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On November 7, 2014, the Federal Reserve and the other federal banking bodies issued a press release with a FREQUENTLY ASKED QUESTIONS (FAQs) to clarify the 2013 Interagency Guidance on Leveraged Lending.On November 7, 2014, the Federal Reserve and the other federal banking bodies issued a press release with a FAQs (FAQs) to clarify the 2013 Interagency Guidance on Leveraged Lending. FREQUENTLY ASKED QUESTIONS are available in the Board's press release on the 2014 Shared National Credits Review and Leveraged Lending: (PDF). TO THE OFFICIAL RESPONSIBLE FOR SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO FINANCIAL INSTITUTIONS SUPERVISED BY THE FEDERAL RESERVE APPLICABILITY TO Community Banking Organizations: This guidance applies to all institutions originating or participating in leveraged lending activities; including community banking organizations overseen by the Federal Reserve with total consolidated assets of $10 billion or less.1 The Board of The Federal Reserve System, together with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, has issued the attached Interagency Guidance on Leveraged Lending (2013 leveraged lending guidance). This guide outlines high-level principles related to safe-and-sound leveraged lending activities. This guidance applies to all financial institutions supervised by the Federal Reserve engaged in leveraged lending activities.2 Overview of guidance 2013 Guidance for Lending from 2013 and replaces the 2001 Interagency Guidance on Leveraged Financing (2001 guidance).3 Further, The 2013 leveraged lending guidance is intended to be consistent with sound industry practices and to expand on recent guidance on stress testing.4 In conclusion, the 2013 lending guidance takes into account: Definition of leveraged lending. The guidance encourages companies to develop and maintain a definition of leveraged lending that can be applied across all business areas. The guidance also provides examples of loan terms that are common in leveraged lending definitions. Participations Purchased. The guidance concludes that institutions of all sizes may have exposure to loans as leveraged loans by acting as participants. In particular, an institution acquiring a loan share should apply the same standards of prudence, credit assessment techniques, and its own limits that would apply if the institution originated in the loan. In addition, the guidance provides that the loan participants shall receive copies of all loan documents and all other documents relevant to the credit. Methods for determining the enterprise value. The guidance notes that lenders often rely on the business value when they (1) (3) assesses a borrower's ability to access capital markets and (4) estimate the strength of a secondary source of repayment. The guidance describes common methods (i.e. access, income and market) to value close-up companies under conventional business value theory and discuss the circumstances under which each method is most appropriate. Pipeline management. Market disruptions can significantly impede the ability of a loan underwriter to complete syndications or otherwise sell down exposures, which can lead to material losses for the insurer. The guidance therefore shows that institutions should (1) have strong risk management and control over transactions in the distribution pipeline, including amounts to be held and those to be distributed, and (2) be able to differentiate transactions according to their tenor and investor class. An institution's issue requirements should be clear, written and measurable, reflecting the institution's risk appetite. Accordingly, the guidance sets out standards for subscription and risk management for loans such as leveraged loans and encourages institutions of origin to be aware of the reputational risk associated with poorly guaranteed leveraged transactions. Stress testing. Institutions should conduct periodic stress tests on leveraged loan portfolios at loan level, including loans planned for distribution, and incorporate the results into company-wide stress testing activities. Risk management and reporting. Institutions should closely monitor higher-risk credit, including leveraged loans. The guidance therefore suggests that management should receive comprehensive reports on the characteristics and trends of the institution's leveraged lending portfolio at least quarterly and that the institution's board of directors should receive a summary of this information. Internal policies should identify the data fields to be captured by an institution's management information system, which should provide accurate and timely reporting to management and the board. The Reserve Bank is encouraged to distribute this letter to financial institutions overseen by the Federal Reserve in its districts, as well as to its own supervisory and investigation staff. Questions regarding the attached guidance should be addressed to Carmen Holly, Supervisory Financial Analyst, at (202) 973-6122; or Robert Cote, Senior Supervisory Financial Analyst, at (202) 452-3354. In addition, questions can be sent through the Board's public website.5 signed by Michael S. Gibson Director Division of Banking Supervision and Regulation Replaces: SR Letter 01-9, Interagency Guidance on Leveraged Financing Cross References: SR Letter 12-7, Regulatory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets SR Letters 98-25, Sound Credit Risk Management and use of internal credit rating risk at large banking organizations The Angry Birds balloon makes its way down Sixth Avenue during the 89th Macy's Thanksgiving Day Parade in New York City on November 26, 2015. REUTERS/Carlo Allegri A bunch of U.S. regulators decided in 2013 that the lending market was overheated and that it needed to be limited. Wall Street didn't like this. Leveraged loans are loans to companies that have a grade below investment-grade rating, and they are often used to finance takeovers. Regulators, including the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp., issued guidelines for everything from underwriting standards to how the risks associated with these loans should be rated. Regulators were concerned about the growth rate of leveraged lending and what they considered to be deteriorating underwriting standards. In other words, the banks took too much risk. The guidelines, in fact, capped loan multiples, putting an end to some of the more aggressive deals that took place at the time. These loans were typically financing private equity acquisitions. I remember talking to a very senior Wall Street banker about the guidelines around that time. He was furious. He told me that when he met with regulators shortly after the guidelines were published, he was walking around the room shaking his hands. They found this strange, and asked him why he did it. The reason, he said, was that this was the last time he would see them. The guidelines that these regulators had published meant that either: His job wouldn't be inside a bank anymore, and so he would probably do the same for a hedge fund. The new rules would have such an impact on lending that economic growth would slow down, meaning that regulators would likely be out of work. That was then. The market has been bedded down with the new rules, and seems to be working just fine. The banker is still employed by the bank, but it seems that he was partly right about one thing. The Federal Reserve Bank of New York's Liberty Street Economics blog just published some research from staff there, and yes, it seems that nonbanks did step into the void left by the big banks. From the post:Banks overseen by the Large Institution Supervision Coordination Committee (LISCC)—the institutions that may pose heightened risks to U.S. financial stability—reduced their leveraged lending most aggressively in response to the guidance. However, nonbanks increased their leveraged lending—even after the first quarter of 2013.Now, some people might think this is just fine. The risk is no longer available at LISCC banks, a group that includes JPMorgan, Goldman Sachs and Credit Suisse. There was a lot of reporting a while back that the likes of Jefferies and Nomura, who did not carry the LISCC designation, were stepping in. Maybe it's OK, because care about only the banks that are to the economy. The counter-argument is that the risk has not been reduced, just moved, and the system is still just as risky. Here's the Liberty Street Economics post (emphasis added): While not all lenders have reduced their leveraged lending in response to regulators' guidance, it seems that key players, such as LISCC banks, have. However, this reduction in lending did not necessarily lead to a corresponding reduction in risk as non-banks increased their borrowing from banks, possibly to finance their growing leveraged lending activities. This evidence highlights an important challenge for macroprudential policy. As this policy reaches beyond individual banks and target risk throughout the banking system, they are more likely to trigger significant responses that can have unintended consequences. Start PreambleThe Office of the Comptroller of the currency (OCC), Department of the Treasury; Board of Directors of the Federal Reserve System (Board); And the Federal Deposit Insurance Corporation (FDIC). ACTION: Final guidance. SUMMARY: THE OCC, the Board of Directors and the FDIC (collectively, bodies) issue final guidance on leveraged lending. This guidance describes for agency-supervised institutions high-level principles related to safe and sound leveraged lending activities, including underwriting considerations, assessing and documenting corporate value, risk management expectations for credit awaiting distribution, stress-test expectations, pipeline portfolio management, and risk management expectations of exposures held by the institution. This guidance applies to all financial institutions supervised by the OCC, the Board of Directors and the FDIC engaged in leveraged loan activities. The number of local banks with significant involvement in leveraged lending is small; therefore, the agencies generally expect that Community banks are largely unaffected by this guidance. DATE: This guide applies to 22 March 2013. The compliance date for this guidance is 21 May 2013. Start additional info FOR FURTHER INFORMATION CONTACT: OCC: Louise A. Francis, Commercial Credit Technical Expert, (202) 649-6670, louise.francis@occ.treas.gov; or Kevin Korzeniewski, Attorney, Legislative and Regulatory Activities Division, (202) 649-5490, 400 7th Street SW., MS 7W-2, Washington, DC 20219. Board: Carmen Holly, Supervisory Financial Analyst, Policy Section, (202) 973-6122, carmen.d.holly@frb.gov; Robert Cote, Senior Supervisory Financial Analyst, Risk Section, (202) 452-3354, robert.f.cote@frb.gov; or Benjamin W. McDonough, Senior Counsel, Legal Department, (202) 452-2036, benjamin.w.mcdonough@frb.gov; Board of Directors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.Start Printed Page 17767 FDIC: Thomas F. Lyons, Senior Examination Specialist, Division of Risk Management Monitoring, (202) 898-6850, tlyons@fdic.gov; S. Feder, Counsel, Legal Department, (202) 898-8724, gfeder@fdic.gov; 550 17th Street NW., Washington, DC 20429. End Additional Info End Ingress Start additional information additional information: I. Background On 30 March 2012, the agencies requested public comment on the joint proposed guidance on leveraged lending (the proposed guidance) with the comment period ending on 8 June 2012. [1] The agencies have reviewed the public comments and are now issuing final guidance (final guidance) containing some amendments discussed in more detail in Section II of this additional information. As addressed in the final guidance, institutions expect financial institutions to evaluate and monitor guaranteed credit risks in leveraged loans, understand the impact of changes in borrowers' corporate values on the quality of the credit portfolio and assess the sensitivity of future credit losses to these changes in business values. [2] In addition, in underwriting such credits, financial institutions should ensure borrowers are able to repay credit when they mature, and that borrowers have sustainable capital structures, including bank borrowing and other liabilities, to support their continued operations through economic cycles. Financial institutions should also be able to demonstrate that they understand the risks and the potential impact of stressful events and circumstances on the financial position of borrowers. The recent financial crises underline the need for financial institutions to employ sound underwriting guarantees, to ensure that risks in leveraged lending activities are adequately incorporated into the remuneration for credit and leasing losses and capital adequacy analyses, to monitor the sustainability of their borrowers' capital structures and to incorporate stress tests into their risk management of loan portfolios and distribution pipelines. Financial institutions unprepared for such stressful events and circumstances may face acute threats to their financial position and viability. This final guidance is intended to be consistent with sound industry practices and to extend the latest interagency emissions on stress tests. [3] II. Discussion of comments received from the public The agencies received 16 comments on the proposed guidance. Comments were submitted by bank holding companies, commercial banks, financial trade associations, financial advisory firms and private individuals. In general, most comments expressed support for the proposed guidance; however, several comments recommended amendments and clarification of certain provisions of the proposed guidance. The comments highlighted the following as primary issues of concern or interest or areas that could benefit from further explanation: The potential impact of the proposed guidance on medium-sized financial institutions; Definition of leveraged lending; Proposed exclusions for fallen fallen and asset-based loans, and borrowers of investment quality, reporting requirements for deal sponsors; Suggested alternatives to the scant expectations; Effect of covenant-lite and payment-in-kind (PIK)-toggle loan structures; Methods used to determine the enterprise value; Potential comprehensive management information system (MIS) burden presented by the proposed guidance; management responsibilities of a financial institution for loans of origin. In response to these comments, the Agencies have clarified and amended certain aspects of the guidance discussed in the following sections of this additional information. A. Terminology One purpose of the final guidance is to update and replace guidance issued in April 2001, entitled Interagency Guidance on Leveraged Financing (2001 Guidance). The 2001 guidance covered broad risk management issues related to activities with leveraged financing. This final guide focuses on leveraged lending activities carried out by financial institutions. In order to promote clarity and consistency, the agencies have therefore used the term leveraged lending in the final guidance instead of all references to leveraged financing represented in the proposed guidance. This change is intended to focus the applicability and scope of the final guidance on specific types of leveraged lending operations; leveraged loans originating in financial institutions. B. Scope Several comments expressed concern about the potential impact of the proposed guidance for Community banks and medium-sized institutions. The comments highlighted that small financial institutions may also have exposure to leveraged loans. All comments expressed concern that the definition of leveraged lending used in the proposed guidance would cover a significant number of portfolio loans originating from financial institutions, in particular small and medium-sized banks, including, but not limited to, traditional asset-based lending portfolios. One comment expressed concern that the guidance could be misinterpreted to require Community banks to document and bear the burden of proof as to why certain transactions are not considered leveraged lending. Another comment noted that Community banks with an insignificant amount of leveraged lending should not have to follow the same risk management framework as financial institutions with significant amounts of leveraged lending, as defined in the proposed guidance. Some comments suggested that the proposed guidance would exclude financial institutions below a certain asset or capital size, or exclude transactions below a certain dollar threshold. In response to these comments, the Agencies have decided to apply the final guidance all financial institutions originating or participating in leveraged lending operations. However, the agencies agree with the view that a financial institution originating a small number of less complex leveraged loans should not be expected to have policies and procedures commensurate with those of a larger financial Start Printed Page 17768institution with a more complex leveraged origination business. Therefore, the final guidance mainly addresses the latter type of leveraged lending. However, all financial institutions participating in rather than originating in leveraged lending operations should follow the applicable supervisory guidance for purchased equity. In order to clarify supervisory expectations for these types of loans, the agencies have incorporated the section on Purchased Equity from the 2001 Guidance in the Final Guidance. Although the bodies chosen to adopt a definition of leveraged lending covering all business areas, the agencies do not intend for this guidance to apply to small portfolio commercial and industrial loans, or traditional asset-based loans. The agencies have added language to the final guidance to clarify these concerns. C. Definition The agencies received five comments on the proposed definition of a loan transaction with leveraged loans. A number of comments expressed concern about a perceived light line approach to defining leveraged loans and suggested that institutions should be able to define their own definitions based on the characteristics of their portfolios. The agencies agree that different industries have a range of acceptable leverage levels and that financial institutions should carry out their own analysis to define leveraged lending. The proposed guidance addressed this issue by providing common definitions of leveraged lending and directing an institution to define leveraged lending in its internal policies. The proposed guidance also showed that there are many definitions of leveraged lending across the financial services sector as a whole. However, the proposed guidance stated that institutions' policies should include criteria for defining leveraged lending in a way that is sufficiently detailed to ensure consistent application across all business areas and appropriate for the institution. Therefore, the agencies consider that the definition of leveraged lending described in the proposed guidance was appropriate and has retained that definition in the final guidance. In addition, the agencies received comments on how to use earnings before interest, taxes, depreciation and amortization (EBITDA) as a measure to define leverage. Some comments expressed concerns that small banks are focusing on the balance sheet measure of leverage (total debt to tangible net worth) rather than the leverage cash flow measure presented in the proposed guidance definition. In other comments, the as a bright line and suggested that financial institutions should develop their own definition and a leverage measure based on a Business. The agencies agree that each financial institution should define its metrics to define leveraged loans and include these indicators in its credit policy. However, the EBITDA-based leverage measure presented in the proposed guidance represented the supervisory measure that may be used as an important factor that can be taken into account when defining leveraged loans based on each institution's credit products and characteristics. The agencies believe that a consistent definition for supervisory purposes will help to ensure the consistent application of the guidance. The agencies therefore retain this definition from the proposed guidance in the final guidance. D. Information and reporting The agencies received a number of comments on the discussion in parts of the proposed guidance on management information systems (MIS) that financial institutions should implement. The comments indicated that it would be burdensome for small financial institutions to implement the same reporting mechanisms as large financial institutions. Another comment suggested that small and medium-sized institutions should discuss the risks with their supervisory authorities in order to implement appropriate procedures. In order to clarify supervisory expectations for MIS requirements, the final guidance states that information and reporting should be tailored to the size and scope of each financial institution's leveraged lending activities. Agencies expect a global, complex financial institution with significant origination volumes or exposures to leveraged lending to have more complex MIS than a community bank with only a few exposures. In addition, the final guidance concludes that each institution should consider appropriate, cost-effective measures for leveraged lending, given the size and scope of this institution's leveraged lending activities. E. Further comments A comment requested that the definition of leveraged lending be amended so as not to include fallen angels. These are loans that do not meet the definition of leverage dichotomy upon origination, but migrate into the definition at a later date due to changes in the borrower's financial position. The commentary suggested that the inclusion of these loans in the definition would distort portfolio reporting and tracing, double monitoring activities and increase costs without any benefit to financial institutions or supervisors. The agencies agree that fallen angels should not be included as leveraged lending operations, but should be captured within the financial institution's broader risk management framework. Therefore, in the final guidance, the bodies have indicated that a loan should be classified as leveraged only in the case of the originating, amending, extension or refinancing or refinancing. One comment suggested the sponsor evaluation standards in the proposed guidance are and that lenders' financial assessments of contract sponsors should be limited to those sponsors providing a financial guarantor. The agencies agree that the possibility of obtaining financial reports on sponsors can be limited if there is no formal guarantor. Consequently, the final guidance removes the statement that an institution should generally develop guidelines for evaluating deal sponsors and instead focuses on deal sponsors who are relied on as a secondary source of repayment. In these cases, the final guidance states that a financial institution should document the sponsor's willingness and ability to support the credit. Some comments also suggested exemptions for both asset-based loans and investment-grade borrowers. As indicated above, the Agencies recognise that traditional asset-based lending is a distinct product line and is not included in the definition of a leveraged loan unless the loan is part of the entire debt structure of a leveraged debtor; therefore, the agencies have clarified this point in the final guidance. As regards the creditworthiness of a borrower, the agencies do not consider it appropriate to exclude high-quality borrowers from the guidance. Prudent portfolio management of leveraged loans, which is a target of this guidance, covers all loans, including those made to the most creditworthy borrowers. Importantly, the agencies strongly support the efforts of financial institutions to make loans available to creditworthy borrowers, especially in small and medium-sized institutions that expand prudent commercial and industrial loans. All loans and borrowers except those excluded in the final guidance will be covered by the definitions described in the guidance. Starting printed page 17769 The agencies also received comments about borrowers' ability to repay 50 percent of the total debt exposure over a five to seven year period. Some comments saw this measure as a restrictive light line while others suggested alternatives. The measure in the proposed guidance was intended as a general guide to reflect that institutions should set expectations and measures in their policies to reduce leverage over a reasonable period of time. The final guidance retains expectations of reasonable de-leverage, and agencies have revised the underwriting Standards portion of the final guidance to indicate that institutions should consider reasonable de-leverage borrowers, for example if base case cash flow projections demonstrate the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. In addition, the agencies have revised the risk rating loan-to-loan section of the final guidance to include the measure as an example, on the fact that in the context of risk rating of leveraged loans, usually assumes that the to fully amortise senior secured liabilities or the ability to repay at least 50% of the total debt over a five to seven year period provides evidence of sufficient repayment capacity. One comment referred to covenant-lite and PIK-swap loan structures, and recommended that agencies introduce stricter controls around loans with such features. Agencies believe that these types of structures may have a place in the total leveraged lending product set; however, the agencies recognize the additional risk in these structures. Therefore, although the final guidance does not have a different reading for such arrangements, agencies will carefully review such loans as part of the overall credit assessment of an institution. One comment suggested that agencies introduce more conservative guidelines to determine business value. The comment recommended that agencies require financial institutions to use corporate equalizers and follow Internal Revenue Service (IRS) guidelines when estimating the business value of a company. The agencies' intention is not to establish valuation standards for property valuation and valuation of corporate valuation methods or to require a formal assessment of companies for all loans relying on enterprise value as a source of repayment. The objective of the final guidance is to clarify the methods considered credible for determining enterprise value based on common industry practices. These methods, if properly implemented, produce reliable results. Therefore, the final guidance does not require an evaluation to be carried out by an enterprise valuer in determining the value of the enterprise. The agencies' expectations are that a financial institution's internal policies will address the source and method of estimating the value of the enterprise. The agencies received four comments on the burden of the proposed guidance, stating that implementation will increase the high costs already faced by financial institutions. One comment noted that there was no cost-cutting analysis with the proposed guidance. To address these concerns, the final guidance emphasises that an institution must have sound risk management policies and procedures commensurate with its origination activities and exposures to leveraged lending. In addition, the final guidance concludes that a financial institution's leveraged lending risk framework should be consistent with the institution's risk appetite and complexity of exposures. The agencies consider that the implementation of additional schemes or processes needed to promote safe and sound leveraged lending should be considered as part of an institution's overall credit risk management programme. One comment noted that in a credit transaction, financial institutions do not have the responsibility of trust to loan participants they draw and syndicate syndicate Loans. The agencies agree and have not included a reference to management responsibilities in the final guidance. III. Administrative Law Matters A. Paperwork Reduction Act Analysis In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR Part 1320, Annex A.1), the agencies reviewed the final guidance. Agencies may not implement or sponsor, and an organization is not obliged to respond to, a collection of information unless the information gathering displays a currently valid Office for Management and Budget (OMB) control number. Occ and FDIC have submitted this collection to OMB for review and approval under 44 U.S.C. 3506 and 5 CFR Part 320. The Board reviewed the final guidance under the authority that omb delegated to it. This final guidance is not generally adopted, but the agencies have determined that certain aspects of the guidance constitute information collections under the PRA. These aspects are the provisions that say that a financial institution should have (i) underwriting policies for leveraged lending, including stress-test procedures for leveraged credit; (ii) risk management policies, including stress testing procedures for pipeline exposures; and, (iii) policies and procedures to incorporate the results of leveraged credit and pipeline stress tests into the company's overall stress test framework. The frequency of information collection is estimated to be annual. Reporting agents are financial institutions with leveraged lending activities as defined in the guidance. Report Title: Guidance on leveraged lending. Frequency of Response: Annual. Affected Public: Financial institutions with leveraged lending. OCC: OMB Control number: To be assigned by OMB. Estimated number of respondents: 25. Estimated average time per respondent: 1,350.4 hours to build; 1,705.6 hours for ongoing use. Estimated total annual burden: 33,760 hours to build; 42,640 hours for ongoing use. Management Board: Agency information collection number: FR 4203. OMB control number: To be assigned by OMB. Estimated number of respondents: 41. Estimated average time per respondent: 1,064.4 hours to build; 754.4 hours for ongoing use. Estimated total annual burden: 43,640 hours to build; 30,930 hours for ongoing use. FDIC: OMB control number: To be assigned by OMB. Estimated number of respondents: 9. Estimated average time per respondent: 986.7 hours to build; 529.3 hours for ongoing use. Estimated total annual burden: 8,880 hours to build; 4,764 hours for ongoing use. The estimated time per reporting agent is an average that varies by body due to differences in the composition of financial institutions under the supervision of each agency (e.g. size allocation of institutions) and volume of leveraged lending activities. Agencies two comments in response to the requirements for information gathering under the PRA. Pra. comments mentioned how materially burdensome the guidance will be to implement. The agencies realize that the time start printed page 17770required by any institution to follow the guidance may be higher or lower than the estimates, but believe that the given figures are reasonable averages. One comment also noted that there is no cost-benefit analysis and questioned whether the additional information systems required undermine the benefits of information collection. In response to the general comments on birth, the agencies have made various changes to the proposed guidance, including by clarifying the application of the guidance to Community banks and other smaller institutions involved in leveraged lending. In the additional information section, the agencies also stressed their expectations that MIS and other reporting activities would be tailored to the size and scope of an institution's lending activities. In addition, the implementation of any new systems would be part of an institution's overall credit risk management programme. These comments are discussed in more detail in the general commentary summary in Section II of the additional information. Comments continue to be invited: (a) whether the collection of information is necessary for the proper performance of the functions of federal banking bodies, including the practical usefulness of the information; (b) the accuracy of the estimates of the burden of information collection, including the validity of the methodology and assumptions used; (c) ways of improving the quality, usefulness and clarity of the information to be collected; (d) ways of minimising the burden of information collection on respondents, including through the use of automated collection technologies or other forms of information technology; and (e) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information. Comments on these questions should be directed to: OCC: Since the paper mail in the Washington, D.C. area and at occ is subject to delays, commenters are invited to leave comments via email if possible. Comments can be sent to: Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, Attention: 1557-NEW, 400 7th Street SW., Suite 3E-218, Mail Stop 9W-11, Washington, DC 20219. In addition, comments can be sent by fax to (571) 465-4326 or by electronic mail to regs.comments@occ.treas.gov. You can personally inspect and copy comments at OCC, 400 7th Street SW., Washington, DC 20219. For safety reasons, occ requires visitors to make an appointment to inspect comments. You get to do it by calling (202) 649-6700. Upon arrival, visitors will be required to show valid government-issued photo IDENTIFICATION and to submit security check security check to inspect and photocopy comments. All comments received, including annexes and other supporting material, are part of the public record and subject to publication. Do not include any information in your comment or supporting materials that you consider confidential or unsuitable for publication. In addition, please send a copy of your comments by mail to: OCC Desk Officer, 1557-NEW, U.S. Office of Management and Budget, 725 17th Street NW., #10235, Washington, D.C. 20503, or by email to: oira submission@omb.eop.gov. FDIC: Interested parties are invited to submit their comments in writing. All comments should refer to the name of the collection, Guidance on Leveraged Lending. Comments can be submitted by any of the following methods: laws/ federal/ propose.html. E-mail: comments@fdic.gov. Post: Gary Kuiper (202) 898-3877, Federal Deposit Insurance Corporation, 550 17th Street NW., NY-5046, Washington, DC 20429. HandDelivery: Comments can be submitted to the watchstation on the back of the 550 17th Street Building (located on F Street), on working days between 7am and 5pm As the final guidance discusses the importance of stress tests as part of an institution's risk management practices for leveraged lending activities, the agencies note that they expect to review an institution's stress testing policies and procedures as part of their supervisory processes. To the extent that they collect information during a study on the stress test results of a financial institution, confidential treatment may be given to the registers under Exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. 552(b)(8). B. Analysis of legislative flexibility-creating measures The final guidance is not a rule-making measure. The Law on Regulatory Flexibility (5 U.S.C. 603(b)) does not therefore apply to the guidance. However, the agencies have considered the potential impact of the guidance on small banking organisations. For the reasons discussed in Sections I and II of this Additional Information, the bodies are issuing guidance to emphasize the importance of properly underwriting leveraged loan transactions and incorporate these exposures into stress and capital tests for institutions with significant exposures to these credits. The agencies received comments on the potential burden of this guidance on small banking organisations. The final guidance is intended for banking organizations overseen by the agencies with significant exposures to leveraged lending activities, including national banks, federal savings associations, state non-member banks, state member bank banks, bank holding companies, and U.S. branches and agencies of foreign banking organizations. Given the average dollar size of leveraged lending transactions, most of which exceed $50 million, and the agencies' loans tend to be held mainly by very large or global financial institutions, the vast majority of smaller institutions should not be affected by this guidance as they have limited exposure to credit-financed loans. The text of the guidance is as follows: Purpose Of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board of Directors), and the Federal Deposit Insurance Corporation (FDIC) (collective body) issues this leveraged lending guidance to update and replace the April 2001 Interagency Guidance [1] on sound practices for leveraged financing activities (2001). [2] The 2001 Guidance included expectations of the content of the credit policy, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, starting printed page 17771, 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 important role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure that they do not unnecessarily increase the risks by having poorly guaranteed loans. [3] For example, a poorly guaranteed loan that is merged with other loans or participated with other institutions can generate risks for the financial system. This guidance is designed to help financial institutions provide loan-borrowed loans to creditworthy borrowers in a safe and sound manner. Since the 2001 guidance was issued, the agencies have observed periods of huge growth in the volume of credit-financed credit and in the participation of unregulated investors. In addition, debt agreements have often included features that provided relatively limited lender protection including, but not limited to, the lack of meaningful maintenance agreements in loan agreements or the introduction of payment-in-kind (PIK)-switching features in junior equity instruments, which reduced lenders resorting to in the event of a borrower's subpar performance. The capital structures and repayment prospects for certain transactions, whether originating or distributing, have sometimes been aggressive. In addition, management information systems (MIS) in some institutions have proved to be less than satisfactory in terms of properly aggregated exposures on time, with many institutions holding large pipelines of higher risk commitments at a time when buyer demand for risky assets has decreased significantly. This guidance updates and replaces the 2001 guidance in the light of developments and experience gained since the time the guidance was issued. This guidance describes expectations of sound risk management of leveraged loan activities, including the importance for to develop and maintain: Transactions structured to reflect a sound business condition, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with performance projections that can be supported, these elements of a secure and sound loan structure should clearly support a borrower's ability to repay and to de-leverage to a sustainable level over a reasonable period of time, whether they are guaranteed to hold or distribute; A definition of leveraged lending that facilitates consistent application across all business areas; Well-defined issue requirements that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt; a credit limit and a merger framework consistent with the institution's risk appetite; Sound MIS that enables management to identify, aggregate and monitor exposures with leverage and follow the policies of all business areas; strong pipeline management policies and procedures that provide, inter alia, for real-time information on exposures and limits, and exceptions to the timing of expected allocations and approved ratchet 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, performance, liquidity and capital. Applicability This guidance updates and replaces the existing 2001 guidance and forms the basis for the agencies' supervisory focus and supervisory review of supervised financial institutions, including any subsidiaries or affiliates. The implementation of this guidance should be consistent with the size and risk profile of an institution's leveraged activities in relation to its assets, performance, liquidity and capital. Institutions originating or having sponsors of leveraged transactions should take into account all aspects and sections of the guidance. On the other hand, the vast majority of Community banks should not be affected by this guidance as they have limited participation in leveraged lending. The Community and smaller institutions involved in leveraged lending activities should discuss with their primary supervisory authority the implementation of cost-effective controls appropriate to the complexity of their exposures and activities. [4] Risk management frameworkIn view of 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 be based on written risk targets, risk acceptance criteria and risk controls. Lack of robust risk management processes and controls at a financial institution with significant loans could help to monitor the financial institution's engaging in unsafe and unhealthy banking practices. This is describes the agencies' minimum expectations on the following topics: Definition of leveraged lending general policy expectations Participating 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 Definition of leveraged lending policies of financial institutions should include criteria for defining leveraged lending that is appropriate for the institution. [5] For example, there are several definitions of leveraged lending throughout the financial services sector and usually contain some combination of the following: Revenues used for buyouts, acquisitions or capital allocations. Transactions in which the borrower's total debt divided by EBITDA (earnings before interest, taxes, depreciation and amortization) or SeniorDebt divided by EBITDA exceeds 4.0X EBITDA and 3.0X EBITDA, or other defined Start printed Page 17772levels appropriate to the industry or sector. [6] A borrower recognised on the debt markets as a highly leveraged enterprise, which is characterised by a high debt ratio in relation to the net asset. transactions when the borrower's leverage after financing, measured by its leverage ratio (e.g. debt-to-assets, debt-to-net-value, debt-to-cash ratio, or other similar standards common to certain industries or sectors), significantly exceeds industry standards or historical levels; [7] A financial institution engaged in leveraged lending should define it within its policies and procedures in a manner that is sufficiently detailed to ensure consistent application across all business areas. The definition of a financial institution should clearly describe the objectives and financial characteristics common to those transactions, and should include risk to the institution from both direct and indirect exposure via limited regressive financing secured by loans such as leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose vehicles (SPEs)) holding 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 guarantee (e.g. pipeline limits) and is willing to maintain (e.g. transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential impact on performance, capital, liquidity and other risks involved in those positions, and should be approved by its Board of Directors; A which includes limits or guidelines for single debtors and transactions, aggregated hold aggregated pipeline exposure, and industry and geographic concentrations. The border framework should identify the related management approval authorities and the exemption tracking rules. In addition to theoretical 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 use, and income at risk or that otherwise provide a more nuanced view of potential risk; [8] Procedures to ensure the risks of leveraged lending activities are adequately reflected in an institution's deduction of credit and leasing losses (ALLL) and capital adequacy analyses. approval authorities for credit and subscription, including the procedures for approving and documenting changes to approved transaction structures and conditions; Guidelines for appropriate supervision of senior management, including timely adequate reporting to the Board of Directors. Expected risk-adjusted return for leveraged transactions; Minimum underwriting standards (see Underwriting Standards section below); and, Effective underwriting practices for primary loan origination and secondary loan acquisition. Shares Purchased financial institutions purchasing shares and assignments in leveraged lending operations should carry out a thorough, independent evaluation of the transaction and risks before any funds are committed. [9] They should apply the same standards of prudence, credit assessment and approval criteria, and their own limits that would be employed if the purchasing organisation originated in the loan. As a minimum, the policy should include requirements: Obtaining and independently analyzing full credit information both before participation is purchased and in a timely manner thereafter; Obtain from the leading lender copies of all executed and proposed loan documents, legal opinions, title insurance, Uniform Commercial Code (UCC) searches, and other relevant documents; Closely monitor 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 operations. A financial institution should have clear emission limits for leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The Institute of Origin should pay attention to reputational risks in relation to poorly guaranteed transactions, as these risks may be found in a variety of investment vehicles and exacerbate systemic risks in the general economy. At a An institution's issue requirements should consider the following: whether the business condition for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is guaranteed for the institution's own portfolio or with the intention of distributing. The overall structure of a borrower should reflect the application of sound financial analysis and underwriting principles; A borrower's ability to repay and ability to de-leverage to a sustainable level over a reasonable period of time. As a general guide, institutions should also consider whether the forecasts for cash flow analyses in basic cases show the ability to fully amortise senior covered debt or to repay a significant part of the total debt in the medium term. [10] In addition, the projections should include one or more realistic downside scenarios reflecting key risks identified in the transaction; Expectations of depth and breadth of due diligence on leveraged transactions. This should include Start Printed Page 17773standards for evaluating different types of collateral, with a clear definition of the role of credit risk management in such due diligence; Standards for evaluating expected risk-adjusted returns. Standards should include the identification of expected distribution strategies, including alternative strategies for financing and disposing of positions during market disruptions, and the potential for losses during such periods; the degree of reliance on enterprise value and other intangible assets for loan repayment, together with acceptable valuation methods, and guidelines on the frequency of periodic reviews of those values; expectations of the level of support provided by the sponsor (if any), taking into account the sponsor's financial capacity, the extent of its capital contribution at start-up and other motivating factors; Institutions wishing to rely on sponsorship 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 newly documented evidence of the sponsor's willingness and ability to support the credit extension; whether credit contractual terms permit the tangible dilution, sale or exchange of collateral or cash flow-producing assets without the lender's approval; protection of contractual contracts, including financial performance (e.g. debt-to-cash cash, interest coverage or fixed fee coverage), reporting requirements and compliance monitoring; Generally speaking, a leverage level after planned asset sales (that is, the amount of debt that needs to be serviced from operating cash flow) that exceeds 6X Total Debt/EBITDA gives concern for most industries; Credit agreement collateral requirements specifying eligible collateral and risk-aligned measures and controls, including acceptable appropriate collateral valuation methods. Standards for asset-based loans included in the entire debt structure should also describe expectations of the use of security controls (e.g. inspections, independent valuations and payment lock boxes), other types of collateral and account maintenance contracts, and periodic reporting requirements; and, whether loan agreements provide for the distribution of ongoing financial and other relevant credit reports to all participants and investors. Nothing in the preceding standards should be considered to discourage the provision of financing to borrowers participating in training negotiations, or as part of a prepackaged financing under the Bankruptcy Code. Nor are they intended to deter 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 intangible assets when (1) Evaluating the feasibility of a loan request; (2) determination of the debt reduction potential of the planned sale of assets; 3) to assess a borrower's ability to access capital markets. and, (4) estimate the strength of a secondary source of repayment. Institutions may also see the enterprise value as a useful benchmark for assessing a sponsor's financial incentives to provide financial support. Given the specialised knowledge needed for the development of a credible corporate valuation and the importance of company valuations in subscription and ongoing risk assessment processes, company valuations should be carried out by qualified persons independently of an institution's origination function. There are several methods used to value companies. The most common valuation methods are assets, revenues and markets. In asset valuation methods, an entity's underlying assets are considered in terms of net remuneration or liquidation value. Income valuation methods take into account an entity's ongoing cash flows or results and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable business data or sales transactions. However, final value estimates should be based on the methodology or methods that produce supporting and credible results. In many cases, the income method is generally considered to be the most reliable. There are two common approaches that are used 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 that the business can generate in the future. An appropriate cash flow is determined and then shared with a risk-adjusted capitalisation rate, usually weighted average cost of capital. This method is most appropriate when cash flows cash flows stable. The discounted cash flow method is a multi-time valuation model that converts a future series of cash flows to the current value by discounting those cash flows at a rate of return (called the discount rate) that reflects the risk present in it. This method is most appropriate when future cash flows are cyclical or variable over time. Both revenue methods involve a number of assumptions and therefore supporting documentation should fully explain the evaluator's reasoning and conclusions. When a borrower experiences a financial downturn or faces adverse market conditions, a lender should reflect these negative terms in its assumptions for key variables such as cash flow, performance 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 that are more negative than the baseline scenario. Stress tests of company values and their underlying assumptions should be carried out and documented when cutting the transaction and regularly thereafter, incorporating the borrower's actual performance and any adjustments to forecasts. The institution should perform its own discounted cash flow statement to validate the enterprise value implied by proxy metrics 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 safety margins. Based on the nature of an institution's leveraged lending activities, the institution should set limits on the proportion of individual transactions and the total portfolio supported by the enterprise value. Regardless of the methodology used, the assumptions underlying business value estimates should be clearly documented, substantiated and understood by the institution's appropriate decision-makers and risk supervisors. Furthermore, an institution's valuation methods should be appropriate for the borrower's industry and condition. Disruptions in the pipeline management market can significantly impede an insurer's ability to complete syndication or otherwise sell down exposures, which can lead to material losses. Financial institutions should therefore have a strong Start Printed Page 17774risk handling and controls of 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 (e.g. pro-rata and institutional), structure, and characteristics of key borrowers (for industry). In addition, an institution should develop and maintain: a clearly formulated and documented appetite for insurance risk that takes into account the potential impact on performance, capital, liquidity and other risks resulting from pipeline exposures; Written policies and procedures for defining and managing distribution errors and hung offerings, identified by an inability to sell down the exposure within a reasonable period (generally 90 days from closing transactions). The board and management of the financial institution should establish clear expectations of the disposition of pipeline transactions that have not been sold under their original distribution plan. Such transactions that are subsequently reclassified to maturity should also be reported to management and the board; 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, performance, liquidity and capital; Controls to monitor the performance of the pipeline against initial expectations, and regular reports of deviations to management, including the amount and timing of syndication and distribution variances, and reporting of regress sales to achieve deployment; Reports that include individual and aggregatetransaction information that correctly risks credit and depicts risk and concentrations in the pipeline; Limits on total pipeline commitments, Limits on the amount of loans an institution is willing to keep on its own books (i.e. borrowers, counterparty and aggregate holding levels), and limits on the insurance risk that will be made for amounts intended for distribution; policies and procedures identifying acceptable accounting practices and controls in both functional and dysfunctional markets, and to directly prompt recognition of losses in accordance with generally accepted accounting principles; policies and procedures addressing the use of hedging to reduce pipeline exposures and hold, which should address acceptable types of hedging and the conditions deemed necessary to provide a net credit exposure after hedging; and, Plans and regulations addressing conditional liquidity and compliance with Board Regulation W (12 CFR Part 223) when market liquidity or credit conditions change, interrupting normal distribution channels. Reporting and analysis Agencies expect financial institutions to closely monitor higher risk credits, including leveraged loans. The management of a financial institution should receive comprehensive reports on the characteristics and trends of such exposures at least quarterly, and summaries should be submitted to the board of directors of the institution. Guidelines and should identify which fields to fill and by a financial institution's MIS, which should provide accurate and timely reporting to management and the board that may include the following: Individual exposures and portfolio exposures within and across all business areas and legal vehicles, including pipeline, risk rating allocation and migration analysis, including maintenance of a list of 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 default and loss probabilities are given standard; Portfolio performance measures, including non-compliance with covenants, restructuring, crime, non-performing amounts and charge-offs; Amount of impaired assets and the type of impairment loss (i.e. permanent or temporary), and the amount of ALLL attributable to leveraged lending. The total level of policy exceptions and the performance of that portfolio; exposures by security type, including unsecured transactions and those where the enterprise value will be the source of repayment for leveraged loans; Reporting should also consider the consequences of defaults that trigger pari passu treatment for all lenders and thus dilute the secondary support from the sale of collateral; Secondary market price data and trading volume, when available; Exposures and performance through deal sponsors. Offers 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, hedging counterparty concentrations and policy exemptions; Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels above the syndication layer block targets. Pipeline definitions should clearly identify the type of exposure. This includes pledged exposures that have not been accepted by the borrower, commitments accepted but not terminated, and funded and unfunded commitments that have been terminated but have not been distributed; total and segmented leveraged lending exposures, including subordinated liabilities and equity, in addition to established limits; Reports should provide a detailed and comprehensive picture of global exposures, including situations where an institution has indirect exposure to a debtor or holds a previously sold position as collateral or as a reference asset in a derivative; Borrower and counterparty loan accounting should consider exposures booked in other business units throughout the institution, including indirect exposures such as custom and total return swaps, where the distributed paper is named as a covered or referenced asset or collateral exposure through In addition, the institution should consider positions held in available for sale or or portfolios or through structured investment vehicles owned or sponsored by the institution of origin or its subsidiaries or affiliates. Risk rating Leveraged loans In the past, the bodies that issued guidance on credit rating lending and credit rating systems, which applies to all credit transactions, including those in the category of leveraged lending. [11] The risk assessment of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to depalate to a sustainable level within a reasonable period of time. For example, supervisors often assume that the ability to fully amortize senior Start Printed Page 17775secured debt or the ability to repay at least 50 percent of the total debt over a five to seven year period provides evidence of adequate repayment capacity. If the estimated capacity to pay off liabilities from cash flow is nominal with refinancing the only viable option, credit will usually be negatively rated even if it has recently been guaranteed. In cases where leveraged loan transactions have no reasonable or realistic prospect of de-leverage, a substandard rating is likely. In addition, in assessing debt service capacity, extensions and restructuring should be examined to ensure that the institution not only hides repayment capacity problems by extending or restructuring the loan. If the primary source of repayment becomes insufficient, the agencies consider that it would generally be inappropriate for an institution to consider the value of the enterprise as a secondary source of repayment unless this value is well supported. Evidence of well-supported values may be binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully take into account the impact of the borrower's non-performing circumstances and potential changes in business and market conditions. For such borrowers, when part of the loan may not be protected by pledged assets or a well-supported corporate value, reviewers will generally rate that part doubtful or loss and place the loan on nonaccrual status. Credit analysis Effective underwriting and management of leveraged lending risk is highly dependent on the quality of the analysis used during the approval process as well as ongoing monitoring. A financial institution's policy should address the need for a comprehensive assessment of financial, commercial, industry and management risks, including whether cash flow statements depend on overly optimistic or unfounded forecasts of sales, margins and synergies on mergers and acquisitions; Liquidity analyses include performance measures that are appropriate for the borrower's industry; predictability of the borrower's cash flow, measurement of the borrower's operational cash needs, and to meet the derelict of the debt run; Projections show a sufficient margin for unforeseen merger-related integration costs; integration costs; are stress tested for one or more downside scenarios, including a breach of contract, Transactions are reviewed at least quarterly to determine the variance from plan, the related risk impacts and accuracy of risk ratings and accrual status. From the start, the credit file should include a chronological justification for and analysis of all material changes in the borrower's business plan and variance from expected financial performance; Company and security ratings are independently derived or validated outside the origin cropping function, arrive at the right time and consider potential value osion; Estimates of collateral and asset sales estimates are based on prevailing market conditions and trends, Potential safety deficiencies are identified and factored into risk rating and accrual decisions, contingency plans foresee changing conditions in the debt or equity markets when exposures depend on refinancing or the issue of new equity. and, the borrower is adequately protected from interest rate and currency risk. Problem Credit Management A financial institution should formulate individual action plans when dealing with borrowers experiencing reduced operating cash flows, amortized collateral values, or other significant plan deviations. Weak initial guarantee of transactions, along with poor structure and limited covenants, can make problem credit discussions and possible restructuring more difficult for an institution and result in less favourable results. A financial institution should formulate credit policies that define expectations for the management of negativecreditworthy and other high-risk borrowers whose results differ significantly from planned cash flows, asset sales, collateral values or other important objectives. This policy should emphasize the need for training plans that include quantifiable goals and measurable time frames. The measures may include working with the borrower for an orderly resolution while preserving the interests of the institution, the sale of the credit on the secondary market or the liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, impairment accounting 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 conduct processes to regularly monitor a sponsor's financial position. Deal sponsors can provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors can also provide sources of financial support for borrowers who fail to achieve projections. Generally a financial institution rates a borrower analysis of the borrower's independent financial condition. State. a financial institution may consider the support of a sponsor in the allocation of internal risk assessments when the institution can document the sponsor's history of demonstrated support as well as the financial incentive, capacity, and stated intention to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contribution may not mitigate the supervisory hands absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include: the sponsor's historical performance in supporting its investments, financially and otherwise; The sponsor's financial incentives to support, including the nature and principal amount provided at the start-up; Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance); Consideration of the sponsor's restrictions on contractual investments. As far as possible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the possibility of financing multiple trades; Consideration of the sponsor's dividend and capital injection practices. The likelihood that the sponsor supports a particular borrower compared to other trades in the sponsor's portfolio; and, guidelines for evaluating a sponsor's qualifications and a process for regularly monitoring 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 outcomes to its senior management. Due to the elevated risks inherent in leveraged lending, and due to the relative size of a financial institution's leveraged lending activities, the credit audit function of the institution should assess the start of printed page 17776 of the leveraged portfolio more frequently and in depth than other segments of the loan portfolio. Such assessments should be carried out by persons with the expertise and experience of these types of loans and the borrower's industry. Portfolio audits should generally be carried out at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, mergers, negative risk valuation trends or portfolio performance, can dictate more frequent reviews. A financial institution should adequately staff its internal credit audit function and ensure that it has sufficient resources to ensure timely, independent and accurate assessments of leveraged lending operations. Reviews should evaluate the level of risk, risk assessment integrity, valuation methods and the quality of risk management. Internal credit reviews should include the review of the institution's lending practices, policies and procedures to ensure that they are compatible with the regulatory guidance. Stress-Testing A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originating to hold as well as loans originating to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, performance, liquidity and capital. [12] The sophisticated 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 that a financial institution is required to carry out stress tests for the whole company, the leveraged portfolio should be included in all such tests. Conflicts of interest A financial institution should develop appropriate policies and procedures to manage and 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 timeshare rate. A financial institution may face pressure to provide financial or other privileged client information that could benefit a sufficient equity investor. Such conflicts may also arise when the financial institution of underwriting acts as financial advisor to the seller and at the same time offers financing to several buyers (i.e. stapled financing). Similarly, there may be conflicting interests among the various business lines of a financial institution or between the financial institution and its subsidiaries. When these situations arise, potential 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 actions without fear of retaliation and ensure compliance with applicable laws. Furthermore, management should have an established training programme for employees on appropriate practices to follow in order to avoid conflicts of interest, and provide for the reporting, tracking and resolution of any conflicts of interest that arise. Reputational Risk Leveraged Lending transactions are often syndicated through the financial and institutional markets. The apparent failure of a financial institution to fulfil its legal responsibility for taking out and distributing transactions may damage its reputation on the market and impair its ability to compete. Similarly, a financial institution distributing transactions time has significantly higher standard or loss rates and performance problems also see its reputation damaged. Compliance Compliance regulatory issues raised by leveraged transactions are numerous and complex. In order to ensure that potential conflicts are avoided and laws and regulations are complied with, an institution's independent compliance function should regularly review the institution's leveraged lending activities. This guidance is consistent with the principles of security and soundness and other guidance from the Agency on commercial lending. As leveraged transactions often involve a variety of liabilities and banking products, a financial institution should ensure that its policies include safeguards to prevent anti-tying breaches. Section 106(b) of the Banking Holding Act Amendments of 1970 [13] prohibits certain forms of product binding by financial institutions and their subsidiaries. The purpose behind section 106(b) is to prevent financial institutions from using their market entry over certain products in order to gain an unfair competitive advantage in other products. In addition, equity interests and certain debt instruments used in leveraged transactions may constitute securities for federal securities laws. Where 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 adequately address the internal dissemination of material non-public information on transactions in which it plays a role. Starting signature dated: February 19, 2013. Thomas J. Curry Comptroller of the currency. Federal Reserve Board of Directors, March 8, 2013. Robert deV. Frierson, secretary of the board. Dated in Washington, D.C., on this 11th day of March, 2013. Federal Deposit Insurance Corporation. Valerie J. Best, Deputy Executive Secretary. Exit Signature End Supplemental Information [FR Doc. 2013-06567 Filed 3-21-13; 8:45] BILLING CODE 4810-33-P; 6210-01-P; 6714-01-P 6714-01-P