Bank Regulators Issue Guidance on Leveraged Lending

On March 26, 2012, the Office of the Comptroller of the Currency of the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (collectively, the "Agencies") issued new proposed guidance on leveraged lending (the "Proposed Guidance").[1] The Proposed Guidance updates and replaces guidance issued in 2001, generally with a greater degree of specificity than in 2001. The Proposed Guidance would apply to all financial institutions supervised by the Agencies that are substantively engaged in leveraged lending activities. Comments on the Proposed Guidance are due by June 8, 2012.

I. Background

In April 2001, the Agencies and the Office of Thrift Supervision issued guidance regarding sound practices for financial institutions engaged in leveraged lending activities (the "2001 Guidance").[2] The 2001 Guidance addressed credit policy content, the need for well-defined underwriting standards and the importance of stress testing and defining risk appetite for leveraged transactions. Since the issuance of the 2001 Guidance, the volume of leveraged credit transactions and increased participation of non-regulated investors in such transactions has grown tremendously. The Agencies note that the burgeoning demand for leveraged credit has resulted in transactions that are "aggressively priced and structured," with "relatively limited lender protection."[3] The Proposed Guidance specifically highlights credit agreements with no "meaningful maintenance covenants" (often called "covenant-lite" deals) and PIK-toggle instruments (those where the issuer has the option to pay interest in cash or in-kind) as features that the Agencies view as reducing lender recourse. In light of these observations, the Agencies are seeking to articulate clearer guidelines and expectations for regulated institutions.

The Proposed Guidance outlines high level principles to assist institutions in establishing safe and sound leveraged finance activities. Unlike the 2001 Guidance, it uses quantitative metrics to illustrate its points in various areas. The Proposed Guidance is also intended to build on recently proposed guidance on stress testing issued in January 2012.[4] Once adopted, the new leveraged finance guidance will replace the 2001 Guidance.

II. Proposed Guidance

Definition of Leveraged Finance

The Proposed Guidance states that an institution should adopt a definition of leveraged finance within its policies. Unlike the 2011 Guidance that simply required a definition, however, the Proposed Guidance provides that specific criteria should be included in an institution's policies. It further identifies several characteristics common to leveraged finance transactions, including:

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[1] *See* Department of the Treasury Office of the Comptroller of the Currency Docket ID OCC-2011-0028, Federal Reserve System Docket No. OP – 1439, Federal Deposit Insurance Corporation, "Proposed Guidance on Leveraged Lending," (March 26, 2012), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120326a1.pdf.

[2] *See* Joint Release and Attachment, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, "Agencies Issue Risk Management Practices for Leveraged Financing," (April 9, 2001), FDIC Press Release PR-28-2001, *available at* http://web.archive.org/web/20010913060930/http://www.fdic.gov/news/news/press/2001/pr2801.html.

[3] Proposed Guidance at 9.

[4] *See* "Annual Stress Test," Notice of Proposed Rulemaking, 77 FR 3408 (January 24, 2012).

- the proceeds are used for buyouts, acquisitions or capital distributions;
- the borrower's ratio of total debt/EBITDA or senior debt/EBITDA (in each case, without netting cash against debt) is in excess of 4:1 or 3:1; or
- transactions where the borrower's post-financing leverage (as measured by leverage ratios, debt-to assets, debt-to-net worth, debt-to-cash flow or similar metrics) significantly exceeds industry norms or historical levels.

The goal of establishing a sufficiently detailed definition is to ensure consistent application across all business lines. Examiners will also expect the definition to clearly describe the bank's exposure to financial vehicles that engage in leveraged finance, even if the vehicle is not itself leveraged.

Credit Policies and Underwriting Standards

The Proposed Guidance specifies that an institution's credit policies should address, among other things:

- risk appetite (which should include clearly defined amounts of leveraged finance that the institution is willing to underwrite);
- exposure limitations (by obligor, industry and geographic limitations as well as aggregate pipeline limits);
- credit and underwriting approval processes;
- expected risk-adjusted returns;
- a method of ensuring that the risks of leveraged lending activities are appropriately reflected in the institution's allowance for loan and lease losses and capital adequacy analyses; and
- minimum underwriting standards (as discussed further below).

Additionally, appropriate oversight by senior management should be addressed, including adequate and timely reporting to the institution's board of directors.

The Agencies caution institutions to be mindful of "reputational risks associated with poorly underwritten transactions, which may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." The Proposed Guidance provides in detail what, at a minimum, underwriting standards should consider, including, among other items:

- A borrower's capacity to repay and its ability to de-lever to a sustainable level over a reasonable period. The Proposed Guidance notes that as a general guide, base case cash-flow projections should fully amortize senior secured debt or repay at least 50 percent of total debt over a five- to seven-year period and that projections should include one or more realistic downside scenarios that reflect the key risks identified in the transaction. The 2001 Guidance simply said that underwriting standards should require "reasonable" amortization of term loans.
- Degree of support expected from the sponsor, taking into consideration the sponsor's financial capacity, equity contribution and other motivating factors. Although the 2001 Guidance references the role of sponsors, the Proposed Guidance acknowledges the important role of sponsors in the current market by proposing that institutions develop extensive and specific guidance for monitoring sponsored transactions (as discussed further below).
- Credit agreement covenant protections, including financial performance (such as debt to cash flow, interest coverage or fixed charge coverage), reporting requirements and compliance monitoring. The Proposed Guidance notes that "[g]enerally, a leverage level after planned asset sales (i.e., debt that

must be serviced from operating cash flow) in excess of 6x for Total Debt/EBITDA raises concerns for most industries." The 2001 Guidance provided only that the underwriting standards should establish "minimum covenant requirements, particularly minimum interest and fixed charge coverage and maximum leverage ratios."

The Agencies do note that "[n]othing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which banks should consider separate underwriting and risk rating guidance."

Enterprise Valuation Standards

The 2001 Guidance cautioned lenders that reliance upon enterprise value "as a secondary source of repayment can be problematic." The Proposed Guidance does not contain such caution, but rather recognizes that lenders "may view enterprise value as a useful benchmark for assessing a sponsor's incentive to provide financial support." The Proposed Guidance provides that enterprise valuation should be performed or validated by qualified persons independent of the origination function and recommends the income valuation approach (which considers an enterprise's ongoing cash flows or earnings and applies capitalization or discounting techniques) as "the most common and reliable method" (compared to an asset valuation approach or comparable sales market valuation approach).

Pipeline Management

The 2001 Guidance noted that the degree of oversight for leveraged credit should be more intensive given the potential higher risk. The Proposed Guidance establishes a much more detailed framework for establishing strong risk management and other controls over pipeline transactions (whether originated to hold or distribute). The Agencies emphasize that institutions must be able to accurately measure exposure on a timely basis and establish policies and procedures that address market disruptions and pipeline transactions that have not performed according to their original expectations.

Written procedures for defining and managing distribution fails and "hung" deals should be developed and maintained and approved by an institution's board of directors for disposition of pipeline transactions that have not been sold according to the original distribution plan. The Proposed Guidance defines "hung" deals as those where the exposure could not be sold down within a reasonable period and cites 90 days from closing as the period that would generally be deemed reasonable. Any transactions that are subsequently reclassified as hold-to-maturity should also be included in reports to management and the board of directors. Guidelines for conducting periodic stress tests to quantify the potential impact of changing market conditions should also be established.

Reporting and Analytics

One of the overarching themes of both the 2001 Guidance and Proposed Guidance is the Agencies' expectation of diligent monitoring of high risk credits. The Proposed Guidance expands on 2001 Guidance on portfolio analysis and sets forth more detailed descriptions of the level and frequency of monitoring, reporting and analysis that should be adopted. Policies should notably identify and report on, among other items:

- individual and portfolio exposures including pipeline;
- secondary market pricing data and trading volume;
- deal sponsor exposure and performance;

- gross and net exposures, hedge counterparty concentrations and policy exceptions;
- actual versus projected distribution of the syndicated pipeline; and
- exposures to a borrower/counterparty booked in other business units throughout the institution.

As in 2001 Guidance, the Agencies state that reporting should be at least quarterly. Under the Proposed Guidance, management must receive comprehensive reports, while the board of directors may receive summaries.

Risk Rating Leveraged Loans

The Proposed Guidance notes that previously issued extensive guidance on rating credit exposures continue to apply to leveraged lending transactions as they would to all credit transactions.[5] Otherwise, the guidelines remain substantively similar to the 2001 Guidance. When a portion of a loan may not be protected by pledged assets or a well-support enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual.

Other Key Risk Management Components

The Proposed Guidance also identifies several other key risk management components. Many of the policy considerations are the same as those addressed in 2001 including those relating to: comprehensive credit analyses, problem credit management, independent credit review functions and managing conflicts of interest.

Of note, the Proposed Guidance introduces new guidelines to evaluate the qualifications of financial deal sponsors and regularly monitor their performance. Evaluations should include the sponsor's historical performance in supporting its investments, economic incentive to support, documentation of degree of support, contractual investment limitations, dividend and capital contribution practices, likelihood of supporting the borrower (compared to other deals in the sponsor's portfolio) and, to the extent feasible, the sponsor's financial condition. The Agencies do caution, however, that absent a documented commitment of continued support, a sponsor's potential contributions may not mitigate examiner criticism.

The Proposed Guidance reminds institutions that the following are also important aspects of an institution's risk management:

- ensuring that an institution's policies safeguard against violations of anti-tying regulations under the Bank Holding Company Act;
- sensitivity to reputational risk that may arise from distributing transactions that fail to meet legal or fiduciary responsibilities;
- development of policies to ensure adherence to the securities laws when those laws apply (the Proposed Guidance notes that "certain debt instruments used in leveraged finance transactions may constitute 'securities' for the purposes of federal securities laws"); and
- periodic compliance reviews of an institution's leveraged finance activity by the institution's independent compliance function to assure that the institution is avoiding conflicts of interest and is complying with applicable laws and regulations.

[5] *See*, *e.g.*, FRB SR 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," FDIC Risk Management Manual of Examination Policies on "Loan Appraisal and Classifications."

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; Susanna M. Suh at 212.702.3686 or ssuh@cahill.com; or Boji Wong at 212.701.3011 or bwong@cahill.com.

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