Joint Release

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

For Immediate Release March 26, 2012

Agencies Propose Revisions to Leveraged Finance Guidance

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (the agencies) are seeking comment on proposed revisions to the interagency leveraged finance guidance issued in 2001. Transactions that are covered by this guidance are characterized by a borrower with a degree of financial or cash flow leverage that significantly exceeds industry norms as measured by various debt, cash flow, or other ratios.

The agencies observed tremendous growth in the volume of leveraged credit leading up to the crisis and in the participation of non-regulated investors. While there was a pull-back in leveraged lending during the crisis, volumes have since increased while prudent underwriting practices have deteriorated. As the market has grown, debt agreements have frequently included features that provide relatively limited lender protection, including the absence of meaningful maintenance covenants and the inclusion of other features that can affect lenders' recourse in the event of weakened borrower performance. In addition, capital structures and repayment prospects for some transactions, whether originated to hold or to distribute, have been aggressive. Management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, and many institutions have found themselves holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

Leveraged finance is an important type of financing for the economy, and banks play an integral role in making credit available and syndicating that credit to investors. It is important that banks help provide financing to creditworthy borrowers in a safe and sound manner.

In light of the market's evolution, the agencies propose replacing the 2001 guidance with revised leveraged finance guidance that refocuses attention to five key areas:

- Establishing a Sound Risk-Management Framework: The agencies expect that management and the board identify the institution's risk appetite for leveraged finance, establish appropriate credit limits, and ensure prudent oversight and approval processes.

- Underwriting Standards: These outline the agencies' expectations for cash flow capacity, amortization, covenant protection, and collateral controls and emphasize that the business premise for each transaction should be sound and its capital structure should be sustainable irrespective of whether underwritten to hold or to distribute.

- Valuation Standards: These concentrate on the importance of sound methodologies in the determination and periodic revalidation of enterprise value.

- Pipeline Management: This highlights the need to accurately measure exposure on a timely basis, the importance of having policies and procedures that address failed transactions and general market disruption, and the need to periodically stress test the pipeline.

- Reporting and Analytics: This emphasizes the need for MIS that accurately capture key obligor characteristics and aggregates them across business lines and legal entities on a timely basis. Reporting and analytics also reinforce the need for periodic portfolio stress testing.

Although some sections of the guidance should apply to all leveraged transactions (for example, underwriting), the vast majority of community banks should not be affected as they have no exposure to leveraged loans.

Comments on the proposed guidance must be submitted to the agencies no later than June 8, 2012.

Attachment:
Proposed Guidance on Leveraged Lending - PDF (PDF Help)

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FDIC: PR-34-2012