Client Alert

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Banks Face New Obligations in Underwriting, Risk Analysis, and Management of Leveraged Lending

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This Alert describes the recently issued guidance (the "Guidance") from the U.S. banking agencies instructing regulated domestic and foreign banks, subsidiaries and affiliates on implementing an acceptable infrastructure to comply with their safety and soundness responsibilities when engaging in leveraged lending. The effective date for the Guidance is May 21, 2013.

On March 22nd, the federal banking agencies issued the Guidance, which replaces regulatory interagency guidance in effect since 2001.[1] The 2001 guidance, which is somewhat simplistic by today's standards, established a risk management obligation on the part of banking institutions engaging in "leveraged financing." The newly issued Guidance, however, enhances the obligations established by the 2001 guidance by imposing a very robust internal set of controls for all regulated institutions, including banks, thrifts, holding companies, foreign banks operating in the U.S., and related subsidiaries and affiliates.

As stated in the Guidance, covered institutions are charged with the responsibility to:

- Properly evaluate and underwrite credit risks in leveraged loans;
- Understand the effect of changes in the values in a borrower's enterprise on credit portfolio quality; and
- Assess the sensitivity of future credit losses to these changes in enterprise value.

To accomplish these goals, the Guidance requires that an institution adopt policies and procedures in the following topical areas:

- Defining Leveraged Lending
- General Policy Expectations
- Participations Purchased
- Underwriting Standards

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

- 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

Several of the items that the Guidance indicates should be included in each of these categories are described below:

Defining Leveraged Lending. As a small accommodation to the industry, the Agencies substituted the term "leveraged lending" for "leveraged finance," and permit an institution to define the scope of leveraged lending within (and across) all of its business lines. Importantly, the Guidance also provides several examples of definitional criteria that would be acceptable when identifying a leveraged lending transaction, and specifically excludes asset-based lending (typically determined by a borrowing base or formula). In addition, the Guidance indicates that from a timing perspective the determination whether a credit is a leveraged loan is made at the time of origination, modification, extension or refinancing (thereby excluding so-called "fallen angel" credits).

General Policy Expectations. When formulating underwriting policies and procedures, a financial institution should include the following:

- Identify overall acceptable risk, including pipeline risk, and support the determination of risk by an analysis of the effect on earnings, capital, liquidity and other pertinent risks;
- Adopt limits, including appropriate underwriting, on obligors and transactions, including the institution's hold and sale portfolio, pipeline exposure and industry and geographic concentrations;
- Ensure that the identified risks are recognized in the ALLL and capital analyses;
- Create clear credit and underwriting pathways, including modifications to transactional structures and loan terms;
- Reporting pathways to management and the institution's board of directors (or equivalent body);
- Expectations for risk-adjusted returns; and
- Adopt minimum underwriting standards.

It is important to note that the Guidance specifically indicates that the risk appetite component of this category must be approved by the institution's board of directors.

Participations. The Guidance imposes an affirmative duty by a participant to independently evaluate a transaction when purchasing a participation. This includes:

- Analyzing "full" credit information both at the time a participation is purchased and on a regular basis thereafter;
- Obtaining copies of all loan documents, legal opinions and related materials;
- Establishing appropriate monitoring procedures for the borrower; and
- Setting risk management processes.

It should be noted that the Agencies did not exempt small institutions from compliance with the requirements of the Guidance, but rather, have taken the position that it would be unusual for smaller institutions to be acting as a lead lender for leveraged lending. Accordingly, the Guidance indicates that for smaller institutions, compliance with the requirements of the participation category will often be sufficient.

Of particular interest to lead lenders, the final version of the Guidelines deleted references to a "fiduciary" duty owed by a lead lender to participants. This means that the participants in a leveraged loan participation remain free to determine by contract the duty owed among the parties.

Underwriting Standards. This category sets forth extensive items that must be included in an institution's underwriting criteria, including:

- Determining whether the business plan by the borrower is sound and the borrower's capital structure is sustainable (whether underwriting for a portfolio loan or intent to distribute);
- The borrower's ability to repay and ability to delever over a reasonable time frame;
- Establishing reasonable levels of due diligence;
- Setting risk-adjusted returns, including consideration for alternative disposition and funding sources;
- Evaluating enterprise value and the role of a sponsor for repayment and credit enhancement;
- Setting credit agreement terms for covenants, conditions and collateral considerations; and
- Determining legal entitlements regarding covenant protections, including reporting requirements and compliance monitoring, as well as availability of monitoring information to participants.

The Guidance clarifies that underwriting standards for workout and bankruptcy situations are to be separately established. Further, the use of "single asset" structures permits a lender to adopt separate underwriting criteria for such arrangements.

In regard to contractual provisions for leveraged loans, the Guidelines permit lenders the flexibility to adjust to market conditions, such as by negotiating "covenant-lite" provisions. Arguably, such market-based determinations affect risk and would be incorporated into an institution's risk analysis that is performed on a regular basis.

Valuation Standards. The Guidance requires that standards for determining accurate valuation must be adopted, with a focus on enterprise valuation and stress testing.

In regard to enterprise valuation, a financial institution must separate the valuation function from the origination function, and the Guidance provides several (non-inclusive) commonly used methods to establish appropriate valuation for assets, income and other market factors, including capitalized cash flow and discounted cash flow.

Following the determination of value, the Guidance require that a stress test be performed at the time of origination and regularly thereafter.

Pipeline Management. Perhaps in recognition of the financial meltdown of several years ago, the Guidance identifies several items that must be included in the management of an institution's pipeline of transactions, including:

- Underwriting risks;
- Managing distribution and "hung" transactions;
- The obligation to conduct stress testing on pipeline exposures, including comparisons to original risk-adjusted returns;
- Establishing aggregate and individual borrower limits, including enterprise and industry limits;
- Confirming correct accounting for pipeline transactions; and
- Setting hedging policies to address pipeline risk.

As a practical matter, both the pipeline and general risk requirements regarding single borrower and aggregate credit exposure could be viewed as internal lending limitations, both on the business line and enterprise basis.

Reporting and Analytics. The Guidance imposes an obligation to create a "management information system" ("MIS") for leveraged lending, and to provide senior management "comprehensive reports about the characteristics and exposures at least quarterly." The reporting should summarize the foregoing items identified above, including individual and portfolio exposures across all business lines. (Notably, while the reporting must be provided to an institution's management, summaries of risk-related exposures must be provided to the institution's board of directors.)

Risk-Rating Leveraged Loans. The Guidance incorporates by reference existing Agency interpretations and guidance relating to internal risk-rating and classification of leveraged loans. Among other things, the Guidance indicate that a general rule of thumb to avoid a classification issue is support for the ability of the borrower to repay at least 50% of the total debt over a five-to-seven-year period. (This repayment analysis, however, should not be confused with loan terms that *require* repayment within those time periods.)

Ongoing Credit Analysis. The Guidance impose a duty on institutions to analyze the viability of a borrower within the context of the borrower's industry, and integrating that information into both general risk and stress assessments. Considerations include:

- Cash flow analysis;
- Liquidity based upon metrics in the industry;
- Merger and other corporate transactions;
- Variations in the borrower's business and operating plans (performed on a quarterly basis);
- Collateral shortfalls;
- Changes in the debt and equity markets; and
- Interest and foreign exchange risk.

Problem Credit Management. A lender must have in place processes to deal with borrowers whose performance departs from planned cash flows, assets sales, collateral calls and other monitoring factors. In that regard, an institution engaged in a workout should emphasize quantifiable objectives and measurable time frames, including considering alternatives such as the sale of the credit in the market and liquidation of collateral.

Deal Sponsors. The Guidance requires that policies and procedures be in place to evaluate the credit quality of financial sponsors, including the ability to regularly monitor the sponsor's financial condition. (The obligation to perform a credit analysis of a sponsor appears to arise only when the lender views the sponsor as a secondary source of repayment.) This analysis should include:

- The sponsor's historical performance;
- The economic incentive by the sponsor to provide support, including preferring one sponsored borrower over another;
- The enforceability of the credit support being provided, including guarantees, comfort letters, etc.;
- Capital availability, including the sponsor's dividend policy; and
- The contractual ability of the lender to directly monitor the sponsor.

Credit Review. The Guidance recognizes that the inherent risk of leveraged lending generally will require more frequent credit review than other asset categories, and in any event should be performed at least once a year. The credit review function should be independent of the origination function at the institution. In addition, the internal review function should receive adequate resources to perform required functions, including reviews of the level of risk, risk-rating integrity, valuation methodologies and the quality of risk management.

Stress Management. The Guidance incorporates by reference the extensive guidance and requirements adopted by the Agencies regarding the performance of ongoing stress testing.

Conflicts of Interest. In a recognition of the ability of an institution to hold both equity and lending positions relating to a borrower (or an entity affiliated with a borrower), the Guidance instructs a lender to adopt policies and procedures that identify and address potential conflicts of interest.

Reputational Risk. Perhaps in recognition that documents such as the Guidance are often negotiated among the Agencies, the Guidance includes a paragraph to the effect that an institution should remember that leveraged lending may affect reputational risk.

Compliance. Finally, in somewhat of a catch-all item, the Guidance states that ongoing independent compliance is required, and should include a review of all required statutory and legal issues, including securities law compliance and anti-tying considerations.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author. Pillsbury's Financial Services Regulation practice lawyers are actively discussing the numerous issues raised by the Guidance with staff at the federal banking agencies.

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