Federal Banking Agencies Revamp Guidance on Leveraged Lending

Heightened Standards Set for Bank Underwriting Practices and Evaluating the Financial Support of Private Equity Sponsors

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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") have jointly issued guidance on leveraged lending activities by financial institutions.[1] The guidance, which is similar to the proposal released by the Agencies last year,[2] updates and replaces guidance that the Agencies issued in 2001.[3] According to an interagency press release, the revised guidance applies to transactions that are "characterized by a borrower with a degree of financial leverage that significantly exceeds industry norms," as measured by various leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors).

The guidance, which does not constitute a formal rulemaking, outlines "minimum expectations" for financial institutions with substantial exposures to leveraged lending 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, as well as underwriting and monitoring standards for purchased loan participations;
- 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 new guidance does not represent a fundamental change in the Agencies' view of leveraged lending (and much of the guidance generally describes management practices followed today by many large financial institutions), 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

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1 *See* 78 Fed. Reg. 17766 (Mar. 22, 2013).

2 *See* 77 Fed. Reg. 19417 (Mar. 30, 2012).

3 *See* Federal Reserve SR Letter 01-9 (SUP); OCC Bulletin 2001-18; and FDIC PR-28-2001.

provided in the 2001 guidance, the revised guidance contains some bright-line tests by which leverage lending activities will be measured.

The Agencies have set May 21, 2013 as the "compliance date" for the new guidance.

A. BACKGROUND

Since the issuance of interagency guidance in 2001 regarding sound practices for leveraged lending activities, the Agencies have observed periods of "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 unregulated investors. With burgeoning demand from institutional investors, the pipeline of aggressively priced and structured commitments grew rapidly, with some financial institutions lacking 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, which the Agencies recognize as having a place in the overall leveraged lending product set but also worthy of closer supervisory review.

In light of these concerns, the Agencies proposed last year 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[4] or acceptable underwriting standards.[5]

The new guidance also is consistent with 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 guidance represents an attempt by the Agencies to rein in practices perceived as aggressive by imposing heightened risk management expectations.

B. FINANCIAL INSTITUTIONS SUBJECT TO THE REVISED GUIDANCE

The guidance applies to any Agency-supervised financial institution that originates or participates in leveraged lending transactions. The term "financial institution" includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan 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. Subsidiaries

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4 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.

5 In assessing ability to repay, for example, the guidance provides that base case cash flow projections show the ability to fully amortize senior secured debt or repay a "significant portion" of total debt over the medium term. In addition, the guidance notes that a leveraged level after planned asset sales in excess of 6x total debt-to-EBITDA "raises concerns."

and affiliates of financial institutions involved in leveraged lending are also covered. In short, the Agencies will apply the guidance broadly to U.S. banking and nonbanking entities of domestic and foreign financial institutions that are subject to supervision by one or more of the Agencies.

Because leveraged loans tend to be held primarily by very large or global financial institutions, the Agencies believe the vast majority of smaller institutions, including community banks, should be unaffected by the guidance, and the smaller institutions that do originate a small number of less complex leveraged loans would not be expected to have policies and procedures commensurate with those of a larger financial institution with a more complex leveraged loan origination business. Apart from origination, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance regarding purchased participations,[6] and the new guidance also addresses such transactions.

C. HIGHLIGHTS OF THE REVISED LEVERAGED LENDING GUIDANCE

1. Defining "Leveraged Lending"

The guidance reinforces the need for financial institutions to adopt a definition of "leveraged lending" 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 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 recognized in the debt markets as a highly leveraged firm; and transactions when a borrower's post-financing leverage exceeds industry norms—generally constitutes leveraged lending. A financial institution's definition "should describe clearly the purposes and financial characteristics common to [leveraged lending] transactions," while taking into account the institution's direct and indirect exposure from limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans."

Importantly, the Agencies have confirmed in the new guidance that a loan should be designated as leveraged only at the time of origination, modification, extension, or refinancing. Accordingly, loans to so-called "fallen angels" are not subject to the guidance. These are loans to borrowers that did not meet the definition of a leveraged loan at origination but that later migrated into the definition due to deterioration in the borrower's financial condition.

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6 *See, e.g.*, OCC Loan Portfolio Management Handbook, *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf; Federal Reserve Commercial Bank Examination Manual, Section 2045.1 (Loan Participations, the Agreements and Participants), *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf; and FDIC Risk Management Manual of Examination Policies, Section 3.2 (Loans), *available at* http://www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit, Loan Participations (last updated Feb. 2, 2005).

2. *General Policy Expectations*

According to the guidance, institutions should adopt credit policies and procedures for leveraged lending that address, among other things: risk appetite (supported by an 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. *Participations Purchased*

Consistent with the guidance from 2001, the revised guidance reminds financial institutions to make a "thorough, independent evaluation" of the risks involved when purchasing participations and assignments in leveraged lending transactions. They should generally apply the same standards that would be employed as if they were originating the loan, and policies should be in place that, at a minimum, include requirements for:

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter.
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title policies, Uniform Commercial Code (UCC) searches, and other relevant documents.
- Carefully monitoring the borrower's performance throughout the life of the loan.
- Establishing appropriate risk management guidelines.

4. *Underwriting Standards*

Financial institutions need "clear, written and measurable" underwriting standards that accurately reflect their risk appetite for leveraged lending transactions, including size limits on an individual and aggregate basis. Unlike the 2001 guidance, the new guidance includes a warning regarding the "reputational risks" from "poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." While clarifying that the 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 a "significant portion" of total debt over the medium term, 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). Financial institutions seeking to rely on sponsor support as a secondary source of repayment for a loan (for example, where a sponsor provides a financial guaranty) should be able to provide documentation, including financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit.
- 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.

5. *Valuation Standards*

The 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, financial institutions 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 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 guidance notes that while all three commonly accepted valuation methods (asset, income, and market) should be used and reconciled, the income method is generally considered the most reliable.

6. *Pipeline Management*

Because market disruptions may impede the ability of an originating organization to consummate syndications or otherwise sell down exposures, financial institutions must have strong risk management and controls over transactions "in the pipeline." They 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 revised guidance, the Agencies expect financial 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 their asset quality, earnings, liquidity, and capital.

7. *Reporting and Analytics*

The guidance emphasizes that financial 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 a financial institution's management information system are identified in the guidance, including the following:

- Exposure and performance by deal sponsor. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. A financial institution should identify, aggregate, and monitor potential related exposures.
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, nonperforming amounts, and charge-offs.
- Amount of the ALLL attributable to leveraged lending.
- Exposure by collateral type, including unsecured transactions and those where enterprise value will be the 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 the syndication delivery. In particular, the 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).

8. *Risk Rating Leveraged Loans*

The guidance describes the risk rating of leveraged loans as involving "the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time." As an example, the guidance notes that banking supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50% of total debt over a five-to-seven year period provides evidence of adequate repayment capacity.

When assessing a borrower's capacity to service its debt, a financial institution should scrutinize extensions and restructurings "to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan." The 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 adversely rated, even if it has been recently underwritten, and if there are no reasonable prospects for the borrower to de-lever, a substandard rating is likely. 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 credits, 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 status.

The 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.[7]

9. *Other Areas for Enhanced Risk Management*

a. *Evaluating the Support of Deal Sponsors*

The new guidance states that financial institutions that rely on sponsor support as a *secondary source* of repayment should formulate guidelines for evaluating the qualifications of financial sponsors and 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 for borrowers that fail to achieve projections. Under the new guidance, and consistent with the 2001 guidance, such sponsor support may be considered by financial 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, however, the new guidance details more specifically those items that should be considered in evaluating a sponsor's financial support, including the:

- 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;

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

- 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 lending risk is the quality of credit analysis by an institution, both initially and on an ongoing basis. Financial 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 one or more downside scenarios, including a covenant breach.
- Transactions are reviewed at least quarterly to determine variance from plan, the related 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 independently derived or validated outside of the origination function, are timely, and consider potential value erosion.
- Collateral liquidation and asset sale estimates are based on current market conditions and trends.
- 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 risks inherent in leveraged lending," the guidance notes that an institution's credit review function should assess the performance of the leveraged loan portfolio more frequently, and in greater depth, than other segments. Financial institutions are also advised that portfolio assessments should be performed by individuals with the expertise and experience for these types of loans and the particular borrower's industry. The 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. Stress Testing

Financial institutions should develop guidelines for conducting periodic portfolio stress tests on loans originated to hold, as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic or market practices on asset quality, earnings, liquidity, and capital. The sophistication of stress testing practices will vary according to the size, complexity, and risk characteristics of a financial institution's leveraged loan portfolio. The leveraged portfolio should also be included in any enterprise-wide stress tests that a financial institution is required to conduct.

e. Problem Credit Management

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

f. Compliance with Anti-Tying Regulations

The guidance reminds financial institutions that leveraged lending 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 nonbank product from the bank or an affiliate of the bank. The Agencies expect policies to incorporate safeguards to prevent such coercive behavior.

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For more information about the new interagency guidance on leveraged lending, please contact any of the members of our Financial Institutions or Banking and Credit groups, including those listed below.

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