

Financial Institution Compliance Update



May 7, 2013

This communication is designed to provide you with quick snapshots and timely perspective on recent regulatory developments.

Supervisory Guidance on Leveraged Lending

After declining during the financial crisis, leveraged lending has been increasing since 2009. Recently, the Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC) and Office of Comptroller of Currency (OCC) jointly issued supervisory guidance on leveraged lending. This guidance covers transactions characterized by a borrower with a degree of financial leverage that significantly exceeds industry norms. The guidance was published in the Federal Register on March 22, 2013, and replaces guidance issued in April 2001.

Prior to the financial crisis, the volume of leveraged credit transactions grew tremendously and participation by non-regulated investors willing to accept looser terms increased. While leveraged lending declined during the crisis, volumes have since increased and prudent underwriting practices have deteriorated. For example, some debt agreements have included features that weaken lender protection by excluding meaningful maintenance covenants and including other features that can limit lenders' recourse in the event of weakened borrower performance. In addition, capital and repayment structures for some transactions, whether originated to hold or to distribute, have been aggressive. Management information systems at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis.

The Supervisory Guidance on Leveraged Lending takes effect May 21, 2013, and applies to financial institutions – supervised by the OCC, FDIC and Federal Reserve Board – that engage in leveraged lending activities.

Key focus areas from the guidance:

- **Establishing a sound risk-management framework** – The agencies expect that

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management and the board of directors identify the institution's risk appetite for leveraged finance, establish appropriate credit limits, and ensure prudent oversight and approval processes.

- **Underwriting standards** – An institution's underwriting standards should clearly define expectations for cash flow capacity, amortization, covenant protection, collateral controls, and the underlying business premise for each transaction, and should consider whether the borrower's capital structure is sustainable, regardless of whether the transaction is underwritten to hold or to distribute.
- **Valuation standards** – An institution's standards should concentrate on the importance of sound methods in the determination and periodic revalidation of enterprise value.
- **Pipeline management** – An institution should be able to accurately measure exposure on a timely basis; establish policies and procedures that address failed transactions and general market disruptions; and ensure periodic stress tests of exposures to loans not yet distributed to buyers.
- **Reporting and analytics** – An institution should ensure that management information systems accurately capture key obligor characteristics and aggregates them across business lines and legal entities on a timely basis, with periodic reporting to the institution's board of directors.
- **Risk rating leveraged loans** – An institution's risk rating standards should consider 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.
- **Participants** – An institution that participates in leveraged loans should establish underwriting and monitoring standards similar to loans underwritten internally.
- **Stress testing** – An institution should perform stress testing on leveraged loans held in portfolio as well as those planned for distribution, in accordance with existing interagency issuances.

What should your financial institution do to comply with the guidance?

Institutions need to evaluate the impact this guidance has on their risk assessment, lending, valuation and other processes. It is important that banks provide leveraged financing to credit worthy borrowers in a safe and sound manner. Banks should consider and implement all applicable aspects and sections of the 2013 guidance. Examiners will be critical as they evaluate the factors mentioned above when assessing a bank's risk management framework and determining credit classifications on leveraged borrowers.

The full guidance can be found on the Federal Register site here:

<http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-9a.pdf>

