

**Supporting Statement
Leveraged Guidance
OMB Control No. 1557-NEW**

A. Justification

1. *Circumstances that make the collection necessary:*

The OCC, Board, and the FDIC (agencies) are issuing guidance on leveraged lending, which sets forth 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 and portfolio management, and risk management expectations. This guidance will apply to all financial institutions supervised by the Federal Reserve, FDIC, and OCC that substantively engage in leveraged lending activities. The number of community banking organizations with substantial exposure to leveraged lending is small; therefore, the agencies generally expect that community banking organizations largely would be unaffected by this guidance.

All financial institutions should have the capacity to properly evaluate and monitor underwritten credit risks, to understand the effect of changes in borrowers' enterprise values upon credit portfolio quality, and to assess the sensitivity of future credit losses to changes in enterprise values. Further, in underwriting such credits, institutions need to ensure that borrowers are able to repay credit as due and at the same time that borrowers have capital structures, including their bank borrowings and other debt, that support the borrower's continued operations through economic cycles (that is, have a sustainable capital structure). Institutions should also be able to demonstrate that they understand their risks and the potential impact of stressful events and circumstances on borrowers' financial condition. The agencies have previously provided guidance to financial institutions for their involvement in leveraged lending.

The recent financial crisis further underscored the need for banking organizations to employ sound underwriting, to ensure that the risks in leveraged lending activities are appropriately incorporated in the Allowance for Loan and Lease Losses and capital adequacy analyses, to monitor the sustainability of their borrowers' capital structures, and to incorporate stress testing into their risk management of both leveraged portfolios and distribution pipelines, as banking organizations unprepared for stressful events and circumstances can suffer acute threats to their financial condition and viability. The guidance is intended to be consistent with industry practices while building upon the recent issuances on Stress Testing.

In April 2001, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (the "agencies"), and together with the Office of Thrift Supervision issued guidance¹ regarding sound practices for leveraged finance² activities ("2001 Guidance"). The 2001 Guidance addressed expectations for

¹ SR 01-9 (SUP), "Sound Risk Management Practices" April 9, 2001; OCC Bulletin 2001-18; FDIC Press Release PR-28-2001.

² For the purpose of this guidance, references to leveraged lending, leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including senior loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and non-bank investors.

the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, and the importance of stress testing exposures and portfolios.

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 non-regulated investors. Additionally, debt agreements have frequently included features that provided relatively limited lender protection, including but not limited to the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind ("PIK")-toggle features in junior capital instruments, which lessened lenders' recourse in the event of a borrower's subpar performance. The capital structures and repayment prospects for some transactions, whether originated to hold or distribute, have at times been aggressive. Moreover, management information systems ("MIS") at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, with many institutions holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

In light of these changes, the agencies have decided to replace the 2001 Guidance with this updated leveraged lending guidance ("2012 Guidance"). The 2012 Guidance describes expectations for the sound risk management of leveraged lending activities, including the importance for institutions to develop and maintain:

- Transactions that are structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe and sound loan structure should clearly support a borrower's capacity to repay and de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute.
- A definition of leveraged lending that facilitates consistent application across all business lines.
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt.
- A credit limit and concentration framework that is consistent with the institution's risk appetite.
- Sound MIS that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines.
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels.

2. Use of the information:

In April 2001, the agencies (and Office of Thrift Supervision) issued guidance³ regarding sound risk management practices for leveraged lending activities (2001 Guidance). The 2001 Guidance addressed expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, and the importance of stress testing exposures and portfolios.

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 non-regulated investors. Additionally, debt agreements have frequently included features that provided relatively limited lender protection, including the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind ("PIK")-toggle features in junior capital instruments (i.e., a feature where the borrower has the option to pay interest in cash or in-kind, which increases the principal owed), both of which lessen lenders' recourse in the event that a borrower's performance does not meet projections. The capital structures and repayment prospects for some transactions, whether originated to hold or distribute, have at times been aggressive in light of the overall risk of the credit. And, management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, with many institutions holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

Leveraged lending is an important type of financing for the economy, and the banking industry plays an integral role in making credit available and syndicating that credit to investors. Institutions should ensure they do not heighten risks by originating poorly underwritten deals that find their way into a wide variety of investment instruments. Therefore, it is important this financing be provided to creditworthy borrowers in a safe and sound manner that is consistent with this 2012 Guidance.

Under the guidance, institutions must have (i) underwriting policies for leveraged lending, including stress-testing procedures for leveraged credits; (ii) risk management policies, including stress testing procedures for pipeline exposures; and, (iii) policies and procedures for incorporating the results of leveraged credit and pipeline stress tests into the firm's overall stress-testing framework.

3. Consideration of the use of information technology:

National banks or Federal branches or agencies may use any information technology they have available that allows them to meet the requirements of the guidance.

4. Efforts to identify duplication:

This information is not duplicative, as it is not available elsewhere.

³ SR 01-9, "Sound Risk Management Practices," April 9, 2001, OCC Bulletin 2001-18, FDIC Press Release PR-28-2001.

5. *Methods used to minimize burden if the collection has a significant impact on a substantial number of small entities:*

This collection of information will not have a significant impact on a substantial number of small entities.

6. *Consequences to the Federal program if the collection were conducted less frequently:*

The guidance imposes the minimum burden necessary for to ensure bank safety and soundness.

7. *Special circumstances necessitating collection inconsistent with 5 CFR Part 1320:*

This information collection is conducted in accordance with the OMB guidelines in 5 CFR 1320.

8. *Efforts to consult with persons outside the agency:*

The OCC published a notice in the *Federal Register* for 60 days of comment on March 30, 2012 (77 FR 19407). The agencies received four comments regarding the paperwork burden of the guidance, stating that the implementation will add to the regulatory burden that banks already face. One other commenter noted that there was no cost benefit analysis provided with the proposed guidance. The agencies emphasize that the guidance would require sound risk management policies and procedures commensurate with the financial institution's origination activity in and exposures to leveraged lending activities. The risk management framework should be consistent with the institution's risk appetite, and any accompanying additional burden would be included in the financial institution's assessment of risk management.

The OCC published a notice in the *Federal Register* for 30 days of comment on March 22, 2013 (78 FR 17766). In response to the 30-day notice, the OCC received one comment letter. The commenter raised a legal question about the PRA compliance date, a question about the burden estimate, and a few questions about the technical implementation of the guidance. The agencies responded by meeting with the commenter on May 9, 2013, to discuss and resolve the concerns. The agencies resolved the legal question, and answered the questions in the comment letter about the technical implementation of the guidance. Regarding the burden estimate, the agencies noted that the burden number used in the PRA filings is an average across banks of all sizes; the commenters' focus was on the largest institutions, which under the guidance would require significantly more time to implement the suggestions than smaller institutions with little or no leveraged lending activity. The agencies are also planning to hold outreach calls directly with the affected institutions to address their concerns about the burden and implementation of the guidance.

9. *Payment to respondents:*

None.

10. Any assurance of confidentiality:

The information will be kept private to the extent permitted by law.

11. Justification for questions of a sensitive nature:

There are no questions of a sensitive nature.

12. Burden estimate:

Estimated number of respondents: 25.

Estimated average time per respondent: 1,350.4 hours to build; 1,705.6 hours for ongoing use.

Estimated total annual burden hours: 33,760 hours to build, 42,640 hours for ongoing use.

13. Estimates of annualized costs to respondents:

On average, each of the 25 respondents will spend 1,705.6 hours at a cost of \$90⁴ per hour to collect and prepare information for ongoing annual use, resulting in an estimated total cost of \$3,837,600. The key drivers of costs of compliance should be the magnitude of the changes in activities and operations of each covered bank.

14. Estimates of annualized cost to the Federal Government:

Not applicable.

15. Changes in burden:

The increase in burden is due to the fact that this is a new collection.

16. Information regarding collections whose results are planned to be published for statistical use:

Not applicable.

⁴To estimate hourly wages, we used data from May 2011 for wages (by industry and occupation) from the U.S. Bureau of Labor Statistics (BLS) for depository credit intermediation. To estimate compensation costs associated with the rule, they used \$90 per hour, which is based on the average of the 90th percentile for seven occupations (i.e., accountants and auditors, compliance officers, financial analysts, lawyers, management occupations, software developers, and statisticians) plus an additional 33 percent to cover inflation and private sector benefits.

17. ***Display of expiration date:***

Not applicable.

18. ***Exceptions to certification statement:***

Not applicable.

B. Collections of Information Employing Statistical Methods

Not applicable.