



Interagency Guidance on Leveraged Lending

Guest Speakers:

- ▶ **Robert Cote**, Federal Reserve Board of Governors
- ▶ **Lou Ann Francis**, Office of the Comptroller of the Currency
- ▶ **Carmen Holly**, Federal Reserve Board of Governors
- ▶ **Tom Lyons**, Federal Deposit Insurance Corporation

June 19, 2013



ask the Regulators

Welcome everyone

- Today's session
- Questions:
 - Email your question to: rapid@stls.frb.org
or
 - Use the “Ask a Question” feature on the Ask the Fed® website: www.askthefed.org
- This call is being recorded and will be available immediately following the session.
- A survey will be delivered via email following the call. Let us know your thoughts or ideas for future sessions.



ask the Regulators

Today's Presenters



Rob Cote

Federal Reserve
Board of Governors



Carmen Holly

Federal Reserve
Board of Governor



Lou Ann Francis

OCC



Tom Lyons

FDIC



ask the Regulators

To ask a question:

- Email your question to: rapid@stls.frb.org
- Use the “Ask a Question” feature on the Ask the Fed[®] website: www.askthefed.org



Why did the Agencies Issue new Guidance?

Issues observed leading up to the recent financial crisis:

- Significant growth in leveraged lending
- Differences in underwriting on loans originated to hold vs. originated to distribute
- Absence of meaningful financial covenants
- Inadequate reporting and/or aggregating enterprise wide exposures
- Insufficient documentation to support reliance on deal sponsors and/or enterprise values



ask the Regulators

Risk Management Framework

The guidance seeks to ensure:

- Institutions engage in transactions that reflect a sound business premise, an appropriate capital structure, reasonable cash flow, and reasonable balance sheet leverage
- Institutions maintain well-defined underwriting standards that define acceptable leverage levels and amortization expectations
- Borrowers have the capacity to repay and de-lever over a reasonable period of time
- Institutions define exposure and concentration limits
- Management information systems (MIS) reporting is comprehensive and aggregate exposure across all business lines
- Institutions define pipeline management procedures, hold limits, and expected timing for distributions
- Institutions set procedures for portfolio and pipeline stress testing



ask the Regulators

Scope

- Applies to all supervised financial institutions that originate, hold, distribute or participate in leveraged lending activities.
- The agencies generally expect community banks to be largely unaffected by the guidance.
- The policy applies to loans that meet the institution's definition of a leveraged loan:
 - Loans originated and held in portfolio
 - Loans originated and held in a distribution pipeline
 - Loans purchased via participations
- Does not apply to:
 - Small dollar commercial and industrial loans
 - Traditional asset-based loans – unless part of the debt structure of a leveraged obligor.
 - “Fallen Angels” – unless refinanced, restructured or modified.
 - Securities



ask the Regulators

Policy Expectations

Definition of Leveraged Lending

Policies should include criteria to define leveraged lending that are appropriate to the institution such as:

- Proceeds used for buyouts, acquisitions, or capital distributions
- Transactions where the borrower's Total Debt (TD) ÷ EBITDA > 4.0X, or
- Transactions where the borrower's Senior Debt ÷ EBITDA > 3.0X, or
- Transactions where the borrower's post-financing leverage, as measured by its leverage ratios (TD/Assets, TD/Worth, TD/EBITDA or other similar standards) significantly exceeds industry norms or historical levels
- Other defined levels appropriate to the industry or sector
 - Cash should NOT be netted against debt
 - Definition does NOT include asset-based loans (ABLs) unless such loans are part of the entire debt structure of the borrower
 - Definition does NOT include fallen angels until modified, extended, or refinanced



Policy Expectations (continued)

Policies need to be written to specify the risk appetite of the institution and to:

- Be consistently applied across all business lines
- Cover both direct and indirect risk exposure
- Address clearly defined amounts of leveraged lending that the institution is willing to underwrite (e.g., pipeline limits) and willing to retain (e.g., transaction, aggregate hold levels)
- Include a limit framework with guidelines for:
 - Single obligors and transactions
 - Aggregate hold portfolio
 - Aggregate pipeline exposure
 - Industry and geographic concentrations
 - Exception tracking
 - Assessing stress losses, flex terms, economic capital usage and earnings-at-risk



Policy Expectations (continued)

Other important elements

- **The leveraged lending policy should:**
 - Contain procedures for including the leveraged loans in the allowance for loans and lease losses (ALLL) reporting as is necessary
 - Establish approval authorities
 - Establish guidelines for oversight by senior management and reporting to the board of directors
 - Include expected risk-adjusted returns for the transactions
 - Include minimum underwriting standards for loans originated to hold, loans distributed, and loans purchased
 - Establish effective underwriting practices for primary loan origination and secondary loan acquisition



Participations Purchased

Institutions should:

- Make a thorough, independent evaluation of the transaction and the risks involved before committing any funds
- Apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be used if originating the loan

Policies for participations should include requirements for:

- Obtaining and independently analyzing credit information both before the participation is purchased and on a timely basis thereafter
- Obtaining all executed and proposed loan documents, legal opinions and other relevant documents
- Monitoring the borrower's performance throughout the life of the loan
- Establishing appropriate risk management guidelines



Underwriting Standards

Policy standards for underwriting leveraged loans should consider:

- Due diligence expectations including standards for evaluating collateral
- Standards for evaluating expected risk-adjusted returns
- Strategies for funding and disposing of positions during market disruptions
- The acceptable degree of reliance on enterprise value (EV) and other intangible assets for loan repayment
- Acceptable valuation methodologies and periodic reviews of those values
- Procedures for evaluating sponsor support (if any) and consideration of sponsor's financial capacity if viewed as a secondary source of repayment



Underwriting Standards (continued)

Underwriting standards should consider:

- Requiring lender approval on any changes to credit agreement terms
- Covenant protections including financial performance, reporting requirements, and compliance monitoring
- Acceptable collateral and risk-appropriate measures and controls
- Standards for ABLs when they are part of the debt structure

Generally, a leverage level after planned asset sales in excess of 6X TD/EBITDA raises concerns for most industries



ask the Regulators

Valuation Standards

- Institutions may look to rely on Enterprise Value (EV) as a secondary source of repayment.
- Institutions relying on EV or other illiquid and hard-to-value collateral should have policies that provide for appropriate LTV ratios, discount rates, and collateral margins.
- Institutions should also establish limits for the proportion of individual transactions and the total portfolio supported by EV.
- Due to their specialized nature, EVs should be performed by qualified persons independent of the institution's origination function



Valuation Standards (continued)

There are three common methods for determining EV:

- Discounted cash flow
- Asset valuation
- Market valuation

Examiners will want to know:

- How was EV derived? Can the methodology be easily understood?
- Is the EV calculation and conclusion supportable and credible?
- What is the degree of reliance on EV as a source of repayment?



ask the Regulators

Pipeline Management

For transactions in the pipeline, institutions should have:

- A clearly articulated and documented appetite for underwriting risk considering the potential effects on earnings, capital, liquidity, and other risks from pipeline exposures
- Limits on the amount of loans that an institution is willing to retain on its own books and limits on the underwriting risk on amounts intended for distribution
- Clear expectations for the disposition of pipeline transactions addressing:
 - Distribution strategy
 - Failures (loans not sold according to plan or within 90 days of closing)
 - Potential for loss if failure occurs



ask the Regulators

Pipeline Management (continued)

For transactions in the pipeline, institutions should have:

- Guidelines for conducting periodic stress tests on pipeline exposures
- Controls to monitor the actual performance of loans in the pipeline against projected performance
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposure
- The ability for loan level and portfolio monitoring and to differentiate the reporting by tenor, investor class, structure or other key borrower statistics



ask the Regulators

Reporting and Analytics

Management should receive comprehensive reports about the characteristics and trends of the leveraged portfolio at least quarterly, with summaries provided to the board of directors.

MIS reporting may include:

- Exposures within and across all business lines and legal vehicles, including the pipeline
- Risk rating distribution and migration analysis
- Industry mix and maturity profile
- Metrics derived from PDs and LGDs
- Portfolio performance measures (noncompliance with covenants, restructurings, delinquencies, NPAs and charge-offs)



ask the Regulators

Reporting and Analytics (continued)

MIS reporting may include:

- Impaired assets (temporary or permanent)
- ALLL attributable to leveraged lending
- Policy exceptions
- Exposures by collateral type, deal sponsors
- Secondary market pricing data and trading volume
- Gross and net exposures, hedge counterparty concentrations
- Actual versus projected distribution of the pipeline
- Total and segmented exposures
- Exposures booked in other business units



Risk Rating Leveraged Loans

- Risk rate involves 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.
- Supervisors assume that the ability to amortize
 - 100% of senior secured debt, or
 - 50% of total debtover a 5-7 year period provides adequate repayment capacity.
- If the projected repayment capacity is nominal with refinancing the only viable option, the credit will usually be adversely rated, even if recently underwritten.
- Extensions and restructures should be reviewed to ensure repayment capacity problems are not being masked.



Risk Rating Leveraged Loans (continued)

- If there are no reasonable or realistic prospects to de-lever, a substandard rating is likely.
- If the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider EV as a secondary source of repayment unless that value is well supported.
- When a portion of the loan may not be protected by pledged assets or a well-supported EV, examiners generally will rate that portion doubtful or loss and require that the loan be placed on nonaccrual status.



ask the Regulators

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis during the approval process as well as ongoing monitoring.

Policies should address the need for a comprehensive analysis including:

- Cash flow analyses
- Liquidity analyses
- Projections
- Stress-testing of projections
- Variance from plan



ask the Regulators

Credit Analysis (continued)

Analysis should include:

- EV and collateral valuations
- Asset sale estimates
- Collateral shortfalls
- Contingency plans
- Interest rate and foreign exchange risk



ask the Regulators

Problem Credit Management

- An institution should formulate individual action plans and expectations when working with troubled borrowers.
- Policies should stress the need for workout plans that contain quantifiable objectives and measurable time frames.
- Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.



Deal Sponsors

An institution that relies on a sponsor as a secondary repayment source should:

- Develop guidelines for evaluating the qualifications of financial sponsors
- Monitor a sponsor's financial condition on a regular basis

An evaluation of sponsor support should include:

- Historical performance in supporting its investments
- Economic incentive to support including capital contributed at inception
- Documentation of degree of support
- Consideration of the sponsor's contractual investment limitations
- Periodic review of financial statement trends, including liquidity
- Consideration of sponsor dividend and capital contribution practices
- Likelihood of support for a particular borrower compared to other sponsored transactions
- Guidelines for evaluating sponsor qualifications and a process to monitor sponsor performance



Credit Review

An institution should have a strong and independent credit review function that can identify and escalate inappropriate risks and other findings to senior management.

- **The credit review function should:**
 - Assess performance of the leveraged portfolio more frequently and in greater depth than other loan portfolio segments
 - Generally conduct reviews at least annually and consider more frequent reviews when elevated risk characteristics exist
- **Credit review resources should:**
 - Have appropriate expertise and experience
 - Be sufficient to ensure timely, independent, and accurate assessments



Stress Testing

- The sophistication of stress-testing practices and sensitivity analyses should be consistent with the size, complexity and risk characteristics of the leveraged loan portfolio.
- To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included.
- An institution should develop guidelines for stress testing the leveraged portfolio which address:
 - periodic stress tests; and,
 - include loans originated to hold **AND** to distribute.
- Stress tests should include sensitivity analyses to quantify the potential impact on asset quality, earnings, liquidity, and capital.



Conflicts of Interest

An institution should develop appropriate policies and procedures to address and prevent potential conflicts of interest when it has both equity and lending positions.

- Policies and procedures should:
 - Define potential conflicts of interest
 - Identify appropriate risk management controls and procedures
 - Enable employees to report potential conflicts of interest without fear of retribution
 - Ensure compliance with applicable laws
- Management should:
 - Establish a training program for employees on appropriate practices to avoid conflicts of interest
 - Provide for reporting, tracking and resolution of conflicts of interest



ask the Regulators

Reputational Risk

- An institution should consider its market reputation in underwriting and distributing transactions in the financial and institutional markets.
- An institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete.
- An institution that distributes transactions which over time have significantly higher default or loss rates and performance issues may see its reputation damaged.



ask the Regulators

Compliance

- An institution should maintain an independent compliance review function to periodically review leveraged lending activity.
- As leveraged transactions often involve a variety of debt and bank products, an institution should ensure its policies include safeguards to prevent violations of anti-tying regulations.
- Equity interests and certain debt instruments used in leveraged transactions may constitute “securities” under federal securities laws, and if so an institution should ensure compliance with applicable securities laws.
- Institutions should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.



ask the Regulators

To ask a question:

- Email your question to: rapid@stls.frb.org
- Use the “Ask a Question” feature on the Ask the Fed® website: www.askthefed.org

ask the Regulators



Thanks for joining us.