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Bank Regulators Tackle Leveraged Lending

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On March 22, 2013, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the "bank regulators") released their final guidance on leveraged lending activities.[1] The final guidance does not deviate significantly from the proposed guidance released last year on March 26, 2012, but does attempt to provide clarity in response to the many comment letters relating to the proposed guidance received by the bank regulators. The final guidance is the latest revision and update to the interagency leveraged finance guidance first issued in April 2001.[2]

Background

Given the immense growth in the volume of leveraged lending as well as the increased participation of non-regulated lenders in the leveraged lending business over the last decade, bank regulators have expressed concern that prudent underwriting practices have deteriorated and that aggregate system-wide exposure to leveraged loans has increased at an uncomfortably high rate. In particular, bank regulators have expressed concern with respect to the absence of meaningful maintenance covenants in loan agreements and the aggressive nature of capital structures and repayment assumptions for some transactions. There is also concern that management information systems (MIS) at some institutions have fallen short in accurately tracking such institutions' aggregate exposures on a timely basis.

In light of these concerns bank regulators are replacing the April 2001 Interagency Guidance regarding sound practices for leveraged lending activities with this final guidance, which will form the basis of their supervisory focus on financial institutions going forward. The final leveraged lending guidance applies to all OCC-, FRB-, and FDIC-supervised financial institutions that are substantively engaged in leveraged lending activities and describes the regulators' expectations for sound risk management of such activities.

The guidance is intended to be implemented consistent with the size and risk profile of an institution's leveraged lending activities and is particularly applicable to institutions that originate or sponsor (as opposed to those that acquire participations in) leveraged transactions. Community banks (as a sector of the marketplace), because they have limited involvement in leveraged lending activities, should be largely unaffected by the guidance

and those community banks that are engaged in leveraged lending activities are advised to discuss cost-effective and appropriate risk management controls and other tools with their primary regulators.

A major substantive change in the final guidance from the proposed guidance released last year is the inclusion of the "Participation Purchased" section. This section was incorporated from the original 2001 guidance to clarify the agencies' expectations of institutions that do not originate leveraged loans but participate in leveraged loans by acquiring participations and assignments in such loans.

The regulators also agreed with commentators that, given the administrative burden of the sponsor evaluation criteria, such criteria should be limited to sponsors that are providing a financial guarantee and that are relied on as a secondary source of repayment.

The proposed guidance suggested than an institution's underwriting standards should consider a borrower's ability to fully amortize senior secured debt or repay 50 percent of the total debt exposure over a five- to seven- year period. Some commentators felt that standard was a bright-line rule. The regulators clarified that it was intended as a general guideline and removed that language from the final guidance section relating to underwriting standards. They instead state that institutions should consider whether 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. A footnote in the final guidance stresses that the measurement of ability to de-lever and repay should use the most realistic financial projections.

Despite comments expressing concern about the use of EBITDA as a measure to define leverage, the final guidance retains the measure in its definition section. Regulators felt that having a consistent definition would help lead to consistent application of the principles enunciated in the final guidance. Neither the proposed nor the final guidance actually requires an EBITDA-based measure, but EBITDA is used therein as an example of a useful component in defining leveraged lending.

In response to comments, the regulators clarified that MIS requirements should be tailored to, and be cost-effective in relation to, the size and scope of an institution's leveraged lending activities.

The regulators also clarified in the final guidance that a loan should be designated as "leveraged" only at the time of origination, modification, extension, or refinance. Loans that deteriorate and then meet the definition of leveraged only after origination because of a change in the borrower's financial condition, or "fallen angels", should be captured within a broader risk management framework but should not be viewed as leveraged lending transactions.

Though some commentators suggested that investment-grade borrowers be excluded from the guidance, the regulators declined to do so. However they note in the release that they strongly support the efforts of, in particular, small and mid-sized institutions to extend prudent commercial and industrial loans.

Finally, though the regulators declined to include tighter controls for covenant-lite and PIK-toggle loan structures in the final guidance, they did acknowledge that such structures pose additional risks, and stated in the final guidance that they will closely review such structures in their overall credit evaluations of institutions.

Although the final guidance provides a significant amount of detail regarding the particular supervisory requirements that the regulators intend to impose with respect to leveraged lending, the following list of seven bullet points summarizes, in a general way, the principal requirements applicable to institutions that engage in leveraged lending:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with suitable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending 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 consistent with the institution's risk appetite;
- Sound MIS that enables management to identify, aggregate, and monitor leveraged exposures, and to 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; and
- Guidelines for conducting periodic portfolio and pipelines stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Risk Management Framework

Institutions engaged in leveraged lending should adopt a risk management framework that has as its foundation written risk objectives, risk tolerance standards, and risk controls. As such, the final guidance significantly expands on the 2001 guidance. The most relevant elements of the framework are highlighted below:

Definition of Leveraged Lending. Institutions should define leveraged lending within their lending policies in a way that is appropriate to the individual institution and with sufficient detail to ensure consistent application across all business lines. The definition should include leveraged lending risk from both direct and indirect exposures, including exposures to other financial institutions that engage in leveraged lending. The guidance also provides several examples of commonly accepted industry definitions of leveraged lending, including those incorporating total debt or senior debt to EBITDA ratios.

Policy Expectations. The leveraged lending policy should, at a minimum, identify an institution's risk appetite and the stated risk appetite should be supported by an analysis of its potential effect on the lender's business metrics such as earnings, capital, and liquidity. The guidance stresses the importance of creating a multifaceted, risk-limits framework that includes guidelines for the following: single obligors and transactions exposures; aggregate pipeline exposure and aggregate hold positions; and industry and geographic concentrations. It requires institutions to ensure that the risks of leveraged lending activities are appropriately reflected in the institution's Allowance for Loan and Lease Losses (ALLL) as well as in its capital adequacy analyses. An institution's policy should also include credit and underwriting approval authorities and guidelines for senior management and board oversight, including board approval of the policy itself and timely reporting to the board more generally.

Participations Purchased.[3] In cases where institutions are acquiring participations and assignments in a leveraged lending transactions, the guidance requires that such institutions apply the same credit assessment, approval, and in-house limit criteria that they would use if they were originating the loan. In addition to having appropriate risk management policies as described in the final guidance, the policies for participations and assignments should, at a minimum, include an independent analysis of credit information before and after participation purchase, obtaining all relevant documentation related to the loans and monitoring borrower performance throughout the life of the loan.

Underwriting Standards. In the words of the bank regulators, underwriting standards should be "clear, written, measurable and should accurately reflect the institution's risk appetite for leveraged lending transactions." Such standards should require an evaluation of the borrower's capital structure to ensure that it reflects sound financial analysis and underwriting principles. The guidance gives significantly more direction in this section than was provided in the original 2001 guidance. In addition to stressing the importance of setting standards for evaluating various types of collateral and defining credit risk management's role in due diligence, the regulators have recommended that in setting standards for evaluating expected risk-adjusted returns, institutions

include alternative strategies for the funding and disposing of positions during market disruptions and also consider the potential for losses during such periods. Of particular importance is projecting a borrower's capacity to repay and its ability to de-lever over a reasonable period of time. These projections should reflect considerations of the key risks identified in the transaction and demonstrate the borrower's ability to fully amortize senior secured debt or to repay a significant portion of total debt over the medium term. Underwriting standards should assess the extent to which used valuation methodologies rely upon intangible assets such as enterprise value and other intangible assets for loan repayment. Provisions describing appropriate collateral requirements in credit agreements as well as more general credit agreement covenant protections (such as coverage ratios, reporting requirements and maximum acceptable leverage (6 X total debt to EBITDA) are also set forth in this section of the final guidance. Furthermore, the regulators are also concerned about the substantial reputation risks that often arise when a lending institution becomes associated in the public mind with poorly underwritten and poorly performing loans.

Valuation Standards. Given the importance of enterprise valuation in the leveraged lending underwriting process, the guidance addresses in particular the methodologies used to determine enterprise value and highlights the danger to institutions of relying too heavily on enterprise valuations. An institution should focus on sound methodologies in its determination of enterprise value. Although conventional appraisal theory provides three approaches for valuations (asset, income, and market), the regulators note that in many cases the income approach is considered the most reliable. When using the income approach - whether relying on the "capitalized cash flow" method (most appropriate when cash flows are predictable and stable) or the "discounted cash flow" method (most appropriate when future cash flows are cyclical or variable between periods) - supporting documentation should fully explain the evaluator's reasoning and conclusions. Furthermore, the stress testing of enterprise values and their underlying assumptions should be conducted and documented periodically. Policies dealing with enterprise value and hard-to-value collateral should provide appropriate LTV ratios, discount rates, and collateral margins, and should call for well documented and supported assumptions underlying enterprise value estimates and hard-to-value collateral estimates. Enterprises valuations should be performed by qualified persons independent of an institution's origination function.

Pipeline Management. In order to mitigate the effects of market disruption on their ability to syndicate or sell down exposures, institutions must be able to accurately measure exposures on a timely basis (differentiating between tenors, investor classes, structures, and key borrower characteristics) and to establish strong risk management and controls that address failed transactions as well as general market disruptions. This includes written procedures for defining and managing distribution failures and "hung" deals, as well as clear guidelines for conducting periodic stress tests on pipeline exposures. Financial institutions should also maintain limits on aggregate pipeline commitments, the amount of loans that they are willing to retain on their own books, and the underwriting risks that will be assumed for loans intended for distribution. Additionally, regulators expect that institutions will establish controls to monitor pipeline performance against original expectations and report material variances (e.g., loans reclassified from "loans for distribution" to "loans held to maturity") to senior management and the board of directors. The guidance also calls for policies addressing the use of hedging to reduce pipeline exposure and identifying acceptable accounting methodologies that require prompt recognition of losses in accordance with GAAP.

Reporting and Analytics. The guidance clarifies that bank regulators expect lending institutions to diligently monitor leveraged loans throughout the life of those loans. Institutions should build MIS platforms that accurately capture key borrower characteristics in order to aggregate them across business lines and legal entities on a timely basis. The final guidelines included the following additional fields that can be incorporated into an institution's MIS:

- risk rating distribution and migration analysis;
- industry mix and maturity profile;
- metrics derived from probabilities of default (PD) and loss given default (LGD);
- portfolio performance measures such as noncompliance with covenants, restructurings, delinquencies, and charge-offs;
- amount of impaired assets and the nature of the impairment;
- amount of the ALLL attributable to leveraged lending;
- exposures by collateral type, including unsecured loans;
- exposure and performance by a deal sponsor;
- secondary market pricing data and trading volume (when available);
- gross and net exposures and hedge counterparty concentrations;
- aggregate level of policy exceptions;
- actual versus projected distribution of the syndication pipeline; and
- total and segmented leverage lending exposures (both direct and indirect) on a global basis.

The bank regulators also advise that borrower/counterparty leveraged lending reporting should consider both direct and indirect exposure booked in other business units as well as positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its affiliates and subsidiaries. Comprehensive reports should be provided to management and summaries should be provided to the board of directors at least quarterly.

Risk Ratings. Bank regulators have previously issued guidance on risk rating credit exposures and credit rating systems more generally. That guidance applies to all credit transactions, including leveraged lending.[4] This guidance stresses the importance of using realistic repayment assumptions (for example, the ability to fully amortize senior debt or to repay at least 50 percent of total debt over a five- to seven-year period) in the risk rating process for leveraged loans and provides insight into the circumstances in which bank regulators might force the reclassification or write-off of loans. In particular bank regulators note that enterprise value should be well supported to be considered appropriated as a secondary source of repayment when the primary source becomes inadequate.

Credit Analysis. Stressing the importance of the loan approval process, the regulators explain that credit policies must include critical analysis during the approval process as well as ongoing monitoring. To address the need for comprehensive assessment of financial, business, industry, and management risks, lending policies should, at a minimum, address whether:

- cash flow analyses are based on realistic and substantiated sales projections and merger and acquisition synergies;
- liquidity analyses include appropriate metrics regarding the borrower's industry and the borrower's own particular financial condition;
- an adequate margin for unanticipated merger-related integration costs is included in projections;
- projections are stress tested for one or more downside scenarios;
- enterprise and collateral valuations are derived or validated independently of the loan origination function;
- transactions are reviewed at least quarterly to determine variance from plan and related risk implications;
- transactions are reviewed at least quarterly to ascertain risks related to any variance from the plan;
- potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- changing market conditions in the debt and equity markets are carefully monitored in cases wherein loan requirements rely on refinancings or issuance of new equity; and
- the borrower is adequately protected from interest rate and foreign exchange risk.

Problem Credit Management. Credit policies

should define expectations for the management of high risk loans—particularly those for which actual performance significantly departs from planned performance targets. The policies should also stress the need for individualized workout plans with quantifiable objectives and measurable timeframes. Institutions should formulate individual action plans when working with borrowers that are experiencing significant repayment difficulties, and problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors. The guidance places an emphasis on - and gives specific recommendations for - evaluating the qualifications of deal sponsors that are relied upon as a secondary source of repayment and implementing a process to regularly monitor the financial condition of these sponsors. These recommendations include an evaluation of the following: the sponsor's historical performance in supporting investments; the sponsor's incentive to support a given transaction; the degree and type of sponsor support; the sponsor's contractual investment limitations; the sponsor's financial position; and the sponsor's dividend and capital contribution practices.

Credit Review. The guidance reiterates the need to conduct annual portfolio reviews that evaluate the level of risk and risk-rating integrity, valuation methodologies, and the quality of risk management. To maintain a strong and independent credit review, the credit review function should be appropriately staffed and authorized to report inappropriate risks "up the chain" to senior management. Given the level of risk typically found in leveraged lending portfolios, a more detailed credit review of the leveraged loan portfolio should probably be conducted more frequently than would be necessary with a less risky portfolio.

Stress Testing. The guidance instructs financial institutions to implement guidelines for stress testing on both their loan portfolios and general stress testing to assess market conditions on their assets quality, earnings, liquidity, and capital. The guidance points the institutions to previously released interagency guidance as a point of reference and asks that financial institutions required to conduct enterprise-wide stress tests include leveraged portfolios in such tests.[5]

Conflicts of Interest. Credit policies should clearly identify potential conflicts of interest and contain appropriate risk management controls and procedures to avoid or to mitigate such conflicts. For example, conflicts of interest may arise if a lender serves as the financial advisor to the seller and simultaneously offers financing to multiple buyers. A conflict is also present where the lender invests in the equity of the borrower. These and other possible conflicts of interest require a financial institution's management to provide training to employees on how to avoid conflicts of interest, and also to encourage employees to report conflicts "up the chain" to senior management.

Reputation Risk. The agencies expressed concern that institutions may incur damage to their reputations from failing to meet their legal responsibilities in underwriting transactions or from distributing transactions with disproportionately high default rates.

Compliance, Anti-Tying, and Securities Laws Concerns. The guidance advises institutions to incorporate safeguards in their policies to prevent violations of anti-tying statutes. Section 106(b) of the Bank Holding Company Act Amendments of 1970 prohibits certain forms of product tying by banks and their affiliates.

Additionally, institutions should establish policies to ensure their compliance with any applicable securities laws.

Conclusion

The final guidance closely follows the proposed guidance released at this time last year and shows a clear intention by regulators to constrain aggressive and risky leveraged lending practices. Going forward, financial institutions that regularly engage in leveraged lending will have to reevaluate their internal policies and procedures and tighten their underwriting standards to ensure that they are compliant with the heightened standards now imposed on them by their regulators. The compliance date for the final guidance is May 21, 2013.

1 Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar. 22, 2013). Portions of the final guidance are reproduced verbatim throughout this article as appropriate.

2 FED. RES. BD., SR 01 9 (SUP), INTERAGENCY GUIDANCE ON LEVERAGED FINANCING (Apr. 17, 2001).

3 The final guidance also refers to the following OCC and FDIC publications: OCC Loan Portfolio Management Handbook, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf, Loan Participations, Board "Commercial Bank Examination Manual," http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf, section 2045.1, Loan Participations, the Agreements and Participants; and FDIC Risk Management Manual of Examination Policies, section 3.2 (Loans), http://www.fdic.gov/regulations/safety/manual/section3-2.html # other Credit, Loan Participations, (last update Feb. 2, 2005).

4 *See*, e.g., FED. RES. BD., SR 98-25 (SUP), SOUND CREDIT RISK MANAGEMENT AND THE USE OF INTERNAL CREDIT RISK RATINGS AT LARGE BANKING ORGANIZATIONS (Sept. 21, 1998), OCC Comptroller's Handbooks "Rating Credit Risk" and "Leverage Lending", and FDIC Risk Management Manual of Examination Policies, "Loan Appraisal and Classification."

5 *See* interagency guidance "Supervisory Guidance on Stress-testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets," Final Supervisory Guidance, 77 FR 29458 (May 17, 2012), at http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm, and the joint "Statement to Clarify Supervisory Expectations for Stress-Testing by Community Banks," May 14, 2012, by the OCC at http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm; the Board at http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76.html; and the FDIC at http://www.fdic.gov/news/news/press/2012/pr12054a.pdf. *See also* FDIC Final Rule, Annual Stress Test, 77 FR62417 (Oct. 15, 2012) (to be codified at 12 CFR part. 325, subpart. C).

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