Interagency Guidance on Leverage Lending
(Transcript of Interagency "Ask-the-Regulator" call, June 19, 2013)

Well good morning and good afternoon, everyone. Welcome to a special session today that we're calling "Ask the Regulators". Today's topic: Interagency Guidance on Leveraged Lending. This is Eric Soel. I'm joining you from the Federal Reserve here in St. Louis. There's a lot of great information to cover in the next 90 minutes, but first I'd like to cover just some housekeeping items as seen on slide 2 of the presentation that hopefully everybody has.

First off, a couple things: This is a moderated call, so what that means is everyone's phones are automatically on mute. If you would like to ask a question during today's session, you have a couple options: You can send an email directly to rapid@stls.frb.org, or, if you're on the Ask the FED web site, on the right hand side of that site, there's an ask a question feature; either option works, and we'll get all the questions the same way, so whatever works for you.

Second, as a service to you, this call, like all of these calls, is being recorded, and what we do is turn it into an audio file that will be available from your regulator's web site, so the FDIC, the OCC will post this as well; we'll also put it on the Ask the Fed web site so we'll do that as soon as the call is over.

Third, everybody who is registered for today's Ask the Regulators Session will be e-mailed a very brief survey after the call, and I'll just mention that if you're interested in any CEU credits for today's session, all you have to do is complete that last section of the survey, and we're happy to offer that to you guys.

Finally, a little legal language; "Ask the Regulators" is a cooperative program of the Federal Reserve, FDIC, and OCC for senior officials and banks, holding companies and state bank commissioners. Use of the presentation materials, including audio recording of this presentation is strictly prohibited except by written permission of the Federal Reserve System, the FDIC, or the OCC. The opinions expressed in the presentations are statements of the speakers' opinion, are intended only for informational purposes and are not formal opinions of, nor binding on the Federal Reserve System, the FDIC or the OCC. Each participant is responsible for its own business, financial, investment or credit decision.

Okay. Let's jump to slide 3. I'd like to introduce our presenters for today's session. First off, we're extremely pleased to have Tom Lyons join us from the FDIC. We're also welcoming Rob Cote and Carmen Holly, both from the Federal Reserve Board of Governors, and then finally, we also welcome Lou Ann Francis from the OCC. Behind the scenes facilitating our questions and answers today will be Grant Wilson from the OCC and Brian Valenti from the Federal Reserve Board of Governors, so you've got a crew of people here that are going to make this hum along nicely.

So let me just orient everyone to today's session. What we're going to start with is about 35, maybe 40 minutes of presentation by our panel, and you see the presentation there in the PowerPoint, and then we're going to move into Q and A, so I will mention we've already received some really great questions.

Our goal really is to get through as many questions as we can today, so where appropriate, we're going to try to merge some similar questions together where that makes sense, but I will tell you guys, any questions that we can't answer due to time, we're going to ask that your primary regulator get back to you in the next couple of weeks, so again slide 4 shows the two ways that you can ask questions, either that rapid e-mail box that I mentioned or anyone that's signed in the Ask the FED web site, you can use that ask a question feature, again, both methods work the same so it's just really your preference at that point.

So, let's jump in. Let's go to slide 5, and I'm going to turn this over to Rob Cote to kick it off, so Rob, it is all yours.

Alright, well, thank you all for dialing in today. I understand that we have over 1650 registered participants, so it's clear the issuance of this guidance has generated a good deal of interest in the industry. The agencies are pleased to come together to jointly present our views on the guidance and to make ourselves available as Eric just said, to answer as many of your questions as we can get to today.

I'm going to start by talking about slide 5, why the agencies decided to update the 2001 guidance. The guidance touched on many of the right topics and issues, but it needed to be enhanced in a number of ways as it wasn't effective enough in restraining excessive risk taking. The agencies also learned a lot from the annual shared national credit review and from direct examiner feedback. We learned that the original guidance needed greater clarity around many of the basic fundamental expectations that supervisors have around the safe conduct of leveraged lending. As was explained in the revised guidance, the agencies expect institutions to evaluate and monitor underwritten credit risks and leveraged loans and assure borrowers are able to repay credits when due, have sustainable capital structures and are able to support their continued operations through economic cycles.

When the 2001 guidance, while it addressed the expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite, the importance of stress testing, it was also intended to restrain excessive risk taking type of activity, and it was not effective in accomplishing its goal as the industry struggled through the financial crisis.

We observed a number of issues leading up to the crisis, including tremendous growth in the volume of leveraged credit, particularly in the period from 2005 to 2007. During that time, a significant transition in underwriting standards emerged, as industry arrangers and syndicators moved from originate to hold, which we would normally think of as a traditional banking approach, to an originate to distribute model with terms that were more bond like, pricing the market without full regard to risk and increasingly sold these loan exposures to a growing institutional or non-bank investor class.

Additionally, the loan agreements frequently contained features that provided relatively limited lender protection that would otherwise protect banks from a borrower's weakening performance or default. These included the absence of meaningful maintenance covenants and the inclusion of payment in kind or PIK toggle features.

Further, borrower capital structures and repayments capacities for some transactions whether it is originated to hold or distribute, were at times very aggressive. Management information systems at several institutions were less than satisfactory at accurately aggregating exposures on a timely basis and when many institutions held large pipelines of higher risk commitments at a time when buyer demand for risky assets diminished significantly.

The agencies recognize of course, that leveraged funding is an important type of financing for the US and global economies, and the US banking system plays a key role in making credit available by syndicating credit to investors. The banks must not unnecessarily heighten risks by originating and distributing poorly underwritten loans. A poorly underwritten leveraged loan that has pooled with other loans or has participated with other institutions can generate excessive risk to the financial system. Revised guidance is designed to address these deficiencies and assist in providing leveraged lending to credit worthy borrowers in a safe and sound manner. Financial institutions must be able to demonstrate that they understand the risks and the potential impact of stressful events and circumstances on a borrower's condition.

The recent financial crisis also underscored the need for banks to employ sound underwriting to ensure the risks and leveraged lending activities are appropriately incorporated in the allowance for loan and lease losses and capital adequacy analyses, and incorporate stress testing in the risk management leveraged loan portfolios and distribution pipelines. Institutions that participate in this lending activity but do not implement strong risk management practices that are discussed in this guidance, will be criticized by the appropriate regulatory agency. I'll conclude this slide by saying that supervisors believe that if an institution is not willing or able to implement strong risk management processes, they open themselves up to significant risk, and they should rethink their participation in this type of lending.

So this second slide, risk management framework, speaks to the goals of the guidance, what we hoped to accomplish when we wrote it. Now regulators want to see transactions that reflect a sound business premise, appropriate capital structures, reasonable cash flow, reasonable deal leverage. We go on elsewhere in the guidance to lay out exactly what we want to mean by these terms – appropriate, reasonable, and Lou Ann will cover some of them in detail in just a bit.

Institutions also need to define their own underwriting standards and set in-house limits on their own risk taking. The guidance sets the expectation that borrowers, all borrowers, have the capacity to repay and de-lever over a reasonable period of time in order to not be rated special mention or worse. Again, we're talking about capacity to repay here, not the contractual obligation to do so. I would say that this particular element is not a new standard despite questions we received last year when we put the guidance out for public comment. It's, in fact, the standard the supervisors have used internally for many years on how to risk rate these credits. We just made our existing criteria more transparent to you all.

Whether a loan is originated to hold or to distribute, supervisors are not comfortable with structures that keep borrowers so stressed that they can barely meet interest payments. Banks also need to define exposure and concentration limits, and they need to expect regulators will be looking to make sure that these limits are appropriate and being adhered to.

Comprehensive MIS reporting: Given what we aim to see in this area, I expect that it will take some time for institutions to get this exactly right, but institutions should have already started this planning in earnest, and upcoming exams will seek information to gauge the progress that's being made in this regard. Some of the slides coming up will highlight the types and limits and procedures we believe are prudent when engaging in this business, and lastly, stress testing; while we don't cover a lot of new territory on stress testing here, we do highlight that we believe banks need to have adequate procedures for portfolio and pipeline stress testing.

In the next section, Carmen will walk you through the scope of the guidance.

Okay, thank you, Rob. I am going to be starting on slide 7 and talk to you about scope and now that Rob gave you an indication of why we initiated the guidance and also about what the goals are of the guidance in regards to risk management, I would like to lead off with what is going to be our policy review section of this presentation.

So onto slide 7 then, scope seeks to answer the question of whom and what the guidance applies to. Really, when you think about it, there's something in this guidance for all institutions who are involved in leveraged lending. If your institution is a large agent bank who maintains a pipeline of leveraged deals for distribution to investors, or if you syndicate leveraged loans to other banks, if the loans are large size, say over fifty million dollars, then you can pretty much rest assured that all of what's written in this guidance applies to you. If your institution is a medium sized or community bank and you participate in syndicated leveraged loans, say you buy in when you see a good deal, then perhaps only parts of the guidance would apply to you. In particular, the participations purchased section is one area that you would want to focus in on if you're a small or community bank. The guidance also states that as a small participant, you should discuss cost effective measures for monitoring and controlling these types of loans with your primary regulator. But overall, as bankers, you should implement this guidance based on the size and complexity of your particular leveraged lending portfolio.

The second question that we sought to answer when we sat down to write this guidance was, what does it apply to? And really, it covers all types of leveraged loans; that would be loans held in portfolio, loans that are marked for distribution and as mentioned, purchased participations. So then, we thought about who and what the guidance applies to, then we asked ourselves the question what does it not apply to? The guidance does not apply to small dollar C&I loans. A good example of these would be perhaps if a borrower comes in and wants to do a loan for an individual franchise. I always use the example if a borrower is looking to purchase a Dunkin Donuts franchise, for example. Another example would be a small company buyout, perhaps between family members. These types of loans would not be swept into the scope of the guidance.

A traditional asset-based lending portfolio; the guidance would not apply to these loans, and what we're talking about are loans that are structured that are fully policed, they have lock box, they have full cash dominion, in addition to borrowing bases. These loans would not be within the scope of the guidance unless they happen to be part of the debt structure of a leveraged borrower. For example, if you have a leveraged borrower that has asset-based loans as part of their overall capital structure, then the guidance should be applied to those loans when you're analyzing that particular borrower.

The guidance also does not apply to "fallen angels", and these would be loans that don't start out as leveraged, but they've migrated into that space due to performance issues, we would consider these risk management issues, and we would not capture those under the scope of the guidance. However, if you would refinance these loans, or modify or restructure them in some way, or make any change to the original loan agreement, then at that time, these loans would be included in the leveraged loans space if they meet the definition at that time.

Speaking of definition, I'm then going to move on to slide 8 and talk about the definition in the guidance. The guidance allows financial institutions to develop their own definition of leveraged lending that encompasses their particular leveraged lending business. What we do, or what we wrote in the guidance is actually an example of common characteristics that we've seen used to define leveraged loans, so they're really not bright lines, they're really more of an example of the definition for leveraged lending. And also these characteristics would be the starting point where we as supervisors would look when we're looking to define a leveraged loan. And these characteristics are listed on slide 8, so you would want to take a look at slide 8, and I'll go through a couple of them quickly. For example, if proceeds are used for buyouts, acquisitions for capital distributions, or if you have transactions where the borrower has a total EBITDA greater than four times or senior debt to EBITDA is greater than three times.

Another characteristic would be transactions where post financing leverage exceeds industry norms. These types of characteristics would be a starting point where we as supervisors would look to define a leveraged loan. But overall, each institution should look at their business model for leveraged loans, look at our example, and then formulate their own definition which they would then need to incorporate into their policies.

Moving on then to slide 9, I'd like to talk for a little bit about the policies, leveraged lending policies. The guidance requires that banks to have a written policy for leveraged lending. We then went on to discuss what that policy might look like. Banks need to state in their policy what their risk appetite is for this type of lending. That would be one primary characteristic that we would look for. Also, included as part of the policy should be how much they pose to underwrite and how much they pose to keep in house and how much would get flagged for distribution.

The policy should also establish a limit framework. Limits should be specified based on the nature of the particular portfolio. We discussed limits in the 2001 guidance, but the list has been expanded somewhat here. Some examples of types of limits that you would want to include in your policy are included on slide 9. You'll want to take some time and look at those.

On slide 10 are some other important elements of a leveraged lending policy. Some of these are how that policy would look at the ALLL, approval authorities around these types of loans, management oversight, and most importantly, that the policy should include standards for underwriting all types of leveraged exposures.

That's all I have to say about policy and I now want to next spend some time talking about participations, I am now on slide 11. Pretty much all of the agencies have existing guidance out there around participations. What those various policies basically say are that institutions should apply the same independent and prudent risk management standards to loans they participate in as to loans they would have originated themselves.

What we wanted to emphasize for you today is that participants should, number one, do their own underwriting of the transaction. They should obtain all executed loan documents, and they should do their own monitoring of the credit over the life of the loan. Now it's okay to accept an underwriting package from an agent bank when you're participating in a loan, but we as regulators would expect that a participant would insure, that the package was complete, also that you have a full understanding of the credit and a full understanding of all the information that's in that underwriting package, and also take the next step, and underwrite the credit to your own policy standards.

Another important thing to bring out about participants is that you should fully understand what your rights and responsibilities are under the participation agreement. That's all I had to say on participations.

I am now going to turn it over to Lou Ann Francis, who is going to discuss underwriting standards.

Okay, thanks Carmen. We're on slide 12 now, and the guidance describes underwriting policy standards that outline expectations for key items used in assessing leveraged lending transactions. This includes cash flow capacity, amortization requirements, covenant protections, collateral controls, and the underlying business premise for each transaction.

The underwriting standards should also consider whether the borrower's capital structure is sustainable, irrespective of whether the transaction is underwritten to hold or distribute. Now throughout the guidance, we emphasize that underwriting standards should be similar for all transactions, whether underwritten to hold or distribute. If a bank has poor underwriting or risk management standards, for example, if a bank is underwriting special mention or worse loans, bankers should expect examiners to criticize the bank's risk management processes for underwriting special mention or worse transactions, and this may include an MRA in the report of examination. This is the case even in situations where transactions are fully distributed. The analysis and risk grading of individual loans is important, but regulators are thoughtful of the banks' leveraged lending program as a whole, and we want to emphasize that we expect sound underwriting standards, even if a bank distributes the risk.

So as previously mentioned, underwriting standards need to be clear, written, and measurable. They need to accurately reflect the institution's risk appetite for leveraged lending. They should include the size that the institution will arrange, both in the individual transaction, and in the aggregate. These standards include the other expectations outlined on the slide 12, and these are what we would expect. I'll just briefly touch on a couple; due diligence, standards for risk adjusted return, the strategies that are going to be used to fund and dispose of positions, particularly during market disruptions, the acceptable degree of reliance on enterprise value and other intangible assets for loan repayment, acceptable valuation methodologies for these assets and procedures for evaluating sponsor support, if any, and consideration of the sponsor's financial capacity if they are viewed as a secondary source of repayment.

So now I'm moving on to slide 13, to talk a little more about underwriting standards, so they should also consider these following items: prohibition of credit agreement terms to allow for changes without lender approval, covenant protection, protections including meaningful financial performance, reporting requirements, and compliance monitoring types of covenants. There should be acceptable collateral and risk appropriate measures and controls, and standards for asset-based loans should be included when they are part of the total debt structure.

Generally, a leverage level in excess of six times total debt to EBITDA raises concerns for most industries. And I'll just quickly touch on that underwriting standards should also consider some of the other items discussed in the guidance: reputation risk, the sound business premise for the transactions, a sustainable capital structure, and the ability of the capacity of the borrower to de-lever to sustainable levels over a reasonable period, and by that we mean full amortization of senior secured debt or repayment of a significant portion of total debt over the medium term. Projections should include one or more realistic downside scenarios that emphasize key risks and use the most realistic financial projections.

Carmen, I'll turn it back to you.

Okay, thanks, Lou Ann, I'm going to pick up on slide 14 and talk about enterprise value now. The key message that we wanted to get across in regards to enterprise value is that it should be a secondary source of repayment, and bankers would need to establish procedures for formulating credible and supportable values. The guidance sets up some standards for determining enterprise value. First of all, persons who perform the valuation should be independent of the origination function in the transaction. Secondly, there are three common methods for determining enterprise value. You can use the discounted cash flow method, asset valuation or the market valuation method. The method or a combination of methods that's most appropriate for the transaction is the one that should be used.

The policies of the bank should stipulate which of the three methods it finds most acceptable for leveraged lending transactions. The policy should also establish, as part of the limit framework, the amount acceptable for transactions that are supported by enterprise value. Your policy should also define acceptable loan to values, discount rates and collateral margins when you're looking at enterprise value. Supervisors are going to look at what method was chosen, how the method was calculated, was the method used consistently, is the value credible and supportable and also to what degree enterprise value is being relied on as a source of repayment. If enterprise value is the only source of repayment in the deal, that's going to raise a red flag as Lou Ann alluded to earlier. So the take away is that enterprise value should be, first of all, credible and supportable and should also be the secondary source of repayment.

I'm then going to move on to slides 16 and 17 and talk a little bit about the pipeline. Institutions should have controls in place for managing their pipeline and should extend good risk management practices to the pipeline as well. An example of good pipeline management is to establish limits on the types and amounts of exposures that are maintained in the pipeline. Another good example of good pipeline management is having in place a clear distribution strategy. That strategy should, of course, address distribution failures, and these would be loans that are not sold down within 90 days of closing or for some reason are not sold down according to plan. An examiner would look to understand what the original distribution plan was and then how that plan was modified in light of the failure.

Bankers should also be able to quantify the potential for loss if a distribution failure does occur. The distribution strategy and the contingency plan for distribution failure should be established, according to bank policy. It should also be written down as part of the original underwriting of the loan.

Some other examples of good pipeline management include having procedures for stress testing pipeline exposures and also being able to monitor actual verses projected performance. MIS reporting guidelines, which Lou Ann is going to talk about again in a few minutes should also be applied to the pipeline exposures. Lastly, if institutions are hedging risk in the pipeline, then there should be policies and procedures outlining acceptable hedging activities.

So as mentioned, I'm now going to turn it back over to Lou Ann Francis, who is going to pick up talking about reporting and analytics.

Thanks, Carmen. We're now on slide 18. Reporting and analytics emphasizes the need for management information systems that accurately capture key risk obligor characteristics. Management should receive comprehensive reports about the characteristics and trends of their leveraged lending portfolio at least quarterly, and summaries need to be provided to the Board of Directors.

MIS also needs to be aggregated across business lines and legal entities on a timely basis and should include pipeline exposures. MIS may also include other items outlined on the slide, risk rating distribution, industry mix, maturity profile, metrics derived from probabilities of default and loss given default. Portfolio performance measures include compliance with covenants or lack thereof, restructuring, delinquencies, non-performing assets and charge-offs.

We'll move on to slide 19, to continue with reporting and analytics. There are a number of items listed on this slide, again, that would be optimal for what we would like to see for MIS reporting; impaired assets, allowance attributable to leveraged lending, policy exceptions, etc., you can read them on the slide. But I did want to emphasize that in terms of the pipeline, definitions should clearly identify the exposures that are in excess of the hold targets including committed exposures that have not been accepted by the borrower, commitments accepted but not closed and funded, and unfunded commitments that have closed but have not yet been distributed.

Total and segmented exposures should include subordinated debt and equity holdings alongside of established limits. All reports should provide a detailed and comprehensive view of global exposures, including indirect exposures, or, if the institution is holding a previously sold position as collateral or as a referenced asset in a derivative. Borrower and counter party exposures should consider exposures booked in other business units, including indirect exposures such as default swaps and total return swaps, and there is more detail in the leveraged lending guidance, so I will refer you to that.

Moving along to slide 20, I will now discuss the risk rating of leveraged loans. The guidance addresses the banks' risk rating standards which should consider a realistic repayment in order to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. So as supervisors or regulators, we commonly assume that realistic repayment is typically full repayment of senior secured debt or at least 50 percent repayment of total debt over a 5 to 7 year period.

If the projected repayment capacity is nominal, with refinancing the only viable option, the credit will usually be adversely rated even if it has recently been underwritten. Judgment should be used in evaluating the degree of repayment and the related risk ratings, and there are no bright lines for classification. Extensions and restructures should also be reviewed to insure repayment capacity problems are not being masked.

On slide 21 there is more about the risk rating of leveraged loans. For distressed borrowers where a portion of the loan may not be protected by pledged assets or a well-supported EV, the risk rating will generally reflect a more severe classification or non-accrual status. Therefore, 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 the secondary source of repayment unless that value is well supported. And when a portion of the loan is not 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 non-accrual status.

So, evidence of well supported value might include binding purchase and sale agreements with qualified third parties, or through asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions.

Slide 22 discusses the credit analysis process. An institution's policy should address the need for a comprehensive analysis, including cash flow analyses that are reasonable, verses ones that rely on overly optimistic or unsubstantiated projections or synergies. Liquidity analyses that use appropriate metrics, predictability of cash flow, operating cash needs and the ability to meet that maturity is included in that analysis. Projections should consider unanticipated merger-related costs, and should also be stress tested for one or more downside scenarios including a covenant breach and an interest rate shock, particularly in this low interest-rate environment. Transactions should be reviewed at least quarterly to determine variance from plan and assess the accuracy of risk ratings.

Slide 23 discusses that the analysis should also consider a few more items; whether enterprise valuation and collateral valuations are independently derived or validated outside of the origination function, whether they are timely, and whether they consider potential value erosion.

Collateral liquidation, and asset sale estimates should be based on current market conditions, and the analysis should insure that potential collateral shortfalls are identified and factored into the risk rating and accrual decisions, and that contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity, and that the borrower is adequately protected from interest rate and foreign exchange risk.

Slide 24 discusses problem credit management. An institution should formulate individual action plans and expectations when working with troubled borrowers. Troubled borrowers would include those with diminished operating cash flows, depreciated collateral values, unanticipated asset sales to support repayment, or other significant plan variances. Policies should stress the need for workout plans that contain quantifiable objectives and measurable time frames. And problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs. Also included in problem credit management is that an institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers.

And now I'll turn the presentation over to Tom Lyons of the FDIC.

Thank you, Lou Ann, I appreciate that. I'll be taking us through the rest of the guidance, and I'm going to start with deal sponsors on slide #25. When institutions are relying on deal sponsors to provide financial support for a particular transaction, the institution really should be able to document the extent of the sponsor's willingness and ability to support the deal. This would include developing and implementing guidelines to evaluate the qualifications of the sponsor, as well as performing ongoing monitoring of the sponsor's financial position relative to supporting the credit, should such support become necessary.

The guidance lays out several items that should be considered in evaluating a sponsor's support for a transaction. In short, these include the sponsor's historical support for other deals, their economic incentive to support that deal, including nature and amount of capital invested, the degree of support for this deal (such as guarantee), a comfort letter or verbal assurance (that is, how that support is documented), contractual limitations, financial analysis of the sponsor, capital contribution practices, the likely support given the sponsor's commitments to other deals, and guidelines to evaluate and monitor that sponsor. Institutions may consider a sponsor's support in determining a credit's risk rating when it can document the sponsor's history of support, as well as its economic incentive, capacity and stated intent to continue to support the transaction.

I'm going to move on to the next slide, which is credit review on slide 26. Here, the guidance lays out supervisory expectations for a strong and independent credit review function. Independence here is crucial, as credit review staff need the ability to bring significant issues and concerns to senior management's attention in a timely manner and without the appearance of any filtering or interference. Due to the elevated risks inherent in leveraged lending, a credit review function should assess portfolio performance more frequently than other segments of the portfolio. For the same reasons, the depth of the portfolio review penetration should be deeper than that for other lending areas.

While portfolio reviews should generally be conducted at least annually, more frequent reviews should be considered when heightened risk factors exist in the portfolio, such as a high reliance on enterprise values, credit concentrations, or adverse risk rating or performance trends. Also, the credit review function should be provided with sufficient resources to insure well qualified personnel, with appropriate expertise and experience, can complete timely, independent and accurate assessments of the institution's leveraged lending activity.

On slide 27, we're going to talk some about stress testing and what the guidance has in store for that. The slide is relatively self-explanatory and walks through the guidance expectations for stress testing a leveraged loan portfolio. Note that the guidance also lays out expectations for individual loan stress testing in other sections of the guidance, including those on valuation standards, pipeline management, and credit analysis. We covered those a few minutes ago.

Guidelines should be developed to address periodic portfolio stress testing of all originated leveraged loans regardless of whether they are to be held in portfolio or to be distributed. This should include sensitivity analysis to estimate the potential impact on the institution's financial condition for various changes in economic and market conditions. Particular attention should be placed on the effects on asset quality, earnings, liquidity and capital. Additionally, where enterprise wide stress testing is being performed, leveraged lending should be included in that process.

Now stress testing practices should be commensurate with the size and complexity of the institution's activity and should reflect consideration of the banking agency's guidance specific to stress testing and referenced in footnote #12 of the leveraged lending guidance. Those issuances get into broader stress testing expectations beyond those discussed today for leveraged lending. So please pay attention to those particular issuances on that footnote #12.

On slide 28 we're going to talk a little bit about conflicts of interests. Instances may arise where an institution has both equity and lending interests in a particular deal. These situations increase the potential for conflict of interest between the institution and the customer. The guidance contains several examples of instances that could potentially cause a conflict, such as when an underwriting institution also serves as advisor to the seller, while simultaneously offering financing to multiple buyers.

To address these situations, the institution should develop and implement appropriate policies and procedures that provide its employees with clear guidance on how to avoid conflicts of interest. In short, it should define potential conflicts of interest, identify appropriate controls, enable employees to report incidents without fear of retribution and insure compliance with applicable laws. Also, management should insure that applicable employees receive appropriate conflict of interest training and that a process is established to track and resolve reported conflicts of interest.

I'm going to move next on to slide 29, reputational risk. The guidance addresses potential risks to an institution's reputation that arise from underwriting and distributing leveraged lending transactions, particularly when problems arise. An institution engaged in this business should carefully consider these reputational risks and insure appropriate controls. The leveraged lending market is a relatively small world where even the appearance of an institution not meeting its legal responsibilities could adversely impact its ability to compete in this market. Likewise, if transactions an institution originates and distribute have a poor performance record, such as high default rates, the institution's reputation may become damaged, and its ability to distribute future deals may be impaired. So please pay very close attention to your reputational risk if you're going to be engaged in this activity.

On slide 30, we're going to talk a little bit about compliance. Leveraged transactions often raise numerous and complex regulatory and legal issues that require careful attention to ensure compliance with related laws and regulations. To mitigate the compliance risk, an institution should maintain an independent and periodic compliance review to insure compliance with applicable laws and regulations.

Due to the nature of leveraged lending and a variety of debt and banking products that can be involved in a transaction, the institution should insure it maintains safeguards to prevent violation of anti-tying laws and regulations, such as those contained in section 106b of the Bank Holding Company Act Amendments of 1970. Various federal securities laws may also need to be considered, as equity interests and some debt instruments may be considered as securities.

Lastly, policies and procedures should address the dissemination of material, non-public information about these transactions, to ensure information is only accessed by those with a need to review the information.

With that, that concludes our presentation on the guidance itself and I will send it back now to Eric for the next part of our discussion today.

Alright, Tom. Excellent, thank you very much. Nice job, guys. So we called this session "Ask the Regulators" so let's take some questions. We've got a bunch of questions here. I'll give you guys just a heads up. We have received a lot of great questions. We're getting more in even as I speak here so we're going to try to fit in as many as time allows.

But with that, I'll remind you as seen on slide 31, there's two ways to submit questions. And again, anything we don't get to today, your primary regulator will respond to you in the next couple of weeks or obviously you can always reach out to your primary regulator. So Grant and Brian, I'm going to turn this over to you guys to lead us to the Q & A.

Well thank you, Eric. And I want to reiterate your comment and thank the presenters, Lou Ann, Carmen, Tom and Rob. I think that was a very, very comprehensive overview of the guidance. And as Eric alluded to, we received, since we've issued the guidance, we've received a number of questions from the institution. We also received questions that have come in as we announce the preparation for this call, and others have come in today. And we actually want to start with one that came in today, as kind of a base. We get this question occasionally from the industry and it's always good to reiterate our thoughts on this.

And Rob Cote, I'll direct this to you. The question is how does our guidance differ from regulation? And this particular question, you're asked if there's a comment period for this?

Well, guidance doesn't carry the same weight as a violation of law, but it does establish safety and soundness practices regulators feel are important. And also, this guidance was already exposed to a comment period.

Okay thanks, Rob. I think that it is always good to reiterate the difference between those two things. I'm going to ask you another question as well. We've received a lot of questions and feedback from the industry regarding the compliance date which we've stated as being May 21st so, this has been in effect for about a month. So, what do we mean Rob, when we talk about compliance? What are we expecting the banks to be doing or have done at this point? Could you expand on that a little bit?

Sure. The May 21st date represents the date that supervisors expect institutions to have a plan in place on how they will comply with the Leverage Lending Guidance. This means that they ought to be making meaningful progress towards adopting policies and procedures, towards implementing the guidance. Further, institutions will need to be able to discuss the plans that they have and demonstrate significant progress and actually implementing the guidance during the next supervisory activity.

So, the agencies are clearly aware as we mentioned earlier that significant changes may be required to MIS systems in particular to implement the guidance. For those institutions, we would want to understand how far along they are in the process of maybe identifying systems that should be upgraded and time tables for completing their system enhancements.

We'd also – I'll sort of finish the response by saying, we also would expect that greater progress towards implementation is sort of expected from those institutions that are actively engaged in leveraged lending versus those whose involvement is just minimal.

Thank you, Rob. That was a good answer. We have received questions on the Leverage Lending Guidance and its relation to the FDIC's final rule on assessments, dividends, assessment based and large bank pricing that was issued October 31st, 2012. So Tom, can you clarify the difference between and the relationship to the assessment rule and the leveraged lending guidance for us?

Sure Grant, thank you for that. We have been getting a lot of questions on the differences between the FDIC's final rule and the leveraged lending guidance. It's important to point out that the FDIC's deposit insurance assessment rule and the leveraged lending guidance address different regulatory issues. The FDIC's Rule is used in determining deposit insurance assessment rates for large and highly complex institutions.

The interagency leveraged lending guidance focuses on high level principles related to safe and sound leveraged lending activities and importantly, supervisory expectations for risk management processes and practices covering leveraged lending. Some of the questions surrounded whether the definition of a high risk, commercial and industrial loan, a C&I loan, contained in the FDIC's rule, is consistent with the definition of provisions of the leveraged lending guidance.

Institutions should establish a definition of leveraged lending that makes sense for the institution's activities and which considers those elements discussed within the guidance. Whether the C&I loan definition contained in the FDIC's Rule may be appropriate, will depend on the particular circumstances of the institution. Now, Institutions are encouraged to discuss questions about their own specific and particular circumstances with their examiners. But the point, the main point that we really need to get across for everybody to understand, is that the FDIC's Assessment Rule is for a separate purpose than the leveraged lending guidance, so there's two different purposes.

Thanks for that clarity, Tom. That's helpful.

The next question I'm going to direct at Lou Ann, and it has to do with what the guidance applies to. We've gotten a number of questions about applicability, scope. We talked about loans, bonds, both, structured transactions such as CLOs, asset backed securities, the whole kind of gamut of financial instruments out there, including asset backed securities, capital commitment lines, repos and other instruments. Lou Ann, what really is in the scope of this guidance regarding transactions?

Well thanks, Brian. This guidance covers leveraged loans and leveraged lending activities and it does not cover securities, including asset backed securities or repos. For structured transactions such as CLOs when the institution is an investor, or for a capital commitment line where repayment is dependent upon a capital call from an investor in the fund and not reliant on cash flow from the underlying assets, again, the guidance would not apply.

However, the guidance would apply to CLOs at a bank that is funding with debt, as well as BDCs or business development companies that are publically traded, private equity companies. For asset-based loans, as we've mentioned a number of times throughout this presentation; they are not included unless they are part of the entire debt structure of the obligor. The reference is to ABL lending that is a distinct segment of the market, and Carmen talked about that; tightly controlled, fully followed, secured by specific assets, governed by a borrowing base, cash dominion, lockbox, etc.

Okay. Thank you, Lou Ann.

Rob, we've received numerous questions regarding the definition of whether certain types of loans or assets would be considered leveraged for purposes of the guidance. I'm going to start with a couple of these items and I'll come back later as time permits for some of the others that we've received questions on. So to start with, are loans held in the trading book considered covered by the guidance?

Yes, Grant, they are included. Our expectation is that MIS should be able to capture all exposures to leveraged loans, regardless of the business line or legal entity.

Okay, now I have kind of a multi-part question for you. The guidance definition says that proceeds used for buyouts, acquisitions, or capital distributions, does that mean that the guidance applies for only those purposes but not otherwise? Or can the definition look for all the criteria to be present, purpose, leverage, and industry tests? And does acquisition as used in the guidance definition, mean a whole company, division or also to include asset purchases?

Well, there's not one standard definition of leverage lending used in the industry. And we're not providing one here in this guidance. Instead, the guidance lays out the types of characteristics we typically would find when looking at leveraged loans. And as we've said, each institution must define its leverage lending that's appropriate to their institution, and the definition may contain, some combination of the characteristics we described in the guidance; total and senior debt multiples, the purpose of loan proceeds, that sort of thing. Generally any or more of the criteria are enough to properly identify a leverage loan. It doesn't need to contain all of them in order to be covered.

Okay, thanks. In relation to the last item I discussed, does acquisition as used in the guidance definition meaning a whole company, division or, also to include asset purchases?

Well, we were, thinking in terms of an LBO. I mean usually that would mean the acquisition of a whole division or an entire company. Not sure exactly what kind of other asset purchasers that the question may be asking or referring to. But, the guidance also speaks to any sort of leverage that is significantly increased as opposed to, or as a process of refinancing or if the leverage amount is significantly higher than industry averages. All of these things sort of constitute a leverage loan.

Thanks, Rob. Let's switch to talking about enterprise values for a minute. We've received some questions recently and in fact, one very similar question came in today regarding enterprise value -Tom, I'll direct this at you. The question they're specifically asking, how can an institution achieve an independent review of enterprise value? What do we mean by that? Does that have to be performed by a person outside of the origination function and what about for the smaller banks or banks where there may not be enough volume for like a fully separate enterprise evaluation unit?

Well thanks, Brian. I think it's all about independence for reviewing these EVs. Individuals tasked with providing an independent review of the EVs or the enterprise valuation should have the expertise and experience appropriate for the complexity of the evaluation to be reviewed. The reviewer's independence from the leveraged loan origination and approval process should be well documented. Institutions with limited resources have been able to achieve this independence in a variety of ways, including use of qualified directors and senior officers, individuals from other business lines or affiliates or third parties.

For independence, and I think this is critical, the reviewer should not have any involvement or interest in the transaction or development of the evaluation tool that's being used here, for the evaluation. The EV assumptions should be clearly documented, well supported and well understood by the lending decision makers in risk oversight.

So, a follow up for you, Tom –when we talk about appraisals, we suggest the banks be updating these periodically as conditions changed. So with respect to enterprise value and updating enterprise values. So are we saying this should be completed annually, perhaps when the credit is downgraded, when conditions change, do you have any thoughts there?

Sure. First off, institutions that put some reliance on the enterprise values, or the EV, in the origination process, should perform a stress analysis on those EVs and their assumptions at origination and periodically thereafter. That said, the establishment of policies and practices relative to updating these evaluations is an appropriate credit monitoring practice that should consider various factors, including a degree of reliance on that evaluation, the borrower performance, and changes in economic conditions.

A determination on when to update will likely depend on the level of risk in the credit. Annually would seem reasonable as a general starting guideline. But certainly, if a borrower is experiencing adverse financial or market conditions, the lender should update those key assumptions to reflect those adverse conditions when assessing their enterprise evaluation as a potential source repayment.

Alright, thank you, Tom. We have a question that relates to the risk rating session of the guidance. Lou Ann, I'll address this one to you. If a loan structure includes a guarantee from a guarantor who demonstrates the willingness and capacity to support the transaction, will this be considered in the calculation of the leveraged ratio?

Thanks, Grant. We tend to view guarantor support as a secondary source of repayment. It's not a primary source of repayment as is cash flow from operations or cash flow from the business performance. The EBITDA used for the leverage calculation is expected to capture a proxy free cash flow from the borrower, but it should not include cash flow from the guarantor. Guarantor support as a secondary source of repayment should be considered in the determination of the borrower's risk rating, however, and may be cause for strengthening of the risk rating, but again, the guarantor is a secondary source of repayment.

Thanks, Lou Ann. I'm going to throw this back to Rob, and let's talk a little bit about small C&I loans. We've received a number of questions recently and again, another one, a very similar one came in today. So Rob, are small C&I loans within the scope of the guidance, can the banks use a de minimus amount of loan to scope out loans from the guidance, can there be materiality tests similar to the incremental debt being 20% of the existing debt, can you give us some clarity around that?

Sure. Well, while a smaller community and midsize bank portfolio loans originated by these institutions are not specifically excluded from the scope of the guidance, the leveraged lending activity that we were targeting by the guidance, are usually much larger credits. It's incumbent on each institution to define a leverage transaction that's appropriate to their institution and risk profile. With respect to de minimus amount, while the guidance doesn't address any sort of de minimus amount, below which loans wouldn't need to be considered as leverage, it's conceivable that some institutions might determine that they want to have some sort of a cut off, maybe. Below which, they use a more simplistic method for determining whether a transaction is a leverage lending transaction. It's important though that they would need to ensure that the established leverage loan definition is appropriate for the size and complexity of the institution and lending activity as we've been saying throughout this presentation, really.

Any institution considering a cut off would need to periodically review these criteria and also want to make sure that they are appropriately capturing institutions' leveraged transactions. As far as a materiality test, the answer would be similar to what I just said about there being de minimus amount, unless the question is referring to something else, such as FDIC's rule requirements.

Thanks, Rob. On a related matter, we've received recently a lot of questions about specific types of loans. Are there any specific types of loans excluded from the definition of leveraged loans? Examples include energy loans, sports lending, lending the utilities, real estate reaps, floor plan loans, that kind of thing - could you talk a little bit about that?

Sure. You know, the guidance is fundamentally about loans and about how leveraged the borrower is, due to the fact that they have substantial outstanding loans, regardless of the specific type of loan. Typically repayment as Lou Ann was just mentioning, comes from cash flow from operations, with a secondary source of repayment being enterprise evaluation or company assets. We did not intend to have any groups of loans, specifically excluded by the guidance except for the ABLs that are part of the entire debt structure of a leveraged obligor. We also excluded "fallen angels", but only up until the time that they're modified, extended, or refinanced.

An institution ought to be able to define their lending, leverage lending and material in a manner, that's sufficiently detailed to ensure consistent applications across all business lines, and industries that are traditionally highly leveraged may be included in the guidance by their nature. But a bank may already manage them under a policy specific to that industry so, for example, if an industry or an institution wants to make a case that real estate loans and REITS should be specifically scoped out, based on their reliance or repayments on these operations, part collateral and that part collateral is available as a secondary source of repayment, the institution should capture that definition in their policies, and then of course there should be back testing to ensure that true leveraged credits aren't being excluded from the necessary risk management monitoring.

Thanks, Rob. Alright Grant, you may have a question for Tom.

Tom, is the stress testing performed with respect to the c-car and d-fast sufficient to meet the requirements of this guidance?

Thanks, Grant. This is an excellent question. Let me get into this a little bit. The guidance lays out the agency's expectations for the periodic stress testing of leveraged loans portfolios included performance of sensitivity analysis and I went through that just a few moments ago. In short, stress testing activities should be commensurate with the size and complexity of the portfolio and the institution's risk profiles. Enterprise wide stress testing practices such as for c-car and d-fast purposes, could suffice to meet the guidance's expectations when the institution appropriately incorporates the leverage lending into that process. So as long as the Leverage Lending is included in there, you know, that could suffice. Regardless of the chosen stress testing methods, all institutions should ensure that they're stress testing systems and related assumptions as appropriate for their respected portfolios.

Thanks, Tom.

Lou Ann, we've received a number of questions about when we refer to repayment capacity and the term, nominal. What do we mean when we talk about nominal repayment capacity in the statement? And, what are your thoughts about that? Can you provide some more definition around what we're talking about?

Sure, Brian. In the guidance, it states that if projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it's been recently underwritten. So from our view, nominal means that the level of cash flow is one that would have the borrower unable to de-lever from their typical operating cash flow ability and that they must refinance. They have no alternative. The refinance would likely then be at a higher interest rate than for similar transactions of better quality and the higher interest costs would further negatively impact future cash flows.

As an example, if the borrower is unable to pay 50 percent of total or 100 percent of senior debt in 5 to 7 years, examiners will consider an adverse criticism for the credit. There's no minimum threshold established for a mandatory criticism and the nominal guideline will be subject to examiner judgment, but banks should also establish internal amortization thresholds and relate them to their internal risk rating systems so that credits are appropriately graded and managed.

Thank you for going on with that, Lou Ann. What is meant by the term, “related exposures” as used in the guidance?

In the reporting and analytics section, we described the deals introduced by sponsors that may in some cases be considered exposures to related borrowers. An institution should identify, aggregate and monitor potential related exposures. And for this purpose, related exposures include exposures to different borrowers that have common equity sponsors when the equity sponsors are being relied upon as the secondary source of repayment for the leveraged loans.

In addition, the related exposures language also comes up in the context of guarantors or sponsor support. If this kind of support is to be relied upon to mitigate examiner criticism of a cash flow weak borrower, then the institution relying on sponsors or guarantees should be able to assess whether the sponsor or guarantor has the financial capacity and willingness to step in. This can be complicated by the fact that a sponsor or guarantor may have many obligations, not just the one in question.

Thanks, Lou Ann. Let’s talk about de-levering a little bit. If borrowers de-lever to levels below four times total debt to EBITDA, should they still be considered as and classified as leveraged?

Well, the leverage threshold of four times is not the only criteria for measuring a leveraged borrower and we’ve noted that throughout the guidance and throughout this presentation. Still, we expect institutions to monitor their leveraged portfolio, and at the point of any modification, renewal, or restructure, reevaluate whether the borrower’s debt level would still meet the institution’s internal definition of leveraged.

We outline in the guidance the four times leverage should cause an institution to be looking more thoroughly at that loan from a risk payment capacity, just because their financial flexibility is becoming more strained. But again, there’s no specific definition or criteria for measuring the leveraged borrower and it is up to each institution to determine their own definition of leveraging, of leverage.

Thank you, Lou Ann.

Tom, what are the implications that guidance from a regulatory reporting standpoint, will the call report be affected by anything in this guidance?

Very good question, Grant. At this time, we don’t anticipate any changes to the call report instructions based on the leverage lending guidance that we’re discussing today. However, I do want to point out that since June of 2011, large and highly complex institutions which generally are institutions with 10 billion dollars or more in total assets, have been required to report and call report schedule RC-O, the amount of their “leveraged loans”, and I’d put quotations around that, as defined by the FDIC’s rule for deposit insurance assessments. That would be appendix C to subpart A of Part 327 of the FDIC’s rules and regs of the deposit insurance assessment rule.

As schedule RC-O data is used for deposit insurance assessment purposes. Amendments to the FDIC’s deposit insurance assessment regs that took effect on April 1st, have changed some of the definitions used in the large bank deposit insurance pricing model, and these amendments replace the term “leveraged loans” with “higher risk commercial and industrial loans” and this change for large and highly complex institutions will be reflected in the call report schedule RC-O for June of 2013. Again, higher risk C&I loans as defined by the FDIC's deposit insurance regulations include certain leveraged loans.

Thanks, Tom.

Let's talk about accounting issues a little bit here. Lou Ann, will the banks need to make any modifications to their processes for developing estimates for loan loss reserves in light of this guidance?

Well Brian, institutions need to consider and evaluate these loans similar to the way they look at other loans in making any allowance determination. They are subject to the same accounting and regulatory guidance, and if they become distressed, they would need closer monitoring and consideration from an allowance perspective. The leveraged lending guidance itself doesn't require a specific type of analysis, particularly since these loans span across many loan types and categories. But again, the accounting rules still apply, impaired loans would be subject to individual review, and other loans would be pulled and looked at from a risk perspective in determining the provision amount.

Thank you, L0u Ann.

Now Tom, is there a threshold for community banks, say under $200 million in assets that would be required to comply with the guidance leverage lending?

Thanks, Grant. The number of community banks with substantial involvement in leverage lending is small. Therefore, the agencies generally expect community banks to be largely unaffected by this guidance so we tried to relay that within the preamble to the guidance and as well as in our communications. However, to the extent that they are involved, we do expect them to implement risk management controls and processes that are appropriate for the level and complexity of their involvement. It's our understanding that such involvement is more likely to be in the form of participations purchased, and therefore, these community banks really need to pay particular attention to the participation aspects of the guidance and I think we talked on that quite a bit earlier in our discussion and I think they should really focus in that area.

Somewhat of a follow up to that question, say a community bank occasionally purchases participations and leverage deals, would we expect them to independently determine enterprise value and how sophisticated would you expect the community bank to be in relation to that aspect of it?

Another good question. Any institution that purchases a participation in a leveraged transaction should perform an independent review of the documentation to ensure they fully understand the deal. I think that's important, the full understanding. Where enterprise value is relied upon in the underwriting process, even as a secondary source of repayment, the bank should ensure it obtains an independent and credible EV. This can be done internally if the institution has the appropriate expertise, or obtained from a qualified third party.

In some cases, we've seen where participants share the cost of obtaining an evaluation from a well-qualified vendor and then share that evaluation amongst themselves. This could be a cost efficient way for community banks to ensure they receive an appropriately prepared independent EV for the transaction.

Okay. Thank you. Thank you very much. And one last question for you, are government guaranteed SBA loans covered by guidance or are they exempt in any way?

Somehow I don't think this is going to be the last question for me. [Laughter]

The leveraged lending guidance does not provide an explicit exemption for any particular loan program or lending type, outside of what we talked about earlier on asset based lending. That said, each institution should establish its own definition for leverage lending that makes sense for the institution's activity.

As we indicated earlier in the presentation, the guidance was aimed at larger credit facilities, and was really not intended for smaller credits to be captured, such as many of those with SBA guarantees. Still, as with any loan, examiners will expect institutions to implement appropriate risk management practices for any of its lending activity, whether they be leveraged borrowers or not.

Thanks, Tom.

Rob, I want to turn to you. And, a question came in today on pipeline management. Let the callers know so, what do we mean when we talk about a pipeline? What is a pipeline? What do we expect around the management of that pipeline?

Well by pipeline, we're talking about deals that were booked including commitments to be distributed to others. So, these should account for or capture all of the amount of the exposure.

Okay. So, pipelines typically relate to syndicated loans that are held for sale. So, are all syndicated loans considered leveraged loans?

No, not all syndicated loans are leveraged loans. You know, based on some of the preliminary analysis that we've done, we believe that leveraged loans make up about 20 percent of the syndicated loans captured with the Shared National Credit Program, although they account for roughly three quarters of all criticized assets in the program.

Very interesting. So follow up to that, let's get into the SNC exam. I think we just finalized our onsite portion of that exam. Do you or Lou Ann have any observations or findings from this year's SNC exam that might pertain to leveraged lending, in particular?

Well, I think the SNC exam only finished Friday of last week, so it's probably a little early to talk about specific observations or findings. One of the things that we did do in this year's SNC process as part of the first day letter, we asked banks to self-identify which loans they believe are leveraged loans, and supervisors will make comparisons in the coming weeks with what examiners will need for leveraged loans and see if any gaps exist. And this analysis of course should help us in scoping out future examination work with respect to compliance with the guidance, as well as help point to any changes we could make in next year's exam.

Lou Ann, do you have anything further you might want to add?

Well Rob, the only thing I want to say is that we continue to be keenly aware of leveraged lending risks systemically both within the banking system and those that are distributed outside of the banking system and we've emphasized this over and over. Just because they're distributed outside of our regulated institutions, they are still in the system and that's a concern I would say that we want to be sure we fully understand (this risk) and don't dismiss it just because our banks are able to distribute it.

So one other thought that really isn't quite leveraged lending per se but it is more SNC related, the exam wrapped up as I said last Friday, the results are actually expected to go out to banks tomorrow. That's all I have.

This question can go to Lou Ann or Rob. What is meant by covenant-lite transactions and what is the regulatory view of these transactions as it relates to leveraged lending, particularly?

As we stated to the preamble to the guidance, covenant-lite and PIK toggle structures may have a place in the leveraged lending product set, however, we do recognize the additional risk in these structures.

And from a supervisory perspective, we're going to closely review those types of loans as part of the overall credit evaluation, particularly when we assess transaction structure. So again, although we are saying that we understand covenant lite loans are out there, we certainly aren't endorsing them from any sort of underwriting perspective.

And after quite a bit of discussion amongst the agencies, I think we ended up pretty close to what our current practices are. Cov-Lite and PIK toggle can be misused to mask borrower performance, and examiners are trained to evaluate these structures. So if the borrower missed its sale targets and their margins are shrinking and PIK was used to counteract the cash burn, this is not good for the bank. Deferred interest payments from this sort of PIK use would put a bank in a weaker position with respect to protecting against future losses from the borrower.

So, while PIK toggle exists, and it certainly ties with the ability and not so much the obligation to pay, examiners will look closely at such structures and will scrutinize their use.

Thanks, Rob and Lou Ann. So we have about seven or eight minutes left, we have a few more questions here. One of the first ones I wanted to ask though is about participations purchased in that section of the guidance: how supervisors' expectations change with respects to banks purchasing syndicated loans or leveraged credits. Rob, could you provide some clarity on that?

Well, what I would say first is that the language in the 2013 guidance is essentially identical to that of the 2001 version with respect to participations purchased. But in retaining the original language, we're also renewing our commitment to make sure it's adhered to.

The primary take away as Carmen laid out and the presentation boiled down to do your own underwriting and due diligence, get copies of all legal documentation and monitor the credit for the life of the exposure. The smaller banks need to bear in mind that the agent bank that they bought the deal from may not still be in the deal when the borrower experiences financial difficulties. Agents buy and sell their positions in the normal part of risk management of their business. And the bigger the deal, the more likely it is to occur. It's very important that we remind smaller banks that their interest and that of the agent bank they bought the deal from, may not align at precisely the time they most need it to. That's why they should underwrite and treat a purchased participation no differently than they would any other C&I borrower attempt that they would lend to directly.

And I'd just like to add just one thing onto that Rob, if I may, and that is the things that you're talking about there are very important to understand, what your rights and responsibilities are under the participation agreements so those smaller banks really pay attention to the legal language within there that that could come into play.

Very good, thank you.

We had a very good question come in that we want to make sure that we address, because I think this would be of interest to all of the financial institutions listening in today. And the question is how will the three agencies ensure consistent application of these guidelines and make sure all arrangers are being evaluated on the same basis? Lou Ann, can you tackle that one?

Sure, Grant. Well, I can personally tell you that we worked awfully hard to write this guidance from an interagency perspective and therefore, we wanted the guidance to apply to all of our regulated institutions because we thought it was very important from a competitive and regulatory standpoint to have consistent guidance. Then, I would say we're having this joint regulatory call and that's another way we're trying to make sure that we have everybody hearing the same message, provided by all of us, different regulators, so that we are clear in terms of defining what our expectations are for having good leveraged lending activities.

I want to mention also the Shared National Credit Program and that's another interagency program. In fact, I think Rob mentioned we evaluate many or most large leverage deals in that interagency process where we have at least two if not three individual regulators evaluating the risk rating on a particular credit.

All of these items were discussed during our (SNC) training that we held for our examiners, that we had with FED, FDIC and OCC examiners. And it was most specifically geared towards leveraged lending and identifying the key risk rating items that we look for when we're assessing leveraged lending and our training focused on having a consistent roadmap for how you would evaluate those individual risk-rating drivers and then coming to an overall conclusion. So, I can actually say I feel pretty comfortable that the leverage lending loans that were looked at under the Shared Credit program were evaluated pretty consistently and not withstanding that, we did have a quality assurance program further ensure consistency when we were looking at these risk-rating definitions.

And I would add on to that also and say the way we've been treating questions that are coming in from the bankers, we've really made it a point to give careful consideration to questions that have come in. Some of you may have even contacted some of the people in this room with questions. And we are looking at the questions from an interagency standpoint and trying to formulate our answers as a team. We do discuss them between ourselves to confirm that we are putting a consistent message out back to the bankers.

One other thing I did want to add, we have some joint examinations planned using examiners from the agencies to conduct these exams at different institutions. Again, it's all about consistency. We're very focused on that because we want to make sure that our banks and institutions are treated consistently as well as that our examiners are performing their evaluations consistently.

That's right, I mean the guidance was underwritten on an interagency basis, and it's being presented here as such, interagency. The SNC exam is an exam where we will turn over a lot of these credits and review all of these files again. Interagency, we all share the same view with respect to how we want to carry it out. They've centralized a lot of detail on that.

So we have one more question that's left that we're going to ask and a very important question, I won't say it's the most important question but it is a very important question and I'll throw it out to the team. So, in what publication can the industry and other people interested find the guidance? Where can they find that?

Well on the OCC's website, we have a link to it. If you go into the OCC's homepage and type 'leverage lending', you'd be able to pull it up right away.

I think all of the agencies have that. We have it on the Board's public website as well.

And the FDIC you know, has it as a link on the financial institution letter that went out. And you can also find it in the federal register notice. So, you'll see it if you go in there. You can read it directly from there.

Very good, very good. So, thanks everybody. Eric, we're at 2:00 so I will throw it on back to you.

Alright, Brian, everybody, thank you very much. Let me just offer a couple things guys and then we're going to wrap up here. First of all, thanks to all of you for joining us. A very, very special thanks to Tom, Rob, Carmen, Lou Ann for all of their work, preparing for and leading today's session. As you guys might imagine, these guys have very, very busy day jobs and they found time to put some materials together and we certainly appreciate it.

A huge thanks to Grant and Brian for humming along. We appreciate that, guys.

Keep an eye out for the survey. Again, it should take you about a minute to complete. It's very short but we really do want to know your thoughts on today's session, especially if you like this 'ask the regulators' concept. This seemed to work pretty well so hopefully we can do it again.

And just a reminder, the session is eligible for continuing education units or CEUs. All you need to do is just make sure that you're registered for today's session and then complete that very last section of the survey. It's pretty easy. We did get some questions from folks asking if today's call is being recorded. It is. And all of the regulators will have that audio recording, so very soon you can go to the FDIC, the OCC's website and grab that and obviously it's on the Ask the FED website as well.

Finally, Ask the Regulators is intended only for informational purposes, these are not formal opinions of, nor binding on the Federal Reserve System, the FDIC or the OCC. So thank you all very, very much for joining us. Have a great day.