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Federal Banking Agencies Propose New Guidance on Leveraged Finance

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On March 26, 2012, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, the "Agencies") jointly issued for comment proposed new leveraged lending guidance, to be applicable to substantially all financial institutions regulated by the Agencies, that would replace the existing guidance issued in April 2001.[1]

The Agencies note that as the leveraged finance market has grown:

- debt agreements have frequently included features that provide relatively limited lender protection, including "covenant-lite" and PIK-toggle features
- capital structures and repayment prospects for some transactions have at times been aggressive in light of the overall risk of the credit
- the pipeline of aggressively priced and structured commitments has grown rapidly

In light of these changes, the Agencies decided to replace the 2001 guidance with the new guidance described below.

The proposed guidance outlines minimum regulatory expectations regarding 16 topics:

- Definition of leveraged finance
- General policy expectations
- Underwriting standards
- Valuation standards
- Pipeline management
- Reporting and analytics
- Rating leveraged loans
- Credit analysis
- Problem credits
- Deal sponsors

- Credit review
- Conflicts of interest
- Anti-tying
- Reputational risk
- Securities laws
- Compliance function

Items of particular note in the proposed new guidance are:

- Underwriting standards should provide that, as a general matter, base-case cash flow projections should show the ability to fully amortize senior secured debt or repay at least 50% of total debt over a five to seven year period;
- A borrower with a total leverage level after planned asset sales in excess of 6x "raises concerns for most industries;"
- If refinancing of a loan is the only viable repayment option, the credit will be criticized even if it has been recently underwritten;
- Financial institutions should develop guidelines for evaluating the qualifications of financial sponsors and implement a process to regularly monitor their performance;
- Compliance with reporting and MIS requirements in the proposed guidance may result in significant incremental cost for many financial institutions; and
- Cautionary comments are made regarding "covenant-lite" loans and "PIK Toggle" bridge loans/securities.

Comments on the proposed guidance are due by June 8, 2012.

DISCUSSION OF THE PROPOSED NEW GUIDANCE

I. Definition of Leveraged Finance

The proposed guidance states that financial institutions' policies should define leveraged finance in a manner sufficiently detailed to ensure consistent application across all business lines and noted that many such definitions in the banking industry contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions;
- Total leverage or senior leverage exceeding 4x or 3x, respectively;
- High debt-to-net-worth ratio; and
- Leverage that significantly exceeds industry norms or historical levels.

II. General Policy Expectations

The proposed guidelines state that financial institutions' credit policies should address the following items:

- The institution's leveraged finance underwriting limits and aggregate hold levels, which should be approved by its board of directors;
- Limits for single obligors and transactions; industry and geographic exposure;
- Reflect leveraged lending activities in the institution's loan losses and capital adequacy analyses;
- Appropriate oversight by senior management, including adequate and timely board reporting;
- Expected risk-adjusted returns;
- Minimum underwriting standards; and
- The degree to which underwriting practices may differ between primary loan originations and secondary loan acquisition.

III. Underwriting Standards

The proposed guidelines provide that financial institutions' underwriting standards should, at a minimum, consider:

- Whether the entire capital structure is sound, not just that portion the institution is underwriting and irrespective of whether it is to be held or distributed by the institution;
- The borrower's capacity to repay and delever over a reasonable period. As a general guide, base-case cash flow projections should show the ability to fully amortize senior secured debt or repay at least 50% of total debt over a five to seven year period. Projections should also include one or more downside scenarios.
- Due diligence expectations, including standards for evaluating collateral and credit risk management's role in due diligence;
- Standards for evaluating expected riskadjusted returns, including identification of expected distribution strategies, alternative distribution strategies during market disruptions, and potential losses during market disruptions;
- Expected degree of support by the financial sponsor (if any);
- Whether the credit agreement allows for material dilution, sale or exchange of collateral or cash flow producing assets without lender approval;
- Credit agreement covenant protections, including financial covenants, reporting and compliance monitoring. The Agencies note that, generally, a total leverage level after planned asset sales in excess of 6x raises concerns for most industries;
- Collateral requirements in credit agreements that specify acceptable collateral types, loan-to-value guidelines and appropriate collateral valuation methodology; and
- Whether loan agreements provide for financial reporting to all participants.

IV. Valuation Standards

The proposed guidance states that enterprise valuation often relied on for evaluating a loan request delevering potential of asset sales ability to access capital markets and a secondary source of loan

repayment should be performed or validated at financial institutions by qualified persons independent of the loan origination function. While all three commonly accepted approaches (asset, income and market) should be used and evaluated in combination, the income approach will be considered the most reliable. Furthermore, the stress testing of enterprise valuations and their underlying assumptions should be stress tested and documented at origination and periodically thereafter.

V. Pipeline Management

The proposed guidance states that financial institutions should have strong risk management and controls over transactions in the pipeline, including the ability to differentiate transactions according to tenor, investor class, structure, and industry. Financial institutions should develop and maintain:

- Underwriting limits that consider effects on earnings, capital, liquidity and other risks;
- Written procedures for "hung" deals which are identified by an inability to sell down exposure within a reasonable time (generally 90 days from closing). Any reclassification of "hung" loans to "hold-to-maturity" should be reported to the board of directors of the financial institution;
- Guidelines for periodic stress tests on pipeline exposures;
- Controls to monitor performance of the pipeline against original expectations and reports of variances to management;
- Reports for individual and aggregate transaction information;
- Limits on aggregate pipeline commitments and periodic testing of such exposures under different market scenarios;
- Limits on aggregate hold level and aggregate underwriting risk for loans intended for distribution;
- Policies and procedures that identify acceptable accounting methodologies and controls;
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures; and
- Plans and provisions addressing contingent liquidity and compliance with Regulation W when normal distribution channels are disrupted.

VI. Reporting and Analytics

The proposed guidance provides that the Agencies expect financial institutions to diligently monitor leveraged loans. An institution's management should receive comprehensive reports, with summaries thereof to the board of directors, at least quarterly. An institution's MIS should yield accurate and timely reporting that may include:

- Individual and portfolio exposures within and across business lines and legal vehicles;
- Risk rating distribution and migration analysis;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;

- Portfolio performance measures, including non-compliance with covenants, restructurings, delinquencies, non-performing amounts and charge-offs;
- Amount of impaired assets and nature of impairment and the amount of loan losses attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposure by collateral type, including unsecured loans (including implications of cross defaults);
- Secondary market pricing data and trading volume;
- Gross and net exposures, hedge counterparty exposures and policy exceptions;
- Actual versus projected distribution of syndicated pipeline — identified by open commitments not accepted by borrower yet accepted commitments that have not closed, funded and unfunded commitments that have closed but have not been distributed, and
- Total and segment exposures, included subordinated debt and equity holdings.

The proposed guidance also note that institutions should develop guidelines for stress tests on the portfolio to quantify the potential impact of changing economic or market conditions on asset quality, earnings, liquidity, and capital.

VII. Risk Rating Leveraged Loans

The proposed guidance states that the Agencies' previously issued guidance on risk rating of credit exposures, generally applies to leveraged lending transactions. Additionally, if refinancing of a loan is the only viable repayment option, the credit will usually be criticized even if it has been recently underwritten.

VIII. Credit Analysis

The proposed guidance states that financial institutions' credit approval and monitoring policies should address comprehensive risks, including whether:

- Cash flow analyses rely on overly optimistic or unsubstantiated projections of merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for borrower's: industry, predictability of cash flow, operating cash needs, and debt maturities;
- Projections exhibit adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for several downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan (from inception the credit file should contain a chronological rationale for and analysis of all substantive charges to borrower's operating plan and variance from expected financial performance);
- Enterprise and collateral valuations are derived or validated independently of origination and consider potential value erosion;
- Collateral liquidation and asset sale estimates are conservative;

- Potential collateral short-falls are factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or new equity; and
- Borrower is adequately protected from interest rate and foreign exchange risks.

IX. Problem Credit Management

The proposed guidance provides that financial institutions shall formulate individual action plans for borrowing that are experiencing diminished operating cash flows, depreciated collateral values, or other significant variance to plan. In addition, financial institutions shall formulate credit policies that define expectations for the management of adversely rated and other high risk borrowers with quantifiable objectives and measurable time frames.

X. Deal Sponsors

The proposed guidance provides that financial institutions should develop guidelines for evaluating the qualifications of financial sponsors and implement a process to regularly monitor their performance. Lending institutions may consider support from a sponsor in assigning an internal risk rating when the institution can document the sponsor's history of demonstrated support as well as economic incentive, capacity, and stated intent to continue to support the transaction. An evaluation of a sponsor's financial support should including the following:

- Sponsor's historical performance in supporting its investments, financial and otherwise;
- Sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support;
- 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;
- Likelihood of supporting the borrower compared to other deals in the sponsor's portfolio; and
- Guidelines for evaluating the qualifications of financial sponsors and a process to regularly monitor performance.

XI. Credit Review

The proposed guidance provides that depending on the relative size of an institution's leveraged finance business, it may be prudent for the institution's credit review function to examine the leveraged portfolio more frequently than other segments, go into greater depth, and be more selective in identifying personnel to assess the underlying transactions. Portfolio reviews should generally be conducted at least annually. For many institutions, the risk characteristics of the portfolio may dictate more frequent review.

XII. Conflicts of Interest

The proposed guidance provides that institutions should develop appropriate policies to address and prevent potential conflicts of interest, including the situation where the institution or an affiliate owns

an equity interest in a borrower or is providing stapled financing. Policies should clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report conflicts without fear of retribution, and ensure compliance with laws.

XIII. Anti-Tying Regulations

The proposed guidance provides that institutions should ensure that their policies incorporate safeguards to prevent violation of anti-tying regulations under Section 106(b) of the Bank Holding Company Act Amendments of 1970.

XIV. Reputational Risk

The proposed guidance notes that failure to meet legal or fiduciary responsibilities in underwriting and distributing transactions can damage an institution's reputation and impair its ability to compete and that distributing transactions that have significantly higher default or loss rates and performance issues may also damage an institution's reputation.

XV. Securities Laws

The proposed guidance notes that when securities are involved in leveraged finance transactions, institutions should ensure compliance with securities laws, including establishing procedures regarding the dissemination of material non-public information.

XVI. Compliance Function

The proposed guidance provides that an independent compliance function should periodically review an institution's leveraged finance activity, with reference to the Agencies' existing guidance on compliance with laws and regulations.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] See 77 Fed. Reg. 19417 (March 30, 2012)

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