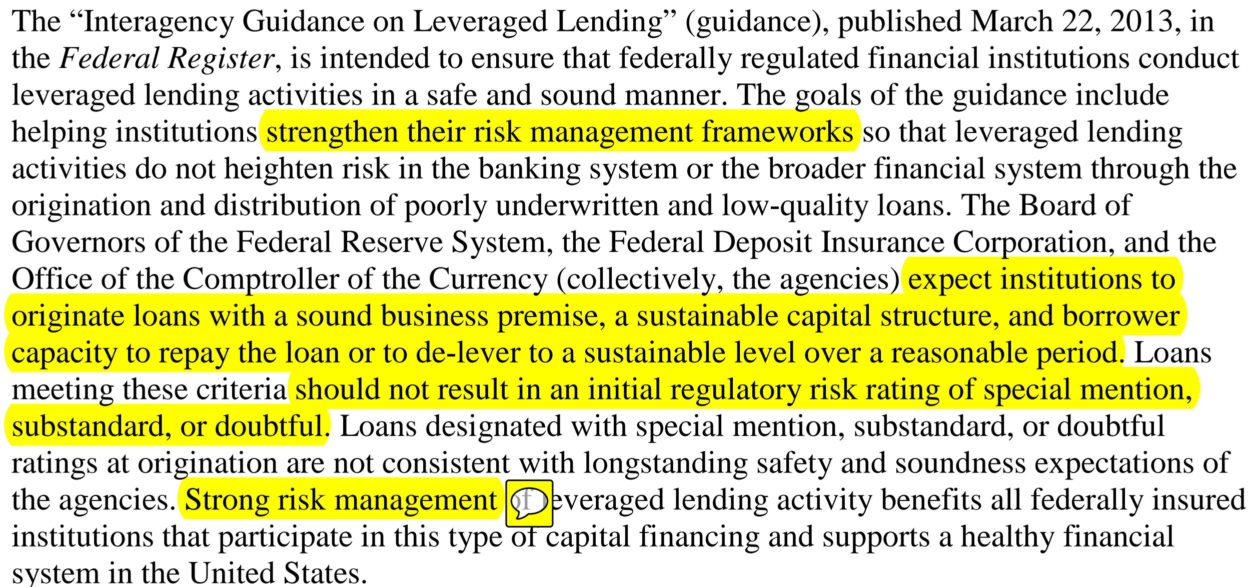
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending

November 7, 2014



The "Interagency Guidance on Leveraged Lending" (guidance), published March 22, 2013, in the *Federal Register*, is intended to ensure that federally regulated financial institutions conduct leveraged lending activities in a safe and sound manner. The goals of the guidance include helping institutions strengthen their risk management frameworks so that leveraged lending activities do not heighten risk in the banking system or the broader financial system through the origination and distribution of poorly underwritten and low-quality loans. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the agencies) expect institutions to originate loans with a sound business premise, a sustainable capital structure, and borrower capacity to repay the loan or to de-lever to a sustainable level over a reasonable period. Loans meeting these criteria should not result in an initial regulatory risk rating of special mention, substandard, or doubtful. Loans designated with special mention, substandard, or doubtful ratings at origination are not consistent with longstanding safety and soundness expectations of the agencies. Strong risk management of leveraged lending activity benefits all federally insured institutions that participate in this type of capital financing and supports a healthy financial system in the United States.

Since the publication of the March 2013 guidance,[1] the agencies have received and addressed many questions relating to how the agencies are interpreting and implementing the guidance. The agencies' answers to the following questions are designed to foster industry and examiner understanding of the guidance and supervisory expectations for safe and sound underwriting and to promote consistent application of the guidance.

Q1. How should an institution consider the four common characteristics outlined in the guidance when defining leveraged loans for the institution?

Institutions should use the characteristics outlined in the guidance as a starting point for developing an institution-specific definition of leveraged loans, which should take into account the institution's individual risk management framework and risk appetite. Loans identified as leveraged in the debt markets have all or many characteristics in common with the leveraged loan characteristics listed in the guidance. Therefore, at a minimum, an institution's definition should include borrower characteristics that are recognized in the debt markets as leveraged for each industry to which the institution lends.

[1] 78 Fed. Reg. 17766 (March 22, 2013).

Q2. Is it acceptable for an institution to articulate a leveraged loan definition that requires a loan to meet a "purpose test" (for example, buyout, acquisition, or capital distribution) in addition to other criteria?

No. The supervisory expectation is that institutions establish sound underwriting and risk management processes for a broad range of credits to leveraged borrowers. Management should consider each of the common characteristics discussed in the guidance individually to identify leveraged loans for the institution's definition. Excluding loans from the leveraged lending category solely because they do not meet a purpose test is inconsistent with a comprehensive risk management framework for leveraged lending.

Q3. Are all loans that meet any one common characteristic, such as exceeding 3 times senior debt or 4 times total debt divided by earnings before interest, taxes, depreciation, and amortization (EBITDA), automatically considered leveraged?

No. Leverage is an important indicator, but it should be considered in relation to other loan characteristics. It is generally appropriate to exclude certain loans secured by tangible collateral (for example, accounts receivable, inventory, property, plant and equipment, and real estate) that do not rely on enterprise valuations for repayment, even where leverage exceeds 3 times senior debt or 4 times total debt divided by EBITDA, because the lender has additional sources of repayment beyond the cash flow from the operations of the borrower. Accordingly, the agencies would not expect most loans secured by commercial real estate and small business loans to be included in an institution's definition of a leveraged loan. Many of the risk management principles in the guidance for leveraged lending also apply to these loans, and management should have underwriting, monitoring, structure, and repayment expectations for these credits that reflect the characteristics of the collateral and the unique risks of these loans.

Leverage multiples should be calculated at origination based on committed debt, including additional debt that the loan agreement may permit. Examiners will criticize situations in which EBITDA is defined in loan documents in ways that allow enhancements to EBITDA without reasonable support.

Q4. How should institutions determine if they may exclude asset-based loans (ABL) from their definition of leveraged loans?

The ABL exclusion in the guidance is meant to allow exclusion of ABL facilities when they are the dominant source of ongoing funding for a borrower. In these cases, term debt outside of the ABL facility is usually limited or is secured by tangible collateral, such as real estate, machinery, or equipment. ABLs that are part of a larger debt structure of a company should not be excluded from the leveraged definition (even if they are the only tranche of the debt structure an institution holds) and should be captured within the institution's leveraged lending risk management framework. Similarly, loans referred to as ABLs that lack evidence of the full monitoring typically associated with asset-based financing (such as borrowing base advances, field audits, and enhanced reporting

requirements) should also be captured within the leveraged lending and risk management framework.

Generally, an enterprise valuation analysis is not necessary if the ABL tranche is the only tranche that an institution holds and the ABL is subject to the full monitoring typically associated with ABLs. In these instances, the agencies expect repayment analyses based primarily on conversion of the related working capital assets to cash and an understanding of the overall cash flow of the borrower.

Q5. How have the agencies viewed institutions that originate loans with a non-pass risk rating (special mention or worse)?

The agencies have criticized institutions that originate non-pass leveraged loans. Leveraged loans originated with a non-pass risk rating would be inconsistent with safe and sound lending standards and the risk management criteria outlined in the guidance. Leveraged lending policies and practices should deter the origination of loans rated non-pass at inception, unless the origination is part of a risk mitigation strategy in which the origination is intended to improve an existing non-pass loan.

Q6. What does "origination" mean for purposes of the guidance?

An origination occurs on the date of a new extension of credit, refinancing, or modification of an existing loan agreement, or a renewal of a matured or maturing loan transaction. A refinancing or modification includes any type of restructuring or change to an existing nonmatured loan.

Q7. Who is the originator of a loan for purposes of supervisory expectations under the guidance?

Institutions that arrange, underwrite, or distribute leveraged loans are considered originators. Institutions that only purchase participations in leveraged loans in the primary or secondary markets are not considered originators, but they are expected to have practices that are consistent with the guidance section on participations purchased.

Q8. How does the guidance apply to a leveraged loan origination that is downgraded to a non-pass rating after the inception date? Does this result in an origination that is inconsistent with the intent of the guidance to originate loans in a safe and sound manner?

Conditions may develop over time that warrant a change in a loan's risk rating to a non-pass rating category. The agencies expect an institution to work with a borrower to establish and implement a reasonable plan to restore such transactions to a pass rating in a timely manner. If the downgrade to a non-pass rating occurs within a short period of time (typically, six months) after the inception date, an institution should evaluate the risk-rating documentation and decision-making processes both at inception and at the time of rating downgrade. The institution's loan review function should then assess

whether the factors that caused the rating change existed at inception, or if the factors were the result of subsequent deterioration in the borrower's financial condition and repayment capacity. Examiners consider this review when evaluating the institution's efforts to originate loans in a safe and sound manner.

Q9. May an institution refinance, modify, or renew a loan with a special mention risk rating? What constitutes an acceptable refinancing, modification, or renewal of a loan rated special mention?

It is not the intent of the agencies to preclude agents or participating lenders from refinancing, modifying, or renewing an existing credit facility. An agent or participating lender should demonstrate that action is being taken to correct or mitigate the structural or credit-related concerns that result in the special mention rating. Credit approval documents should clearly identify and document the mitigating actions taken to strengthen risk management concerns at refinance. Generally, lowering the pricing structure (or interest rate) or extending the maturity date of a loan are not, alone, viewed by the agencies as an effective resolution or mitigant of the structural or credit-related concerns that typically result in the special mention rating.

Q10. How do the agencies view refinancing, modification, or renewal of special mention credits that involve the extension of new funds to the borrower?

A refinancing, modification, or renewal of a special mention credit that involves the extension of additional funds to the borrower is considered a new origination. Unless the institution can clearly show how the extension of new funds mitigates existing risks, such a loan is generally subject to an adverse risk rating.

Q11. How are "covenant-lite" leveraged loans viewed in the context of regulatory risk ratings? Are they automatically assigned a non-pass risk rating? Are all longer maturity term loans rated non-pass?

Leveraged loans reviewed by examiners are assigned ratings consistent with the agencies' established supervisory rating system, and the designation of a loan as "covenant-lite" does not automatically result in a non-pass rating under that system. The analysis of the transaction evaluates the repayment capacity of the borrower and the structure of the debt, as described in the risk rating section of the guidance. Potential weaknesses in one aspect of a transaction structure (such as covenants, maturity, or repayment structure) are assessed along with the financial aspects of the borrower in determining the final supervisory rating. Loans with relatively few or weak loan covenants should have other mitigating factors to ensure appropriate credit quality.

Q12. Many leveraged finance transactions are structured with multiple loan tranches. Should all of the tranches be rated pass at inception?

Yes. An institution's policies should deter the origination of non-pass leveraged loans in each loan tranche. The borrower's total capital structure should be sustainable and reflect the application of sound financial analysis and underwriting principles.

Q13. Does a low ratio of debt-to-enterprise value offset other underwriting weaknesses that might be present in a leveraged loan transaction, such as weak cash flow or high balance sheet debt ratios?

No. Strong enterprise value coverage alone is insufficient to avoid a non-pass risk rating if other factors call into question the borrower's ability to repay. Examiners evaluate all aspects of a leveraged transaction.

Q14. How are classified loans (that is, loans rated substandard, doubtful, or loss) considered when they are evaluated in relation to the guidance?

The guidance is not intended to discourage an institution from providing financing to a borrower engaged in problem loan workout negotiations or as part of a loss-mitigation strategy. A workout typically includes an existing transaction rated at least substandard or doubtful before a refinancing, or a transaction identified and managed under an institution's problem loan policy. The supervisory review focuses on management's actions to strengthen the credit(s).

Q15. Are trading assets subject to the guidance?

Yes. For purposes of risk measurement, reporting, and monitoring of leveraged exposures, trading assets are covered by the guidance. The expectation is that institutions should be able to identify and aggregate their exposure to leveraged borrowers, regardless of the accounting classification.

Q16. Is it consistent with the guidance for trading desks to buy and sell non-pass credits in the bank's trading account?

Yes. The agencies do not consider the purchase of a trading asset that is a preexisting leveraged loan or portion thereof to be an origination or refinancing under the guidance. Trading desks, governed by appropriate risk management processes, can buy and sell non-pass loans in the secondary market as part of their trading activities. Institutions should look to applicable rules and guidance that govern investments and securities for trading activities. Loans held or purchased for the available-for-sale or held-to-maturity portfolios are subject to the guidance.

Q17. The underwriting standards section of the guidance states that a leverage level exceeding 6 times total debt divided by EBITDA raises concerns for most industries. What do the agencies mean by this statement?

The agencies do not view 6 times total debt divided by EBITDA as a bright line when evaluating the risk in a transaction. Management and examiners consider all underwriting factors when reviewing credits. Excessive levels of leverage, however, raise supervisory concerns. Loans to borrowers that exceed this leverage level may receive additional scrutiny to assess the sustainability of the capital structure and repayment capacity of the borrower. Examiners evaluate the leverage level in a debt structure within the context of the expected future cash flows as well as the condition of the borrower's industry. Management information systems should include risk management reports that stratify the leverage-lending portfolio into meaningful segments based on risk.

Q18. Would a borrower's inability to fully amortize senior secured debt or to repay at least 50 percent of total debt over five to seven years automatically result in a non-pass rating by the agencies?

No. All aspects of credit risk are considered when the agencies evaluate the risk rating of a loan. It is possible that a loan that does not meet the de-levering guidelines will be risk rated as a pass when the borrower possesses other compensating means of financial support. Additional considerations such as quality and accessibility of liquid assets, demonstrated guarantor or sponsor support, strength and stability of cash flow sources and the borrower's ability to curtail discretionary expenses or dividends without negatively affecting business operations and growth prospects are some factors that may support a pass risk rating

Q19. Do best effort transactions fall under the guidance?

Yes. The guidance is applicable to the origination and distribution of all leveraged loans, including loans approved on a "best efforts" basis and fully committed distributions.

Q20. Are lenders outside of the largest underwriters held to the same standards for leveraged lending?

Yes. The guidance applies to all federally regulated institutions that originate or purchase leveraged loans.

Q21. Does the guidance apply equally to activities in nonbanking subsidiaries of a bank holding company?

Yes. Leveraged lending activities conducted in nonbank subsidiaries of a bank or savings and loan holding company should be consistent with the provisions of the guidance.

Q22. Do supervisory expectations regarding the guidance apply to businesses outside of the United States?

For U.S. banking organizations, the booking location of a loan is irrelevant and the guidance applies on an enterprise-wide basis. For foreign institutions with U.S. charters, the guidance applies to all leveraged loans that are both originated and distributed in the United States. The agencies closely scrutinize attempts to bypass supervisory expectations.

Q23. Do the agencies expect the guidance to be consistently applied to loans originated to hold versus loans originated only for distribution to other lenders?

Yes. The guidance communicates that an institution should have board-approved leveraged lending policies and underwriting standards that are consistent with the safety and soundness expectations set forth in the guidance. These expectations apply to all leveraged lending activity, whether the originating institution intends to participate in the loan or distribute all of it. An institution may choose to participate in lower-risk tranches based on its risk appetite; the entire transaction structure, however, should reflect a sound business premise and borrower capital structure, consistent with the intent of the guidance.

Q24. How does the guidance apply to indirect exposure to leveraged loans, such as investments in collateralized loan obligations (CLO), direct loans to business development corporations (BDC), or investments in similarly structured transactions?

The risk management and reporting aspects of the guidance should be applied to underlying loans in structured transactions if an institution originates or retains credit risk in the individual loans. For example, the guidance applies if an institution forms a BDC to market its own loans or if an institution funds a CLO with a warehousing line of credit, and that CLO also markets the institution's loans. If an institution is only an investor in CLO securities (that is, if an institution invests in CLO tranches), the guidance does not apply. In that case, the institution should look to existing regulations and guidance relevant to investing in securities. If the institution originates or participates in a loan to a CLO or BDC that holds leveraged loans, then the loan to the CLO or BDC constitutes indirect exposure that should be measured and reported as a leveraged loan.

Q25. How is an institution's implementation of the guidance assessed and monitored?

Examiners evaluate an institution's implementation of the guidance by (1) assessing policies, procedures, limit structures, management information systems, and other risk management processes related to leveraged lending activities, and (2) conducting transaction testing of leveraged loan transactions.

Supervisory reviews of leveraged lending usually occur during the Shared National Credit (SNC) examination, as part of other targeted supervisory examinations of

leveraged lending activities, and through continuous monitoring by the agencies. During SNC examinations, examiners may evaluate the underwriting standards that have been applied to SNC transactions originated since the effective date of the guidance. The agencies may also conduct horizontal reviews of leveraged lending activities on a stand-alone or interagency basis.

For an institution that is not part of the SNC process, examiners assess conformance with the guidance during the regular examination activities associated with that institution.

Q26. Are the requirements in the leveraged lending guidance the same as those required by the Federal Deposit Insurance Corporation's (FDIC) deposit insurance assessment rules, in particular in regard to the definitions? What are the differences between the leveraged lending guidance and the FDIC rule?

No. The FDIC's definition of a higher-risk commercial and industrial (C&I) loan in the deposit insurance assessment rule differs from the definition of a leveraged loan in the leveraged lending guidance. The assessment rule contains several specific tests to determine whether a C&I loan is considered higher risk in order to ensure consistent treatment across large institutions when calculating risk-based assessment rates. An institution's concentration of higher-risk assets, including higher risk C&I loans, is one of many measures used by the FDIC to calculate the risk-based assessment rate of a large institution (generally, institutions with total assets over $10 billion). The guidance does not establish a uniform definition for leveraged lending and instead focuses on high-level principles related to safe and sound leveraged lending activities and supervisory expectations for risk management practices covering leveraged lending. Compliance with the guidance and the deposit insurance rules are assessed separately.