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Private Equity Alert

Bank Regulators Tackle Leveraged Lending

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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 for public comment on March 26, 2012, their proposed joint guidance on leveraged lending activities.[1] The proposed guidance is a revision to the interagency leveraged finance guidance first issued in 2001[2] and is an indicator of greater regulatory scrutiny in an area of finance perceived by bank regulators as an increasing source of risk to financial institutions of varying sizes and complexities. It is difficult to predict the impact, if any, of the proposed guidance and increased regulatory scrutiny on the availability and terms of financing to private equity firms and their portfolio companies.

Background

Given the immense growth in the volume of leveraged lending as well as the increased participation of non-regulated lenders over the last decade, bank regulators have expressed concerns that prudent underwriting practices have deteriorated and that aggregate system-wide exposures to leveraged credits have increased at an uncomfortably high rate. Specifically, bank regulators have referenced the following developments: debt agreements have increasingly included features that provide limited lender protection; capital structures and repayment projections for some transactions have at times been overly aggressive; and management information systems (MIS) at some institutions have fallen short in accurately tracking aggregate exposures (both funded and committed) on a timely basis.

There is an overarching concern by bank regulators that – as has been the case in the past – as the economy rebounds and the level of corporate mergers and private equity buyout deals increases, leveraged loan transactions will become riskier, reverting to the "covenant-lite" trend that offered little protection to lenders in the years leading up to the financial crisis. In light of those concerns, the bank regulators propose replacing their existing guidance with revised leveraged lending guidance that will form the basis of their supervisory focus and their review of regulated financial institutions going forward.

The bank regulators have emphasized the importance of financial institutions having the capacity: to evaluate and monitor credit risk properly; to ensure that each borrower has a sustainable capital structure; to demonstrate an understanding of the potential impact of various forms of distress on a borrower's financial condition; and to

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incorporate stress testing and sensitivity analysis into their risk management of leveraged portfolios. The proposed guidance is intended to build upon the recently proposed guidance on stress testing.[3] With improved sensitivity analysis and increased stress testing, the hope is that financial institutions will be able to better monitor their leveraged lending portfolios and to take action to protect themselves before their borrowers become financially distressed.

Proposed Risk Management Framework

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

- ***Definition of Leveraged Finance***. Institutions should define leveraged finance within their policies with sufficient detail to ensure consistent application across all business lines. The definition should include the institution's exposure to financial vehicles that engage in leveraged lending activities. The guidance also provides several examples of commonly accepted industry definitions of leveraged lending, including those incorporating total debt and senior debt to EBITDA ratios.
- ***Policy Expectations***. The leveraged finance policy should, at a minimum, identify an institution's risk appetite (including pipeline limits and transaction and aggregate hold levels) and the stated risk appetite should be supported by an analysis of its potential effect on business metrics such as earnings, capital, and liquidity. The proposed 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. The proposed guidance requires institutions to ensure that the risks of leveraged lending activities are appropriately reflected in the institution's allowance for loan and lease losses as well as in its capital adequacy analyses.
- ***Underwriting Standards***. In the words of the bank regulators, underwriting standards should be "clear, written, measurable and accurately reflect the institutions risk appetite for leveraged finance transactions." The proposed guidance gives significantly more direction in this section than was provided in the 2001 guidance. In addition to stressing the importance of setting standards for evaluating various types

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of collateral and defining credit risk management's role in due diligence, bank 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 de-lever over a reasonable period of time. These projections should reflect the key risks identified in the transaction and demonstrate the ability to amortize senior secured debt or to repay at least 50 percent of total debt over five to seven years. Furthermore, bank 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 valuation (asset, income, and market) the bank regulators consider the income approach to be the most common and reliable method. 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. Enterprise valuations should be performed or validated by persons independent of the lending and credit process.
- ***Pipeline Management***. The proposed guidance introduces this section as a regulatory expectation not discussed in the 2001 guidance. 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 exposure on a timely basis 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 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, bank 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.
- ***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 proposed guidelines included the following additional fields that can be incorporated into an institution's MIS:

- 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 impairment assets and the nature of the impairment;
- the amount of the Allowance for loan and lease losses attributable to leveraged lending;
- exposure and performance by a deal sponsor;
- secondary market pricing data and trading volume (when available);
- gross and net exposures;
- counterparty concentrations; and
- policy exceptions.

The bank regulators also advise that borrower/counterparty leveraged finance 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. This guidance applies to all credit transactions, including leveraged lending.[4] Additionally, the guidance stresses the importance of using realistic repayment assumptions 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.
- ***Credit Analysis***. Stressing the importance of the loan approval process, the bank 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 analysis is based on realistic and substantiated sales projections and merger and acquisition synergies;
  - liquidity analysis includes appropriate metrics regarding the borrower's industry;
  - an adequate margin for unanticipated merger-related integration costs is included in projections;
  - projections are stress tested for downside scenarios (e.g., a covenant breach);
  - enterprise and collateral valuations are derived or validated independently of the loan origination function;
  - 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; 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 workout plans with quantifiable objectives and measurable timeframes.

Institutions should formulate individual action plans when working with borrowers that are experiencing significant variances, 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 proposed guidance places a new emphasis on – and gives specific recommendations for – evaluating the qualifications of financial sponsors and implementing a process to regularly monitor the performance 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; 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 proposed 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 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.
- ***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.
- ***Anti-tying Regulation***. The proposed guidance includes a new section advising 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.
- ***Reputation Risk***. The agencies expressed concern that institutions may incur damage to their reputations from a failure to meet their legal or fiduciary responsibilities in underwriting transactions or from distributing transactions with disproportionately high default rates.

Overall, implementation of the proposed guidance outlined above should be consistent with the size and risk profile of an institution's leveraged portfolio relative to its assets, earnings, liquidity and capital. Although some sections of the guidance will apply to all leveraged transactions, the vast majority of community banks should not be affected, as they have little or no exposure to leveraged loans. The deadline for submitting comments on the proposed guidance is June 8, 2012.

Conclusion

The recent move by bank regulators to tackle the increased risks inherent in leveraged lending presents an opportunity for financial institutions that are able to get ahead of the curve. To be sure, financial institutions that engage regularly in lending to private equity firms and hedge funds should expect increased supervisory scrutiny in the coming months as the proposed guidance is finalized. Nevertheless, institutions that are able to achieve compliance before the next examination cycle after final release of the guidance will be far better positioned from a regulatory and risk vantage point to seize upon the opportunities in leveraged lending likely to present themselves in the near future.

1 Proposed Guidance on Leveraged Lending, 77 Fed. Reg. 19,417 (Dep't of the Treasury, Fed. Res. Bd., and Fed. Deposit Ins. Corp. proposed Mar. 26, 2012). Portions of the proposed 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 Heath Tarbert and Dimia Fogam, Comment Period Extended for Stress Testing Requirements, Weil Financial Regulatory Reform Center (Apr. 4, 2012), http://financial-reform.weil.com/uncategorized/comment-period-extended-stress-testing-requirements.

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).

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