalidate a rule, both houses of Congress must pass an identical joint resolution of disapproval to be submitted to the President for signature or veto.

The disapproval of any rule under the CRA is retroactive to the date the rule is issued. The CRA provides, "[i]f the [agency] rule is already in effect when the joint resolution of disapproval is enacted ... the rule 'shall be treated as though [it] had never taken effect'" (see the LSTA Q&A at 5 (quoting 5 U.S.C. § 801(f)) (quoting Congressional Research Service, Disapproval of Regulations by Congress: Procedure Under the Congressional Review Act (Oct. 10, 2001)).

In addition, "once a rule is invalidated under the CRA, the agency may not reissue the rule 'in substantially the same form,' and may not issue a new rule 'that is substantially the same' without specific legislative authorization" (see the LSTA Q&A at 5 (quoting 5 U.S.C. § 801(b)(2)). These provisions of the CRA are helpful when an agency properly submits the rule for Congressional review, but, as discussed below, the CRA does not say what effect a rule has where it has not been submitted to congressional review.

THE CRA AND LEVERAGED LENDING GUIDANCE

For the issue raised by Senator Toomey, the Agencies took the position that when the Leveraged Lending Guidance was issued it was not a rule and, therefore, not subject to CRA congressional review. Senator Toomey asked the GAO whether it agreed with the Agencies' position. While the GAO acknowledged that deference should be given to an agency's characterization, "an agency's own label ... is not dispositive" (see Susan A. Poling, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation—Applicability of the Congressional Review Act to Interagency Guidance on Leveraged Lending, US Government Accountability Office, B-329272 (Oct. 19, 2017) (the GAO Determination), at 3 (quoting *Chamber of Commerce v. OSHA*, 636 F.2d. 464, 468 (D.C. Cir. 1980))).

The Agencies issued the Leveraged Lending Guidance to assist banks by providing guidance on how the Agencies evaluate prudent underwriting standards for leveraged lending (see Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17,766 (Mar. 22, 2013). More specifically, the Leveraged Lending Guidance "outlines the Agencies' minimum expectations on a wide range of topics related to leverage lending, including underwriting standards, valuation standards, the risk of leveraged loans, and problem credit management" (see GAO Determination at 2).

For example, the Leveraged Lending Guidance sets out criteria that banks can use to define leveraged loans, including "[t]ransactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA, exceed 4.0X EBITDA or 3.0X EBITDA, respectively" (see the Leveraged Lending Guidance at 17771 and the GAO Determination at 3).

The Leveraged Lending Guidance also describes certain bank actions that may cause the Agencies to initiate further review over these banks and that could require an independent finding that unsafe or unsound action has occurred (see the GAO Determination at 3). For more information on these criteria and actions, see Article, Regulatory Issues Affecting the Middle Market: Leveraged Lending Guidance (6-535-5945), and Practice Notes, What's Market: 2013 Year-End Trends in Large Cap and Middle Market Loan Terms: Box, An Expert's View: Deal Activity Developments in the Large Cap Market (1-554-9588) and What's Market: 2013 Mid-Year Trends in Large Cap and Middle Market Loan Terms: Leveraged Lending Guidelines (2-532-9265).

GAO Conclusion

The GAO concluded that the Leveraged Lending Guidance was a general statement of policy (see GAO Determination at 4). In reaching this conclusion, the GAO relied on a definition used by the US Supreme Court to define a general statement of policy as "statements issued by an agency to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power." (see the GAO Determination, at 4). The GAO further concluded that the Leveraged Lending Guidance "provides information on the manner in which the Agencies will exercise their enforcement authority regarding leveraged lending activities, ... [and] expresses the regulators' expectations regarding the sound risk management of leveraged lending activities" (see the GAO Determination at 4). The GAO noted that although there were exceptions where policy statements would not constitute a rule, the Leveraged Lending Guidance fell squarely within with the CRA (see the GAO Determination at 5 (citing 5 U.S.C. § 552(a)(1)(D), (2)(B)).

HANDBOOK ON OIL AND GAS EXPLORATION AND PRODUCTION LENDING

Two years after the Leveraged Lending Guidance was issued, the OCC published a revised E&P Handbook, replacing its 2014 handbook. The revised E&P Handbook significantly altered the way in which the risk of repayment for oil and gas reserves based loans (RBLs) would be assessed by energy lenders and subsequently evaluated by bank examiners (see Article, The New OCC Oil and Gas Lending Guidelines and Their Implications for Bank Lending in the Oil and Gas Sector (w-001-8221)). Significantly, the revised E&P Handbook instructed bank examiners to review not only their RBL debt, but to look at the borrower's total committed debt (whether

or not fully drawn), including second lien debt and unsecured debt, when risk-rating repayment of the senior loans. Similar to the Agencies' actions, the OCC did not submit the E&P Handbook for review under the CRA.

The change in field examination metrics announced in the E&P Handbook occurred during the depth of the oil and gas commodity price downturn when many E&P borrowers were laboring under the weight of heavy debt loads consisting of not only senior bank RBLs, but also second lien debt and unsecured debt. By March 2016 when the E&P Handbook was issued, the price of oil had fallen from above $100 per barrel in the summer of 2014 down to below $30 per barrel by January 2016. Although senior energy bankers were generally sanguine regarding their borrowers' ability to repay their senior secured loans, there was less optimism that junior secured and unsecured lenders would emerge unscathed. For more information on these issues, see Legal Updates, Oil & Gas Update: 2016 Year in Review (w-005-3860) and Energy Update: Oil & Gas (2-618-0937) and Article, US Oil & Gas Sector: 2017 in Review (w-012-5899).

Between January 2015 and March 2018, almost 150 producers filed for bankruptcy, involving total aggregate debt of more than $90 billion (see Haynes and Boone, LLP: Oil Patch Bankruptcy Monitor). A bloodletting affected many second lien lenders and unsecured lenders that received pennies on the dollar or exchanged their debt for equity in reorganized producers as they emerged from bankruptcy. A few of the senior bank loans also suffered losses, but on balance, losses attributable to RBLs were low in large part because the junior debt acted as a heat shield that protected the first lien RBL banks from the meteoric collapse in energy prices.

Despite this, once the E&P Handbook was issued, energy lenders began to apply the new metrics and many loans that were likely to be repaid in full were still downgraded based on the new total debt analysis. One analysis at the time of 58 publicly reporting E&P companies revealed that only five were likely to pass the strict guidelines under the E&P Handbook (see E&P Companies Continuing to Stumble Under the SNC Review). For more information on E&P bankruptcies, see Practice Notes, Distressed Investor Considerations in E&P Oil and Gas Restructurings (w-001-8965) and Unsecured Creditor Perspectives in Energy Restructurings (w-001-8363) and Diagram: Order of Distribution in Bankruptcy (6-383-6688).

Similar to the Leverage Lending Guidance, the E&P Handbook "addresses the risks associated with lending to upstream oil and gas exploration and production companies and provides examiner guidance on prudent risk management of this lending activity" (see the E&P Handbook at 1). This language tracks closely to the stated purpose of the Leveraged Lending Guidance (see the Leveraged Lending Guidance ("[t]his guidance outlines for agency-supervised institutions high-level principles related to safe-and-sound leveraged lending activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credits awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution")).

It also indicates that the E&P Handbook, like the Leveraged Lending Guidance, is intended to provide criteria for the bank examiners to look for in evaluating reserve based lending (see the GAO Determination at 3). Therefore, it is highly likely the E&P Handbook, if properly challenged, will also be considered a "statement issued by an agency to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power", that is a general statement of policy (see the GAO Determination at 4). If a challenge is made and a conclusion is reached, the E&P Handbook also should have been submitted to the GAO and Congress under the CRA (see the GAO Determination at 7).

WHERE THE OCC RBL RULES STAND TODAY

The CRA does not explicitly state what happens to rules that should be but are not submitted for Congressional review. The CRA states, "[b]efore a rule can take effect, the Federal agency promulgating such rule shall submit to each House of Congress and to the Comptroller General a report ..." (5 U.S.C. § 801(a)(1)(A)). Some argue the opening phrase to the CRA indicates rules that have not been submitted to Congress have not "take[n] effect" (see 135 The Banking Law Journal at 221).

However, the CRA also defines the joint resolution used to disapprove a rule as follows: "[F]or purposes of this section, the term 'joint resolution' means only a joint resolution introduced in the period beginning on the date on which the report ... is received by Congress and ending 60 days thereafter ..." (5 U.S.C. § 802(a)). This suggests the process by which Congress may overrule an agency action does not begin until the agency submits the rule for review (see 135 The Banking Law Journal at 221). Congress has, on a couple occasions, commenced the CRA review process after the GAO determined that an agency statement that had not been submitted to Congress was a rule subject to the CRA (see LSTA Q&A, at 4). However, in each case Congress upheld the rules and, therefore, there is no precedent for Congress invalidating a rule under CRA that an agency has not proffered for review.

Following the GAO's determination regarding the Leveraged Lending Guidance, a banking industry association reported that the GAO was to meet with the Senate Parliamentarian to require the Agencies to submit the Leveraged Lending Guidance to Congress. At that time, Congress was to be given 60 days to decide whether or not to pass a resolution disapproving the rule for the presidential signature. (See LSTA: Will the Leveraged Lending Guidance GAO Away? (Oct. 19, 2017).) To date it does not appear that the Agencies have submitted the Leveraged Lending Guidance to Congress.

Some market participants, including the current Comptroller of the Currency Joseph Otting, believe the Leveraged Lending Guidance is unlikely to be repealed entirely and will remain in effect for the time being. This means that regulators will continue monitoring the leveraged lending activities of banks but will remind them that the Leveraged Lending Guidance are merely guidelines to be observed when conducting these activities (see Reuters: Jonathan Schwarzberg, OCC Head Says Leveraged Lending Guidance Needs No Revisions (May 24, 2018)).

Under this regime, banks may occasionally operate outside of the parameters found in the Leveraged Lending Guidance so long as their actions comport with the ordinary safety and soundness standards to which they are subject under federal statutory law (see Reuters: Jonathan Schwarzberg, OCC Head Says Leveraged Lending Guidance Needs No Revisions (May 24, 2018)); see also, Safety and Soundness Standards, 12 C.F.R. pt. 30). The result of this

approach, therefore, is to provide more flexibility and require greater examiner judgment, which in turn may provide less predictability and uniformity than a bright- line rule like those in the Leverage Lending Guidance (see White and Case: Eric Leicht, et al., Banking Regulators Signal Movement Away from Leveraged Lending Guidance (Mar. 15, 2018)). It was reported the Comptroller's statement "prompt[ed] several bankers to say they have already begun pushing their credit risk officers to allow more aggressive deals" (see Debtwire: OCC Head Says Banks Not Bound by Lending Guidelines, Expects Leverage to Increase (Feb. 27, 2018)).

On the other hand, Board Chairman Jerome Powell has indicated the Agencies might consider simply abandoning the Leverage Loan Guidelines altogether in favor of an alternative approach (see White and Case: Eric Leicht, et al., Banking Regulators Signal Movement Away from Leveraged Lending Guidance (Mar. 15, 2018)). Eric Leicht et al at White and Case reported that Chairman Powell testified before the House Financial Services Committee on February 27, 2018, in response to a question during the hearing, that, "in the case of the leveraged lending guidance, we do accept and understand that that's non-binding guidance".

Chairman Powell also noted that since the GAO's ruling, the Board has "made it a point to go out and make sure that that message is getting out to supervisors of banks," the non-binding nature of the guidelines. He concluded his response by indicating the Board is also considering other ways in which it can underscore this message, "perhaps putting it out for further comment." (See Monetary Policy and the Economy, hearing before the House Financial Services Committee, 115th Cong. (2018), remarks of Federal Reserve Chair Jerome Powell.

IMPLICATIONS FOR THE E&P HANDBOOK

To our knowledge, there has been no discussion about the effect of applying the GAO's analysis to the E&P Handbook. However, if the GAO is tasked with determining the effectiveness of the E&P Handbook, as it was the Leveraged Lending Guidance, it is likely that the same conclusion would be reached because the E&P Handbook is also a general statement of policy subject to the requirements of the CRA and should have been submitted to Congress for review. Because these procedures were not followed, similar to the Leveraged Lending Guidance, the E&P Handbook may also be considered ineffective.

Rescinding the E&P Handbook guidelines does not, however, change the outcome for the many stakeholders that were affected by the E&P bankruptcies that have been filed. Nor would energy bankers necessarily ignore entirely the metrics that the OCC included in the E&P Handbook. However, as with the Leveraged Lending Guidance, clarity to the bank examiners and the regulated banks that the rules outlined in the E&P Handbook are examples and that the banks and their examiners can and should, where appropriate, consider exceptions to the guidelines, could provide some needed flexibility for properly risking E&P RBLs.

Other bankers believe that if written correctly, the E&P Handbook may serve as clear guideposts to both:

- Prevent examiners from conservatively overplaying their discretion.
- Keep more aggressive energy lenders from leading all banks into foul territory by loosening their underwriting parameters in an effort to gain market share.

Human nature and self-interest in job preservation indicates that a field examiner exercising discretion will err on the side of conservatively reviewing and rating E&P loans. Therefore, any perceived flexibility from the E&P Handbook as non-binding could be more constraining and less accommodating.

On the other hand, some bankers confidentially express concern despite the recent spate of producer bankruptcies. They worry that if there are no bright underwriting parameters, some of their brethren could become more aggressive in underwriting loans to grow market share, forcing competing banks to relax their standards to maintain market share. Therefore, it may be the best for regulated and regulators alike to find common ground on underwriting guidelines for RBLs that can then be properly reviewed by Congress under the CRA.

For example, based on RBL bankers' experience with the recent E&P bankruptcies, some bankers believe that the total debt leverage covenants should be more appropriately tied to total secured debt and exclude from the ratio unsecured debt given the different bargaining position of the secured versus unsecured lenders. In connection with an open review and comment process issuing revised guidelines, other refinements may also be discovered.

The various stakeholders affected by the Leveraged Lending Guidance seem to be pushing for a resolution to this unfortunate twilight zone in which they find themselves. They may soon have as additional company energy bankers and their E&P borrowers. Although uncertainty exists regarding whether Congress may act unilaterally to overrule a final agency action that has not been brought before it, it is not hard to imagine that if given the opportunity, the Republican-led Congress sitting today may be willing to wield its power afforded under the CRA to overturn both the Leveraged Lending Guidance and E&P Handbook.

Regulators, including the OCC, may be better served rather than waiting to see if Congress unilaterally takes up a review process under the CRA, to instead work with their regulated banks and industry organizations to find guidelines that better address the needs of oil and gas producers and the RBLs that provide them necessary credit.

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