Interagency Guidance on Leveraged Lending

March 21, 2013

Purpose

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively the "agencies") are issuing this leveraged lending guidance to update and replace the April 2001 Interagency guidance[1] regarding sound practices for leveraged finance activities (2001 guidance).[2] The 2001 guidance addressed expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, and the importance of stress-testing exposures and portfolios.

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans.[3] For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system. This guidance is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner.

Since the issuance of the 2001 guidance, the agencies have observed periods of tremendous growth in the volume of leveraged credit and in the participation of unregulated investors. Additionally, debt agreements have frequently included features that provided relatively limited lender protection including, but not limited to, the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind (PIK)-toggle features in junior capital instruments, which lessened lenders' recourse in the event of a

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[1] OCC Bulletin 2001-18; Board SR Letter 01-9, "Interagency Guidance on Leveraged Financing" April 9, 2001; and, FDIC Press Release PR-28-2001.

[2] For the purpose of this guidance, references to leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and non-bank investors. References to leveraged lending and leveraged loan transactions and credit agreements refer to all debt with the exception of bond and high-yield debt held by both bank and non-bank investors.

[3] For purposes of this guidance, the term "financial institution" or "institution" includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

borrower's subpar performance. The capital structures and repayment prospects for some transactions, whether originated to hold or to distribute, have at times been aggressive. Moreover, management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, with many institutions holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

This guidance updates and replaces the 2001 guidance in light of the developments and experience gained since the time that guidance was issued. This guidance describes expectations for the sound risk management of leveraged lending activities, including the importance for institutions to develop and maintain:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound MIS that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and,
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Applicability

This guidance updates and replaces the existing 2001 guidance and forms the basis of the agencies' supervisory focus and review of supervised financial institutions, including any subsidiaries or affiliates. Implementation of this guidance should be consistent with the size and risk profile of an institution's leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions should consider all aspects and sections of the guidance.

In contrast, the vast majority of community banks should not be affected by this guidance as they have limited involvement in leveraged lending. Community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator the

implementation of cost-effective controls appropriate for the complexity of their exposures and activities.[4]

Risk Management Framework

Given the high risk profile of leveraged transactions, financial institutions engaged in leveraged lending should adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices. This guidance outlines the agencies' minimum expectations on the following topics:

- Definition of Leveraged Lending
- General Policy Expectations
- Participations Purchased
- Underwriting Standards
- Valuation Standards
- Pipeline Management
- Reporting and Analytics
- Risk Rating Leveraged Loans
- Credit Analysis
- Problem Credit Management
- Deal Sponsors
- Credit Review
- Stress-Testing
- Conflicts of Interest
- Reputational Risk
- Compliance

[4] The agencies do not intend that a financial institution that originates a small number of less complex, leveraged loans should have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance provided in the "Participations Purchased" section of this document.

Definition of Leveraged Lending

The policies of financial institutions should include criteria to define leveraged lending that are appropriate to the institution.[5] For example, numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.[6]
- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.[7]

A financial institution engaging in leveraged lending should define it within the institution's policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. A financial institution's definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the institution from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending should address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential

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[5] This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. Asset-based lending is a distinct segment of the loan market that is tightly controlled or fully monitored, secured by specific assets, and usually governed by a borrowing formula (or "borrowing base").

[6] Cash should not be netted against debt for purposes of this calculation.

[7] The designation of a financing as "leveraged lending" is typically made at loan origination, modification, extension, or refinancing. "Fallen angels" or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included within the scope of this guidance, unless the credit is modified, extended, or refinanced.

effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by its board of directors;

- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, the agencies expect that financial institutions with significant leveraged transactions will implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;[8]
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see "Underwriting Standards" section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds.[9] They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for:

[8] Flex terms allow the arranger to change interest rate spreads during the syndication process to adjust pricing to current liquidity levels.

[9] Refer to other joint agency guidance regarding purchased participations: OCC Loan Portfolio Management Handbook, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf, Loan Participations, Board "*Commercial Bank Examination Manual*," http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf, section 2045.1, Loan Participations, the Agreements and Participants; and FDIC Risk Management Manual of Examination Policies, section 3.2 (Loans), http://www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit, Loan Participations, (last updated Feb. 2, 2005).

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- Carefully monitoring the borrower's performance throughout the life of the loan; and,
- Establishing appropriate risk management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, an institution's underwriting standards should consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles;
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base case cash flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term.[10] Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction;
- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, with a clear definition of credit risk management's role in such due diligence;
- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods;

[10] In general, the base case cash flow projection is the borrower or deal sponsor's expected estimate of financial performance using the assumptions that are deemed most likely to occur. The financial results for the base case should be better than those for the conservative case but worse than those for the aggressive or upside case. A financial institution may make adjustments to the base case financial projections, if necessary. The most realistic financial projections should be used when measuring a borrower's capacity to repay and de-lever.

- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Institutions looking to rely on sponsor support as a secondary source of repayment for the loan should be able to provide documentation, including, but not limited to, financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit extension;
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6X Total Debt/EBITDA raises concerns for most industries;
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and,
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured, standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which a financial institution should consider separate underwriting and risk rating guidance.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets should be tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the institution should establish limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates should be clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods should be appropriate for the borrower's industry and condition.

Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, financial institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those to be distributed. A financial institution should be able to differentiate transactions according to tenor, investor class (for example, pro-rata and institutional), structure, and key borrower characteristics (for example, industry).

In addition, an institution should develop and maintain:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from pipeline exposures;
- Written policies and procedures for defining and managing distribution failures and "hung" deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing). The financial institution's board of directors and management should establish clear expectations for the disposition of pipeline transactions that have not been sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be reported to management and the board of directors;
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital;
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication and distribution variances, and reporting of recourse sales to achieve distribution;
- Reports that include individual and aggregate transaction information that accurately risk rates credits and portrays risk and concentrations in the pipeline;
- Limits on aggregate pipeline commitments;
- Limits on the amount of loans that an institution is willing to retain on its own books (that is, borrower, counterparty, and aggregate hold levels), and limits on the underwriting risk that will be undertaken for amounts intended for distribution;
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles;
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures, which should address acceptable types of hedges and the terms considered necessary for providing a net credit exposure after hedging; and,

- Plans and provisions addressing contingent liquidity and compliance with the Board's Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

Reporting and Analytics

The agencies expect financial institutions to diligently monitor higher risk credits, including leveraged loans. A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors. Policies and procedures should identify the fields to be populated and captured by a financial institution's MIS, which should yield accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment (that is, permanent, or temporary), and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes 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 been distributed;

- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative;
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Risk Rating Leveraged Loans

Previously, the agencies issued guidance on rating credit exposures and credit rating systems, which applies to all credit transactions, including those in the leveraged lending category.[11]

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the 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 has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, the agencies believe that it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual status.

[11]Board SR Letter 98-25 "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations;" OCC Comptroller's Handbooks "Rating Credit Risk" and "Leveraged Lending", and FDIC Risk Management Manual of Examination Policies, "Loan Appraisal and Classification."

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. A financial institution's policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether

- Cash flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;
- Projections exhibit an adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for one or more downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance;
- Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- Collateral liquidation and asset sale estimates are based on current market conditions and trends;
- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and,
- The borrower is adequately protected from interest rate and foreign exchange risk.

Problem Credit Management

A financial institution should formulate individual action plans when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and

measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment should develop guidelines for evaluating the qualifications of financial sponsors and should implement processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

- The sponsor's historical performance in supporting its investments, financially and otherwise;
- The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);
- Consideration of the sponsor's contractual investment limitations;
- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals;
- Consideration of the sponsor's dividend and capital contribution practices;
- The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,
- Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Credit Review

A financial institution should have a strong and independent credit review function that demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, the institution's credit review function should assess the performance

of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. Such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution should staff its internal credit review function appropriately and ensure that the function has sufficient resources to ensure timely, independent, and accurate assessments of leveraged lending transactions. Reviews should evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Internal credit reviews should include the review of the institution's leveraged lending practices, policies, and procedures to ensure that they are consistent with regulatory guidance.

Stress-Testing

A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.[12] The sophistication of stress-testing practices and sensitivity analyses should be consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution should develop appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential

[12] *See* interagency guidance "Supervisory Guidance on Stress-Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets," Final Supervisory Guidance, 77 FR 29458 (May 17, 2012), at http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm, and the joint "Statement to Clarify Supervisory Expectations for Stress-Testing by Community Banks," May 14, 2012, by the OCC at http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf; the Board at www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf; and the FDIC at http://www.fdic.gov/news/news/press/2012/pr12054a.pdf. See also FDIC Final Rule, Annual Stress Test, 77 FR 62417 (Oct. 15, 2012) (to be codified at 12 CFR part. 325, subpart. C).

conflicts of interest arise between the financial institution and its customers. Policies and procedures should clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest, and provide for reporting, tracking, and resolution of any conflicts of interest that occur.

Reputational Risk

Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions which over time have significantly higher default or loss rates and performance issues may also see its reputation damaged.

Compliance

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure potential conflicts are avoided and laws and regulations are adhered to, an institution's independent compliance function should periodically review the institution's leveraged lending activity. This guidance is consistent with the principles of safety and soundness and other agency guidance related to commercial lending.

In particular, because leveraged transactions often involve a variety of types of debt and bank products, a financial institution should ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the Bank Holding Company Act Amendments of 1970[13] prohibits certain forms of product tying by financial institutions and their affiliates. The intent behind Section 106(b) is to prevent financial institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

In addition, equity interests and certain debt instruments used in leveraged transactions may constitute "securities" for the purposes of federal securities laws. When securities are involved, an institution should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

[13] 12 U.S.C. 1972.