Federal Banking Agencies Propose Revised Guidance on Leveraged Finance

April 4, 2012

On March 26, 2012, the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") jointly issued for comment revised guidance on leveraged lending activities by banking organizations.[1] Once adopted, the proposed guidance will replace the leveraged finance guidance that the Agencies issued in 2001.[2] According to an interagency press release, the revised guidance would apply to transactions that are "characterized by a borrower with a degree of financial or cash flow leverage that significantly exceeds industry norms as measured by various debt, cash flow, or other ratios."

The proposed guidance outlines minimum regulatory expectations for financial institutions with "substantial exposures" to leveraged finance activities, focusing on several key areas, including:

- credit policies and procedures that identify risk appetite as to both retention and underwriting of leveraged loans;
- underwriting and valuation standards;
- timely measurement of transactions "in the pipeline";
- reporting and analytics that more accurately and more timely measure exposures; and
- guidelines for evaluating the financial support of deal sponsors.

While the proposed guidance does not represent a fundamental change in the Agencies' view of leveraged lending (and much of the new guidance generally describes management practices followed today by many large banking organizations), it does reflect heightened regulatory focus on sound and well-documented lending and risk management practices, including for loans originated for distribution to investors. Moreover, in contrast to more general standards provided in the 2001 guidance, the proposed guidance contains a number of bright-line tests by which leverage lending activities will be measured.

Comments on the proposed guidance are due by June 8, 2012.

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1 *See* 77 Fed. Reg. 19,417 (Mar. 30, 2012).

2 *See* Federal Reserve SR Letter 01-9 (SUP); OCC Bulletin 2001-8; and FDIC PR-28-2001.

A. BACKGROUND

Since the issuance of interagency guidance in 2001 regarding sound practices for leveraged finance activities, the Agencies have observed "tremendous growth" in the volume of leveraged credit—particularly in the build-up to the financial crisis but also more recently—and in the participation of non-regulated investors. The Agencies noted with concern that, to satisfy "burgeoning demand from institutional investors," the "pipeline of aggressively priced and structured commitments" has grown rapidly and that some banking organizations lacked adequate information systems to accurately assess both portfolio and pipeline risk exposures. These risk concerns have been heightened by market developments such as "covenant-lite" loan agreements and pay-in-kind (PIK) toggle features.

In light of these concerns, the Agencies are proposing to replace the existing guidance from more than a decade ago with new guidance that reiterates proven credit management principles, while addressing current industry practices. The new guidance includes, for example, several presumptive standards for leveraged lending[3] or acceptable underwriting standards.[4]

The new guidance also reflects a post-Dodd-Frank focus on accurately measuring through management information systems (MIS) enterprise-wide exposures at multiple levels and anticipating downside risk through stress testing. Overall, the release represents an attempt by federal regulators to rein in practices perceived as aggressive by imposing "meaningful limits" that ultimately will reduce systemic risk.

B. FINANCIAL INSTITUTIONS SUBJECT TO THE REVISED GUIDANCE

The guidance being proposed by the Agencies is intended for banking organizations supervised by the Agencies that are substantively engaged in leveraged lending activities. The proposed guidance would apply to any Agency-supervised "financial institution," which means national banks, federal savings associations, and federal branches and agencies of foreign banking organizations supervised by the OCC; state member banks, bank holding companies and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember insured banks and other institutions supervised by the FDIC. The proposed guidance would also cover subsidiaries and affiliates of financial institutions involved in leveraged lending. In short, the Agencies intend to apply the proposed guidance broadly to

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3 One factor includes transactions where the borrower's total debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) or senior debt to EBITDA exceed 4.0x or 3.0x, respectively.

4 In assessing ability to repay, for example, the proposed guidance provides that base case cash-flow projections should show the ability over a 5-to-7 year period to fully amortize senior secured debt or repay at least 50% of total debt. In addition, the proposed guidance notes that a leveraged level after planned asset sales in excess of 6x total debt to EBTIDA "raises concerns."

U.S. banking and non-banking entities of domestic and foreign banking organizations that are subject to supervision by one or more of the Agencies.

Leveraged loans tend to be held primarily by large or global banking institutions, and the effects of this guidance upon smaller institutions, which do not have substantial exposure in this area, should be negligible. Some sections of the proposed guidance (such as underwriting) would apply to any leveraged transaction, and the limited number of community and smaller institutions that have leveraged lending activities are encouraged to discuss with their primary regulator implementation of cost-effective controls appropriate for the complexity of their exposures and activities.

C. HIGHLIGHTS OF THE PROPOSED LEVERAGED FINANCE GUIDANCE

1. Defining "Leveraged Finance"

The proposed guidance reinforces the need for institutions to adopt a definition of "leveraged finance" in sufficient detail to ensure consistent application across all of their business lines. While noting the diversity of definitions used within the financial services industry, the proposed guidance notes that some combination of four factors—transactions where proceeds are used for buyouts, acquisitions, or capital distributions; transactions where a borrower's total debt to EBITDA or senior debt to EBITDA exceeds 4.0x or 3.0x, respectively; a borrower that is recognized in the debt markets as a highly leveraged firm; and transactions where a borrower's post-financing leverage exceeds industry norms—generally constitutes leveraged finance. The proposed guidance cautions that examiners will expect an institution's definition "to describe clearly the purposes and financial characteristics common to [leveraged finance] transactions," while taking into account the institution's "exposure to financial vehicles, whether or not leveraged, that engage in leveraged finance activities."

2. General Policy Expectations

According to the proposed guidance, institutions should adopt credit policies and procedures for leveraged finance that address, among other things: risk appetite (supported by analysis of potential effect on earnings, capital, liquidity, and other risks); a limit framework (including limits for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations); an appropriate reflection of risks of leveraged lending in allowance for loan and lease losses ("ALLL") and capital adequacy analyses; expected risk-adjusted returns for leveraged transactions; and minimum underwriting standards.

3. Underwriting Standards

In the proposed guidance, the Agencies remind institutions that they will need "clear, written [and] measurable" underwriting standards that accurately reflect their risk appetite for leveraged finance transactions, including size limits on an individual and aggregate basis. Unlike the 2001 guidance, the proposed guidance includes a warning regarding the "reputational risks" from "poorly underwritten transactions, which may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." While clarifying that the proposed guidance is not intended to discourage financing to borrowers engaged in workout negotiations or debtor-in-possession (DIP) financing packages, nor asset-based credit facilities that include strong lender monitoring and controls, the Agencies note that underwriting standards should at a minimum address such things as:

- Whether a transaction (including both underwritten deals and those intended for distribution) is based on a sound business premise and sustainable capital structure.
- Ability of the borrower to fully amortize senior secured debt, or repay at least 50% of total debt, over a 5-to-7 year period, based on projections that include realistic downside scenarios.
- The depth and breadth of due diligence undertaken, including with respect to collateral.
- Standards for evaluating expected risk-adjusted returns that account for funding and disposing of positions during market disruptions.
- Sponsor support of borrowers in light of sponsors' financial capacity, initial capital contribution and "other motivating factors" (as further described below).
- Whether the covenants require lender approval for material dilution, sale or exchange of collateral or cash flow-producing assets.
- Credit agreement covenant protections, including financial covenants such as debt to cash flow ratios and interest or fixed charge coverage ratios, as well as reporting requirements, distribution of ongoing financial and other credit information, and compliance monitoring. The Agencies caution that leverage in excess of 6x for total debt to EBITDA will raise supervisory concerns.
- Collateral valuation, controls and monitoring.

4. Valuation Standards

The proposed guidance recognizes that lenders often rely on enterprise value and other intangibles when (i) evaluating the feasibility of a loan request, (ii) determining the debt reduction potential of planned asset sales, (iii) assessing a borrower's ability to access the capital markets, and (iv) estimating the strength of a secondary source of repayment. In addition, lenders may view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. In light of the importance of enterprise valuation in the underwriting process, the proposed guidance notes that enterprise valuations should be performed or validated independently from the origination function. Valuations should be centered on sound methodologies, with enterprise values (including their underlying assumptions) subject to stress testing under a range of stress scenarios, both at origination and periodically thereafter. The proposed guidance notes that while all three commonly accepted approaches (asset, income, and market) should be used and reconciled, the income approach will be considered the most reliable by the Agencies.

5. *Pipeline Management*

Because market disruptions may impede the ability of an originating organization to consummate syndications or otherwise sell down exposures, institutions must have strong risk management and controls over transactions "in the pipeline." Institutions should be able to differentiate transactions according to tenor, investor class, structure, and key borrower characteristics. Importantly, strong pipeline management involves having policies and procedures that, among other things, provide for real-time information on pipeline exposures and limits on aggregate pipeline commitments, as well as exceptions to the timing of expected distributions and approved hold levels. Consistent with other parts of the proposed guidance, the Agencies will expect institutions to develop and maintain guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic or market conditions on asset quality, earnings, liquidity, and capital.

6. *Reporting and Analytics*

The proposed guidance emphasizes that institutions must have management information systems that accurately capture key obligor characteristics and aggregate exposures on a timely basis. Management should receive comprehensive reports about the characteristics and trends at least quarterly, with summaries provided to the board of directors.

Several analytical components of an institution's management information system are identified in the proposed guidance, including the following:

- Exposure and performance by deal sponsor.
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs.
- Amount of the ALLL attributable to leveraged lending.
- Exposure by collateral type, including unsecured transactions and those where enterprise value is a source for repayment for leveraged loans.
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for syndication delivery. In particular, the proposed guidance notes that pipeline definitions should identify the type of exposure (*e.g.*, committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed).

In addition, the proposed guidance notes that institutions should develop guidelines for conducting periodic portfolio stress tests (including pipeline exposures) or sensitivity analyses to quantify the potential impact of changing economic or market practices on asset quality, earnings, liquidity, and capital. The leveraged portfolio should also be included in any enterprise-wide stress tests.

7. Risk Rating Leveraged Loans

The proposed guidance describes the risk rating of leveraged loans as involving "the use of realistic repayment assumptions to determine the borrower's ability to de-lever to a sustainable level within a reasonable period of time." The proposed guidance specifically notes that if the borrower's projected capacity to pay down debt from cash flow is nominal, the credit will generally be criticized by examiners and if there are no reasonable prospects for the borrower to de-lever, a substandard classification is likely.

When assessing a borrower's capacity to service its debt, institutions should scrutinize extensions and restructurings "to ensure that they are not merely masking repayment capacity problems." The proposed guidance also warns institutions that if the capacity to pay down debt from cash flow is "nominal," with refinancing the only viable option, the credit will usually be criticized even if it has been recently underwritten. Also, if the primary source of repayment becomes inadequate it would generally be inappropriate to consider enterprise value as a secondary source of repayment, absent solid support regarding the value of the enterprise (such as a binding purchase and sale agreement with a qualified third party). For such borrowers, when a portion of the loan may not be protected by pledged assets or well-supported evidence of enterprise value, examiners will generally rate that portion "doubtful" or "loss" and place the loan on nonaccrual.

The proposed guidance does not revise separately issued guidance on the rating of credit exposures and the use of credit rating systems, which apply to all credit transactions, including leveraged lending transactions.[5]

8. Other Areas for Enhanced Risk Management

a. Evaluating the Support of Deal Sponsors

The proposed guidance states that financial institutions should formulate guidelines for evaluating the qualifications of financial sponsors and to implement a way of monitoring performance. The Agencies recognize that deal sponsors may provide valuable support to borrowers, including not only strategic planning, management and "other tangible and intangible benefits" but also financial support. Under the proposed guidance, and consistent with the 2001 guidance, such sponsor support may be considered by lending institutions as long as the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. Unlike the 2001 guidance, the proposed guidance details more specifically those items that should be considered in an evaluation of a sponsor's financial support, including:

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5 *See* Federal Reserve SR Letter 98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations"; OCC Handbooks "Rating Credit Risk" and "Leveraged Lending"; and the FDIC Risk Management Manual of Examination Policies, "Loan Appraisal and Classification."

- sponsor's historical performance in supporting its investments, financially and otherwise;
- sponsor's economic incentive to provide support, including the nature and amount of capital contributed at inception, as well as the degree of support (guarantee, comfort letter or verbal assurance);
- available financial information on the sponsor and analysis of its liquidity and ability to fund multiple deals;
- sponsor's overall portfolio (to determine likelihood of supporting the borrower as opposed to sponsor's other deals);
- sponsor's contractual investment limitations; and
- sponsor's dividend and capital contribution practices.

b. Credit Analysis

Central to effective underwriting and management of leveraged finance risk is the quality of credit analysis by an institution, both initially and on an ongoing basis. Institutions should have policies that address financial, business, industry, and management risks, including whether:

- Cash flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies.
- Liquidity analyses include performance metrics appropriate for the borrower's industry, predictability of the borrower's cash flow, measurement of the borrower's operating cash needs, and ability to meet debt maturities.
- Projections exhibit an adequate margin for unanticipated merger-related integration costs.
- Projections are stress-tested for several downside scenarios, including a covenant breach.
- Transactions are reviewed at least quarterly to determine variance from plan, the risk implications thereof, and the accuracy of risk ratings and accrual status. In addition, from inception, a borrower's credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance.
- Enterprise and collateral valuations are derived or validated independently of the origination function, are timely, 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 the issuance of new equity.
- The borrower is adequately protected from interest rate and foreign exchange rate risk.

c. Credit Reviews

Generally, financial institutions should review credit portfolios at least annually. However, in light of the "elevated risk inherent" in leveraged finance, the proposed guidance notes that an institution's credit review function may need to examine the leveraged loan portfolio more frequently, and in greater depth, than other segments. Institutions are also advised to be more selective in identifying staff to conduct such reviews. The proposed guidance does not specify any particular qualifications, but notes that institutions should staff their credit review function "appropriately" and with "sufficient resources to ensure timely, independent, and accurate assessments" of transactions.

d. Problem Credit Management

The Agencies warn that weak underwriting along with poor capital structure and limited covenants may make problem credit discussions and restructurings more difficult for lenders. Accordingly, the proposed guidance urges institutions to develop action plans and policies for working with borrowers experiencing diminished cash flows or other variances to plan, such as defining expectations for borrower's management and formulating workout plans that contain quantifiable objectives and measureable time frames.

e. Anti-Tying Regulations

The proposed guidance reminds institutions that leveraged finance transactions, which typically involve a number of types of debt and bank-offered products, will need to comply with anti-tying regulations. These regulations, subject to important exceptions and qualifications, generally prohibit a bank from conditioning the availability or price of one product (such as a loan) on the customer obtaining another non-bank product from the bank or an affiliate of the bank. The Agencies will expect institutions' policies to incorporate safeguards to prevent such coercive behavior.

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For more information about the proposed revisions to the interagency leveraged finance guidance and how comments may be submitted to the Agencies, please contact any of the members of our Financial Institutions or Banking and Credit groups.

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