Description of Information Collection for the
Recordkeeping Provisions Associated with
Guidance on Leveraged Lending
(FR 4203; OMB No. to be assigned) ***(Docket No. OP-1439/1438)***

Principal Elements of the Proposed Guidance

The proposed guidance describes expectations for the sound risk management of leveraged finance activities, including the importance of institutions developing and maintaining:

- 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 considerations 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 finance 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.
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

The proposed guidance would replace existing leveraged finance guidance (see below) and forms the basis of the Agencies' supervisory focus and review of supervised financial institutions, including, as applicable, subsidiaries and affiliates involved in leveraged lending. In implementing the guidance, the Agencies would consider the size and risk profile of an institution's leveraged portfolio relative to its assets, earnings, liquidity, and capital. Although some sections of this proposal are intended to apply to all leveraged lending transactions (e.g., underwriting), the vast majority of community banks should not be affected by this guidance as they have no exposure to leveraged credits. The limited number of community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator implementation of cost-effective controls appropriate for the complexity of their exposures and activities.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

Subject: **Leveraged Financing** Description: **Sound Risk Management Practices**

PURPOSE

In 1998 and 1999, the Agencies issued separate statements[1] to the banking industry commenting on the relaxation of sound lending standards for certain types of loans. Since that time, there has been a sharp increase in classified and other problem assets related to these weakened standards. In particular, a significant share of recent problem credits is associated with leveraged financing. Financial institutions have responded to these problems by tightening lending standards, and the current level of problem credits is modest relative to the resources of the system. However, in many cases the problems associated with weakened standards were largely unanticipated by institution management and clearly indicate that the lessons learned from this experience need to be fully incorporated into institution risk management processes and examiner guidance.

As with a broad range of lending activities, leverage financing can be conducted in a safe and sound fashion if pursued with the appropriate risk management structure. Sound practices dictate fully articulated policies with regard to underwriting standards, concentration limits, and ongoing monitoring of risk.

In the wake of these recent developments, institutions have started to improve their management of leveraged financing activities. To facilitate that process, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision (the Agencies) are issuing this guidance to bankers and examiners to describe more fully supervisory expectations regarding sound practices for leveraged financing activities.

[1] OCC Advisory Letter AL 99-4 (May 1999) and FRB Supervisory Letters, SR 99-23 (1999), SR 98-18 (1998).

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BACKGROUND

Leveraged financing is an important financing vehicle for mergers and acquisitions, business re-capitalizations and refinancings, equity buyouts, and business or product line build-outs and expansions. It is also used to increase shareholder returns and to monetize perceived "enterprise value"[2] or other intangibles. A transaction is considered leveraged when the obligor's post-financing leverage as measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular industries significantly exceeds industry norms for leverage. Leveraged borrowers typically have a diminished ability to adjust to unexpected events and changes in business conditions because of their higher ratio of total liabilities to capital. Consequently, leveraged financing can have significant implications for a banking organization's overall credit risk and presents unique challenges for its risk management systems.

Over the last few years, an increasing number of banking organizations have become involved in leveraged financing. Much of this activity appears to stem from the dramatic increase in merger and acquisition activity and the increasing values that were ascribed to firms as a result of a strong expansionary business climate. Estimates of exposure to leveraged financing drawn from examination data and industry sources indicate that leveraged financing transactions account for approximately one-third of syndicated bank loans. Examination data also indicate that leveraged financing is conducted in the broader middle market.

Institutions participate in leveraged financing on a number of levels. In addition to providing senior secured financing, they extend credit on a subordinated basis (mezzanine financing). Institutions and their affiliates also may take equity positions in leveraged companies with direct investments through affiliated securities firms, small business investment companies (SBICs), and venture capital companies or take equity interests via warrants and other equity "kickers" received as part of a financing package. Institutions also may invest in leveraged loan funds managed by investment banking companies or other third parties. Although leveraged financing is far more prevalent in large institutions, this type of lending can be found in institutions of all sizes.

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[2] Enterprise value can be defined as the imputed value of a business. This valuation is often based on the anticipated **or imputed** sale value, market capitalization or net worth of the borrower. The sale value is normally some multiple of sales or cash flow based on recent mergers or acquisitions of other firms in the borrower's industry.

APPLICABILITY

The extent to which institutions should apply these sound practices will depend on the size and risk profile of their leveraged exposures relative to assets, earnings, and capital; and the nature of their leveraged financing activities (i.e., origination and distribution, participant, equity investor, etc.). This issuance supplements and reemphasizes existing guidance and will form the basis of the Agencies' supervisory focus and review.

RISK MANAGEMENT GUIDELINES

The Agencies expect institutions substantively engaged in leveraged financing to adequately risk rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. In general, the risk management framework for leveraged finance is no different from that which should be applied to all lending activities. However, because of the potential higher level of risk, the degree of oversight should be more intensive.

Loan Policy

The loan policy should specifically address the institutions' leveraged lending activities by including:

- A definition of leveraged lending;
- An approval policy that requires sufficient senior level oversight;
- Pricing policies that ensure a prudent tradeoff between risk and return; and
- A requirement for action plans whenever cash flow, asset sale proceeds, or collateral values decline significantly from projections. Action plans should include remedial initiatives and triggers for rating downgrades, changes to accrual status, and loss recognition.

Underwriting Standards

Either the loan policy or separate underwriting guidelines should prescribe specific underwriting criteria for leveraged financing. The standards should avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees. The policy should:

- Describe appropriate leveraged loan structures;
- Require reasonable amortization of term loans (i.e., allow a moderate time period to realize the benefit of synergies or augment revenues and institute meaningful repayment);

- Specify collateral policies including acceptable types of collateral, loan to value limits, collateral margins, and proper valuation methodologies;

- Establish covenant requirements, particularly minimum interest and fixed charge coverage and maximum leverage ratios;

- Describe how enterprise values and other intangible business values may be used; and

- Establish minimum documentation requirements for appraisals and valuations, including enterprise values and other intangibles.

Limits

Leveraged finance and other loan portfolios with above-average default probabilities tend to behave similarly during an economic or sectoral downturn. Consequently, institutions should take steps to avoid undue concentrations by setting limits consistent with their appetite for risk and their financial capacity. Institutions should ensure that they monitor and control as separate risk concentrations those loan segments most vulnerable to default. Institutions may wish to identify such concentrations by the leveraged characteristics of the borrower, by the institution's internal risk grade, by particular industry or other factors that the institution determines are correlated with an above-average default probability. In addition, sub-limits may be appropriate by collateral type, loan purpose, industry, secondary sources of repayment, and sponsor relationships. Institutions should also establish limits for the aggregate number of policy exceptions.

Credit Analysis

Effective management of leveraged financing risk is highly dependent on the quality of analysis during the approval process and after the loan is advanced. At a minimum, analysis of leveraged financing transactions should ensure that:

- Cash flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;

- Projections provide an adequate margin for unanticipated merger-related integration costs;

- Projections are stress tested for one or two downside scenarios;

- Transactions are reviewed quarterly to determine variance from financial plans, the risk implications thereof, and the accuracy of risk ratings and accrual status;

- Collateral valuations are derived with a proper degree of independence and consider potential value erosion;

- Collateral liquidation and asset sale estimates are conservative;

- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or re-capitalization; and
- The borrower is adequately protected from interest rate and foreign exchange risk.

Enterprise Value

Enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt reduction potential of planned asset sales, assess a borrower's ability to access the capital markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit underwriting process. However, enterprise value and other intangible values can be difficult to determine, are frequently based on projections, and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic.

Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop. Events or changes in business conditions that negatively affect a company's cash flow will also negatively affect the value of the business, simultaneously eroding both the lender's primary and secondary source of repayment. Consequently, lenders that place undue reliance upon enterprise value as a secondary source of repayment or that utilize unrealistic assumptions to determine enterprise value are likely to approve unsound loans at origination or experience outsize losses upon default.

It is essential that institutions establish sound valuation methodologies for enterprise value, apply appropriate margins to protect against potential changes in value, and conduct ongoing stress testing and monitoring.

Rating Leveraged Finance Loans

Institutions need thoroughly articulated policies that specify requirements and criteria for risk rating transactions, identifying loan impairment, and recognizing losses. Such specificity is critical for maintaining the integrity of an institution's risk management system. Institutions' internal rating systems should incorporate both the probability of default and loss given default in their ratings to ensure that the risk of the borrower and the risk of the transaction structure itself are clearly evaluated. This is particularly germane to leverage finance transactions structures, which in many recent cases have resulted in large losses upon default.

In cases where a borrower's condition or future prospects have significantly weakened, leverage finance loans will likely merit a substandard classification based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on non-accrual and will likely have a doubtful component. Such loans should be reviewed for impairment in accordance with FAS #114, *Accounting by Creditors for Impairment of a Loan*.

If the primary source of repayment is inadequate and a loan is considered collateral dependent, it is generally inappropriate to consider enterprise value unless the value is well supported. Well supported enterprise values may be evidenced by a binding purchase and sale agreement with a qualified third party or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, where a portion of the loan is not protected by pledged assets or a well supported enterprise value, examiners will generally classify the unprotected portion of the loan doubtful or loss.

In addition, institutions need to ensure that the risks in leveraged lending activities are fully incorporated in the Allowance for Loan and Lease Loss and capital adequacy analysis. For allowance purposes, leverage exposures should be taken into account either through analysis of the expected losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment should be scrutinized to determine the need for and adequacy of specific allocations.

Problem Loan Management

For adversely rated borrowers and other high-risk borrowers who significantly depart from planned cash flows, asset sales, collateral values, or other important targets; institutions should formulate individual action plans with critical objectives and timeframes. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale in the secondary market, and liquidation. Regardless of the action, examiners and bankers need to ensure such credits are reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Portfolio Analysis

Higher risk credits, including leveraged finance transactions, require frequent monitoring by banking organizations. At least quarterly, management and the board of directors should receive comprehensive reports about the characteristics and trends in such exposures. These reports at a minimum should include:

- Total exposure and segment exposures, including subordinated debt and equity holdings, compared to established limits;

- Risk rating distribution and migration data;

- Portfolio performance — noncompliance with covenants, restructured loans, delinquencies, non-performing assets, and impaired loans; and

- Compliance with internal procedures and the aggregate level of exceptions to policy and underwriting standards.

Institutions with significant exposure levels to higher risk credits should consider additional reports covering:

- Collateral composition of the portfolio, e.g. percentages supported by working assets, fixed assets, intangibles, blanket liens, and stock of borrower's operating subsidiaries;

- Unsecured or partially secured exposures, including potential collateral shortfalls caused by defaults that trigger *pari passu* collateral treatment for all lender classes;

- Absolute amount and percentage of the portfolio dependent on refinancing, recapitalization, asset sales, and enterprise value;

- Absolute amounts and percentages of scheduled and actual annual portfolio amortizations; and

- Secondary market pricing data and trading volume for loans in the portfolio.

Internal Controls

Institutions engaged in leveraged finance need to ensure their internal review function is appropriately staffed to provide timely, independent assessments of leveraged credits. Reviews should evaluate risk rating integrity, valuation methodologies, and the quality of risk management. Because of the volatile nature of these credits, portfolio reviews should be conducted on at least an annual basis. For many institutions, the risk characteristics of the leveraged portfolio, such as high reliance on enterprise value, concentrations, adverse risk rating trends or portfolio performance, will dictate more frequent reviews.

DISTRIBUTIONS

Asset sales, participations, syndication, and other means of distribution are critical elements in the rapid growth of leveraged financing. The Agencies expect both lead and purchasing institutions to adopt formal policies and procedures addressing the distribution and acquisition of leveraged financing transactions. Policies should include:

- Procedures for defining, managing, and accounting for distribution fails;

- Identification of any sales made with recourse and procedures for fully reflecting the risk of any such sales.

- A process to ensure that purchasers are provided with timely, current financial information;

- A process to determine the portion of a transaction to be held in the portfolio and the portion to be held for sale;

- Limits on the length of time transactions can be held in the held-for-sale account and policies for handling items that exceed those limits;

- Prompt recognition of losses in market value for loans classified as held-for-sale; and

- Procedural safeguards to prevent conflicts of interest for both bank and affiliated securities firms.

PARTICIPATIONS PURCHASED

Institutions purchasing participations and assignments in leveraged finance must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for:

- Obtaining and independently analyzing full credit information both before the participation is purchased and a on timely basis thereafter;

- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, UCC searches, and other relevant documents;

- Carefully monitoring the borrower's performance throughout the life of the loan; and

- Establishing appropriate risk management guidelines as described in this document.

PROCESS TO IDENTIFY POTENTIAL CONFLICTS

Examiners should determine whether an institution's board of directors and management have established policies for leveraged finance that minimize the risks posed by potential legal issues and conflicts of interest.

Conflicts of Interest

When a banking company plays multiple roles in leveraged finance, the interests of different customers or the divisions of the institution may conflict. For example, a lender may be reluctant to employ an aggressive collection strategy with a problem borrower because of the potential impact on the value of the organization's equity interest. A lender may also be pressured to provide financial or other privileged client information that could benefit an affiliated equity investor. Institutions should develop appropriate policies to address potential conflicts of interest. Institutions should also track aggregate totals for borrowers and sponsors to which it has both a lending and equity relationship. Appropriate limits should be established for such relationships.

Securities Laws

Equity interests and certain debt instruments used in leveraged lending may constitute “securities” for the purposes of federal securities laws. When securities are involved, institutions should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements. Institutions should also establish procedures to restrict the internal dissemination of material nonpublic information about leveraged finance transactions.

Compliance Function

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure that potential conflicts are avoided and laws and regulations are adhered to, an independent compliance function should review all leveraged financing activity.

EXAMINATION GUIDELINES

The attachment to this guidance contains supplemental examiner guidance for reviewing and classifying leveraged financing transactions. Additional information can be found in the Agencies’ existing examiner guidance.

CONTACTS

If you have any questions about the contents of this bulletin please contact: Credit Risk Division (202) 874-5170 at the Office of the Comptroller of the Currency, David M. Wright, Assistant Director, Credit Risk (202) 728-5854 at the Board of Governors of the Federal Reserve System, Pete D. Hirsch at the Federal Deposit Insurance Corporation, (202) 898-6751, or William Magrini, Senior Project Manager (202) 906-5744 at the Office of Thrift Supervision.

Emory W. Rushton
Senior Deputy Comptroller for
Bank Supervision Policy
Office of the Comptroller of the Currency

Richard Spillenkothen
Director, Division of Banking
Supervision and Regulation
Board of Governors of the Federal Reserve System

Michael J. Zamorski
Acting Director Division of Supervision
Federal Deposit Insurance Corporation

Richard M. Riccobono
Deputy Director
Office of Thrift Supervision

EXAMINATION RISK RATING GUIDANCE FOR LEVERAGED FINANCING

The following supplemental guidance should be used in combination with that provided in the main body of this document.

When evaluating individual borrowers, examiners should pay particular attention to:

- The overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
- The history and stability of a borrower's market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
- The relationship between a borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage;

Cash Flow/Debt Service Coverage

Particular attention should be paid to the adequacy of the borrower's cash flow and the reasonableness of projections. Before entering into a leveraged financing transaction, bankers should conduct an independent, realistic assessment of the borrower's ability to achieve the projected cash flow under varying economic and interest rate scenarios. This assessment should take into account the potential effects of an economic downturn or other adverse business conditions on the borrower's cash flow and collateral values. Normally bankers and examiners should adversely rate a credit if material questions exist as to the borrower's ability to achieve the projected necessary cash flows, or if orderly repayment of the debt is in doubt. Credits with only minimal cash flow for debt service are usually subject to an adverse rating.

Enterprise Value

Many leveraged financing transactions rely on "enterprise value" as a secondary source of repayment. Most commonly, enterprise value is based on a "going concern" assumption and derived from some multiple of the expected income or cash flow of the firm. The methodology and assumptions underlying the valuation should be clearly disclosed, well supported, and understood by appropriate decision-makers and risk oversight units. Examiners should ensure that the valuation approach is appropriate for the company's industry and condition.

Enterprise value is often viewed as a secondary source of repayment and as such would be relied upon under stressful conditions. In such cases the assumptions used for key variables such as cash flow, earnings, and sale multiples should reflect those adverse conditions. These variables can have a high degree of uncertainty — sales and cash flow projections may not be achieved; comparable sales may not be available; changes can occur in a firm's competitive position, industry outlook, or the economic environment. Because of these uncertainties, changes in the value of a firm's assets need to be tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress testing of enterprise values and their underlying assumptions should be conducted upon origination of the loan and periodically thereafter incorporating the actual performance of the borrower and any adjustments to projections. The bank should in all cases perform its own discounted cash flow analysis to validate "enterprise value" implied by proxy measures such as multiples of cash flow, earnings or sales.

Finally, it must be recognized that valuations derived with even the most rigorous valuation procedures are imprecise and may not be realized when needed by an institution. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral must have lending policies that provide for appropriate loan-to-value ratios, discount rates and collateral margins.

Deal Sponsors

Deal sponsors can be an important source of financial support for a borrower that fails to achieve cash flow projections. However, support from this source should only be considered positively in a risk rating decision when the sponsor has a history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. Even with capacity and a history of support, a sponsor's potential contributions should not mitigate criticism unless there is clear reason to believe it is in the best interests of the sponsor to continue that support or unless there is a formal guarantee.