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Updated Multi-Agency Guidance on Leveraged Lending Practices

On March 26, 2012, the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Fed") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") proposed joint guidance on leveraged lending.[1] If adopted, the proposed guidance would replace guidance that was previously issued by the Agencies in 2001 on sound practices for leveraged finance activities (the "2001 Guidance").[2] The proposed guidance is broadly consistent with the 2001 Guidance, but contains more specific examination standards that will be used by regulators of financial institutions, and it emphasizes that failure to adhere to such standards could result in a finding that an institution is conducting lending activities in an unsafe and unsound manner.

The proposed guidance would require financial institutions to be able to demonstrate their ability to evaluate and monitor underwritten credits, including unfunded commitments, and understand risks that could result from a variety of external factors, including deterioration in a particular borrower's credit, illiquidity in the loan syndication market, and stresses to a given industrial sector or geographical region. Each institution subject to the proposed guidance would be required to maintain robust risk management processes and controls for its leveraged finance business, and documented policies and procedures on several topics, including:

- a definition of leveraged finance,
- documentation of the institution's risk appetite, including pipeline limits and aggregate hold levels,
- clear and measurable underwriting and valuation standards,
- reporting and analytics guidelines in respect of borrower performance and pipeline exposures, including periodic and real-time reporting to an institution's management and board of directors, and
- rating leveraged loan risk, credit analysis, problem credits, sponsor support, credit review, conflicts of interest, anti-tying, reputation risk, securities laws and compliance.

While the institutions most impacted by the proposed guidance already maintain policies covering many of the topics included in the guidance, they should be aware that the guidance goes farther than any previous regulatory pronouncement on the subject, and would potentially set a range of specific requirements for safe and sound practices for regulatory examinations.

The deadline for commenting on the proposed guidance is Friday, June 8, 2012.

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[1] *See* "Proposed Guidance on Leveraged Lending," 77 Fed. Reg. 19417 (Mar. 30, 2012), *available at* http://www.occ.treas.gov/news-issuances/news-releases/2012/nr-ia-2012-54a.pdf.

[2] *See* Federal Reserve SR 01-09 (SUP), "Interagency Guidance on Leveraged Financing" (Apr. 17, 2001); FDIC-PR-28-2001, "Agencies Issue Risk Management Practices for Leveraged Financing" (Apr. 9, 2001); Office of the Comptroller of the Currency Bulletin 2001-18, "Leveraged Finance: Sound Risk Management Practices" (Apr. 9, 2001).

Background

Since issuance of the 2001 Guidance, the Agencies have witnessed "tremendous growth" in the volume of leveraged finance, as well as the increasing participation of unregulated investors including funds and CLOs whose appetite for "aggressively priced and structured commitments" is not subjected to meaningful prudential limits. Financing innovations have also emerged and become increasingly common, including "covenant-lite" terms and payment-in-kind (PIK)-toggle features. The frequency of these trends crested just prior to the financial crisis of 2007-2008, and as the loan market recovers and lending volumes rise they are becoming more common again. Of significant concern to regulators is that, during the financial crisis, banks and other non-bank financial institutions took significant losses and writedowns, many related in substantial part to the poor performance of loans in their leveraged lending portfolios.[3] The new guidance aims to "clarify regulatory expectations given lessons learned from the recent financial crisis"[4] and to reform those practices not sufficiently conducive to safe and sound leveraged lending. The Agencies refer specifically to the developments mentioned above, along with aggressive capital structures, increased pipeline risk and shortcomings in management information systems as the basis for announcing the proposed guidance.

The standards included in the proposed guidance are not new. The Agencies have been monitoring and addressing risks associated with unsafe and unsound leveraged lending practices since the 1980s,[5] but the pre-2001 guidance was perceived as too vague and only sporadically enforced by prudential regulators. The 2001 Guidance was issued as a result, citing deterioration in leveraged finance portfolios of many banking organizations, "driven in part by the relaxation of sound lending standard in the past years." After the subsequent cycle of further loosening credit standards and agency oversight during the mid-2000s, followed by the severe market correction during the financial crisis, financial institutions are now facing a reinvigorated oversight regime requiring more scrupulous adherence to more specific standards.

Applicability

The proposed guidance would apply to all Fed-supervised, FDIC-supervised and OCC-supervised financial institutions,[6] including insured depository institutions, financial holding companies and bank holding companies and their non-bank subsidiaries, and the US branches and agencies of foreign banks, that are "substantially engaged in leveraged lending activities." Implementation of the proposed guidance at any given financial institution should be "consistent with the size and risk profile of an institution's leveraged portfolio," taking into consideration assets, earnings, liquidity and capital of the supervised institution. Given the dominance in the leveraged finance market by a small group of the largest and most sophisticated banks, the Agencies expect that the proposed guidance will have a minimal impact on regional and community banks and other small financial institutions.

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[3] *See* "U.S., European bank writedowns, credit losses (Factbox)," REUTERS, Nov. 5, 2009, http://www.reuters.com/article/2009/11/05/banks-writedowns-losses-idCNL554155620091105?rpc=44; Senior Supervisors Group: Observations on Risk Management Practices during the Recent Market Turbulence, at pp. 4, 5, 17, *available at* http://www.newyorkfed.org /newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

[4] *See* Craig Torres, Cheyenne Hopkins & Richard Bravo, "Leveraged-Loan Risk Guidance From 2001 May Be Updated by U.S. Regulators," Bloomberg.com, Feb. 28, 2012, http://www.bloomberg.com/news/2012-02-28/leveraged-loan-risk-guidance-from-2001-may-be-updated-by-u-s-regulators.html (quoting Andrew Gray, FDIC Spokesman).

[5] *See* OCC, EC-245, "Highly Leveraged Transactions" (Dec. 14, 1988), *available at* http://www.occ.gov/static/news-issuances/bulletins/pre-1994/examining-circulars/ec-1988-245.pdf); Federal Reserve, SR 98-18 (SUP), "Lending Standards for Commercial Loans" (June 23, 1998).

[6] "Financial institutions" means national banks, federal savings associations, and Federal branches and agencies supervised by the OCC; state member banks, bank holding companies, and all other institutions for which the Fed is the primary federal supervisor; and state nonmember insured banks and other institutions supervised by the FDIC.

The proposed guidance does not apply to unregulated entities like hedge funds, private equity sponsors and their affiliates, mezzanine funds and certain commercial lenders.[7]

Definition of Leveraged Finance

As part of the sound risk management of leveraged finance activities the Agencies expect financial institutions to maintain a definition of leveraged finance that "facilitates consistent application across all business lines." The Agencies include specific criteria for such a definition in the proposed guidance, while acknowledging that numerous definitions exist industry-wide. Significantly, the factors included in the proposed guidance are nearly identical to a prior definition of leveraged finance published by the OCC at the beginning of the financial crisis,[8] including the following.

- The proceeds are often used for buyouts, acquisitions or capital distributions.
- A typical transaction may involve the borrower's Total Debt-to-EBITDA ratio or Senior Debt-to-EBITDA Ratio exceeding 4.0x or 3.0x, respectively, or other defined levels as appropriate to the industry or sector.[9]
- The borrower is recognized in the market as a highly leveraged firm, characterized by its debt-to-net-worth ratio.
- The borrower's post-financing leverage exceeds industry norms or historical levels based on debt ratios or industry standards.

The proposed guidance cautions that an institution's definition of leveraged finance should be sufficiently detailed to ensure consistent application across all of its business lines, including with respect to an institution's credit exposure to financial vehicles, whether or not leveraged, which themselves engage in leveraged finance activities.

General Policy Expectations

In crafting credit policies and procedures responsive to the proposed guidelines, the Agencies expect financial institutions to address (i) the institution's designated risk appetite, with clearly defined pipeline limits and transaction and aggregate hold levels as may be approved by the institution's board of directors, (ii) a framework that includes the institution's limits for single transactions and obligors as well as aggregate portfolio and pipeline exposure limits and geographic and industry concentrations, and which framework assesses the impact of stress losses, flex terms, capital usage and earnings at risk, (iii) how risks of leveraged lending activities are adequately reflected in the institution's Allowance for Loan and Lease Losses and capital adequacy analyses, (iv) credit and underwriting approval authorities, and procedures for approving and documenting changes to approved transaction terms, (v) appropriate oversight by senior management, including adequate and timely reporting to the institution's board of directors, (vi) the expected risk-adjusted return for leveraged transactions, (vii) minimum underwriting standards, and (viii) the degree to which underwriting practices may differ between primary loan origination and secondary loan acquisition.

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[7] However, regulators are beginning to focus on the role of unregulated institutions engaged in lending and other maturity transformation. *See* Paul Tucker, "Shadow banking: thoughts for a possible policy agenda," Remarks at European High Level Conference, Brussels (Apr. 27, 2012) available at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech566.pdf.

[8] *See* OCC, "Leveraged Lending: Comptroller's Handbook" (Feb. 2008), available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/leveragedlending.pdf.

[9] Notably, the proposed guidance does not use or refer to a net debt concept, i.e., netting the borrower's unencumbered cash against indebtedness for purposes of calculating leverage, which is a common feature in many leveraged loan transactions.

Underwriting Standards

The centerpiece of the proposed guidance is that institution's underwriting standards should be "clear, written, measurable, and accurately reflect the institution's risk appetite". The Agencies also stress that financial institutions should have clear limits on the size of transactions they will arrange for distribution, both individually and in the aggregate.

In the proposed guidance, the Agencies emphasize that poor underwriting may be unsafe and unsound regardless whether a loan is fully distributed or held on the books of the originating institution. In prior guidance from the Agencies, the hallmark of unsafe lending practices was the "pipeline risk" of a large unsyndicated commitment. Here, the Agencies caution institutions to be aware of the reputational risk of poorly underwritten transactions "which may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy." Institutions should have underwriting standards that consider the business case of a given financing "regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute."

The Agencies note that the underwriting standards should, at a minimum, consider the following factors:

- The borrower's ability to repay the debt, with cash flow projections showing the ability to fully amortize the senior secured debt or repay at least 50% of the total debt over a five-to-seven year period,[10]
- Due diligence expectations, with collateral evaluation standards and clearly defined credit risk management roles in the diligence process,[11]
- Standards for evaluating risk-adjusted returns including potential losses, taking into consideration normal distribution strategies as well as alternative strategies during market disruptions,
- Reliance on enterprise value and other intangible factors as a predicate for repayment assumptions,
- Expected sponsor support, based on financial capacity, capital contribution, and other motives,
- Whether lender approval is required for material dilution or disposition of collateral or other cash-flow producing assets,
- Financial covenants and ongoing monitoring requirements, including debt-to-cash flow ratios, interest or fixed charge coverage ratios, reporting requirements and compliance monitoring – the Agencies note that a Total Debt-to-EBITDA ratio in excess of 6x "raises concerns for most industries,"
- Whether collateral requirements in credit agreements specify acceptable collateral types, loan-to-value guidelines, valuation methodologies and monitoring functions, and
- Ongoing financial reporting requirements of the borrower.

If adopted as a final rule, the proposed guidance could materially affect underwriting standards at financial institutions, impacting certain market sectors and deal strategies that involve higher proportions of debt or which anticipate refinancing as a means of exiting the credit. The Agencies note, however, that the proposed guidelines are not intended to discourage workouts, DIP and exit financing under the Bankruptcy Code, or "well-structured" standalone asset-based credit facilities.

[10] The guidance does not expressly exclude loans underwritten in anticipation of a refinancing towards the end of the initial term (e.g., bridge loans), or state whether the amortization or repayment expectations would be different for such loans.
[11] Financial institutions should consider how such roles and responsibilities can be best addressed in the diligence process.

Valuation Standards

The proposed guidance observes that financial institutions rely on a borrower's enterprise value when evaluating a loan request, determining a borrower's ability to repay debt through asset sales, assessing a borrower's ability to access capital markets, and estimating a borrower's enterprise value as a "secondary source of repayment". Because enterprise value is important to risk assessment in numerous situations, and because a valuation requires specialized knowledge to prepare, the guidance provides that valuations should be performed or validated by "qualified persons independent of the origination function."

Of the three main approaches to valuing a private company, the guidance emphasizes the reliability of income-driven 'capitalized cash flow' and 'discounted cash flow' methods over asset and market based valuation methods, while noting that "value estimates should reconcile results from the use of all three approaches."[12] Regardless of the methodology, if the guidance is adopted as proposed, examining regulators can be expected to test whether assumptions used in valuations are clearly documented, well supported and understood by decision-makers and risk oversight functions at the institution being examined.

Pipeline Management

The topic of pipeline management receives significant attention in the proposed guidance. The Agencies expect institutions to develop and maintain a clearly documented appetite for risk (taking into account the institutional effects of such risk), procedures for defining and managing "hung" deals and other distribution failures, and ongoing monitoring and periodic stress-testing and reporting of commitments in the pipeline. The guidance cautions that the board of directors is ultimately responsible both for reviewing reports on transactions reclassified as hold-to-maturity and establishing "clear expectations for the disposition of pipeline transactions that have not been sold according to their original distribution plan."

The guidance also provides that institutions should develop controls designed to measure actual pipeline distribution against original expectations, as well as policies and procedures on acceptable hedging practices to reduce pipeline exposure.

Reporting and Analytics

The Agencies expect stronger management information systems ("MIS") at financial institutions engaged in leveraged finance. They caution that a lack of "robust risk management processes and controls" could contribute to a finding of unsafe and unsound banking practices, and call for stronger and more comprehensive monitoring practices, including regular reports to the board of directors. In particular, the Agencies expect institutions to have access to risk management systems that look across business lines and provide periodic and real-time reporting, including migration analysis, deviation from pipeline projections, and aggregate counterparty exposures (including indirect exposures).

The guidance details fifteen categories of information for data capture and reporting to management and the board. They are:

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[12] The guidelines further state that changes in the value of a firm's assets should be tested "under a range of stress scenarios, including business conditions more adverse than the base case scenario." The base case scenario and more adverse conditions appear to be a reference to "baseline" and "adverse" scenarios required under the proposed OCC rules implementing Dodd-Frank stress-testing. *See* "Annual Stress Test," 77 Fed. Reg. 3408 (Jan. 24, 2012). The stress test rules provide for annual testing to assess the potential impacts on capital of an institution under (at a minimum) "baseline," "adverse," and "severely adverse" scenarios as provided by the OCC.

- Individual and portfolio exposures within and across all businesses and entities, including pipeline exposures;
- Risk rating and distribution analysis, including tracking of borrowers removed from the portfolio;
- Industry mix and maturities;
- Default and loss probability metrics;
- Portfolio performance measures (covenant breaches, restructurings, delinquencies charge-offs, etc.);
- Amount and nature of asset impairments, and Allowance for Loan and Lease Losses owing to leveraged lending;
- Policy exceptions and aggregate performance data;
- Exposure by collateral type, including unsecured;
- Sponsor exposure and performance;
- Gross and net exposures, hedge counterparty concentrations and policy exceptions;
- Deviations from syndicated pipeline projections with regular updates;
- Periodic portfolio stress test guidelines, consistent with the size, complexity and risk of the leveraged loan portfolio;
- Total and segment leveraged finance exposures, whether direct or indirect, with detailed global reporting; and
- Exposures booked through other business units including default swaps, total return swaps and repo.

Risk Rating Leveraged Loans

For the purposes of rating credit exposures in a leveraged lending transaction, the Agencies refer to previously issued guidance for rating credit transactions.[13] They note, however, that such analysis should rely on "realistic repayment assumptions to determine the borrower's ability to de-lever" to a sustainable level in a reasonable timeframe and that even recently underwritten credits will be criticized or reclassified as substandard if refinancing is the only viable option.[14] Loan extensions and restructurings would also be subject to greater scrutiny to ensure they are not masking a borrower's incapacity to service debt. In terms of making assessments as to a borrower's repayment ability, the Agencies consider enterprise valuations as generally "inappropriate […] as a secondary source unless that value is well supported" by evidence such as a binding purchase and sale agreement with third parties, or valuations which take into account distressed circumstances. In the absence of collateral support or well-evidenced enterprise value, examiners will rate as "doubtful" or "loss" the unsupported value of such loans, and potentially place the loan on non-accrual. For lenders not accustomed to these tightened standards, significant changes may be required in risk rating and underwriting practices in order to stay compliant with new guidance.

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[13] *See, e.g.*, Federal Reserve, SR 98-25 "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations" (Sept. 21, 1998), *available at*: http://www.federalreserve.gov/boarddocs/srletters/1998/sr9825.htm; OCC, "Leveraged Lending: Comptroller's Handbook," *supra* Note 8; OCC, "Rating Credit Risk: Comptroller's Handbook" (Apr. 2001), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/rcr.pdf. *See also* FDIC, "Risk Management Manual of Examination Policies, Loan Appraisal and Classification" (Feb. 2, 2005), available at http://www.fdic.gov/regulations/safety/manual/section3-2.html#loanAppraisal.

[14] Institutions should consider bridge financing in acquisitions in light of this proposed standard.

Other Key Risk Management Components

The guidance also addresses other components of the underwriting and management of leveraged finance risk. Key insights are described below.

Deal Sponsors

In assessing a borrower's risk rating, lenders may be inclined to assume some level of sponsor support. The Agencies expect institutions to develop guidelines for evaluating the qualifications of financial sponsors to provide such support where relied on, and note that "even with a documented capacity and a history of support, a sponsor's potential contributions may not mitigate examiner criticism absent a documented commitment of continued support." Such documentation should include an analysis of the sponsor's past practices and contractual obligations, history of borrower support, incentives to provide financial support and, most meaningfully, documentation of the degree of support promised (whether by guarantee, comfort letter, verbal assurance or other). Based on these factors, lenders should not rely on a sponsor's history of support or verbal assurance alone, but would be expected to substantiate such reliance where relevant to a particular borrower.

Credit Review

Institutional credit review functions should be strong and independent from oversight or influence which could impair the integrity of credit determination. There should be adequate staffing and resource allocation "to ensure timely, independent, and accurate assessments of leveraged finance transactions" and periodic portfolio reviews.

Conflicts of Interest

The Agencies expect institutions to develop policies to address and prevent potential conflicts of interest, specifically where an institution acts as sell-side advisor and also provides staple financing to potential buyers. In light of litigation involving certain recent financings, which received media attention and critical judicial commentary, financial institutions should be particularly sensitive when crafting conflicts policies, as they could be sought in discovery in the event a leveraged finance deal goes bad.

Implications for Financial Institutions

In the adopting release the Agencies estimate that it would require an incremental several thousand hours per year for an institution to comply with the proposed guidance. The Agencies expect policies and procedures under the proposed guidelines to be strengthened, periodically tested and substantially adhered to by the institutions required to maintain them. In determining whether to comment on the proposed guidance, institutions may wish consider the following issues.

Bridge Financing in M&A Transactions

The guidance takes a skeptical view of the use of enterprise valuation in transaction analysis, particularly where the indicated value is not supported by other (preferably cash-flow based) measures, and also where such valuations are used to assess the strength of a secondary repayment source. To the extent the market for bridge lending relies on enterprise value, the importance of refinancing and limited security, the proposed guidance should be carefully considered.

Increased Board Responsibility

While much of the guidance is directed at implementation and oversight of various practices at the level of management, the guidance provides a number of areas specifically requiring an institution's board of directors to make determinations, set standards and review and presumably act on various risk reports. To the extent that the guidance disturbs the delineation of board and managerial functions or would impede certain operations of financial institutions, it may be advisable to comment.

Highly Prescriptive Risk Management, Stress-Testing and MIS

In general, the guidance takes a detailed and one-size-fits-all approach in describing policies and MIS necessary to maintain safe and sound lending practices. Regulated institutions may find certain guidelines to be unnecessarily brittle, particularly the reporting and analytics requirements. Modifying an institution's MIS is a substantial, expensive and laborious undertaking, and institutions may wish to consider whether a more flexible and tailored process developed in consultation with an institution's principal regulator may be more appropriate than the approach taken by the Agencies in the proposed guidance.

Shadow Banking

To the extent the guidance results in tightened lending policies at financial institutions, unregulated lenders may step into the gap. For instance, hedge funds not subject to the guidance may be incentivized to extend bridge loans requiring refinancing for repayment and loans at higher leverage multiples. This could result in the most sensitive financing being conducted in unregulated or less regulated regions of the market.

Comments on these guidelines by financial institutions or industry groups should be submitted by Friday, June 8, 2012.

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The contents of this publication are for informational purposes only and should not be regarded as legal advice.

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