

AL 99-4
Subject: Leveraged Lending
Date: May 3, 1999

To: Chief Executive Officers, Department and Division Heads, and All
Examining
Personnel Purpose

The volume of leveraged loans in the broadly syndicated loan market has risen significantly since 1993. Additionally, there is strong anecdotal evidence of increased leveraged lending activity in the middle market. The OCC encourages national bank participation in all lending activities that are creditworthy and consistent with sound banking principles, and such activities can include leveraged lending. However, the easing of underwriting standards and credit discipline that has accompanied the growth of leveraged lending activities, as well as lenders' increased tolerance of higher leverage, warrant extra supervisory attention. The combination of high leverage and relaxed underwriting significantly increases the risks associated with this form of lending.

This Advisory Letter provides guidance to bankers and examiners about the elevated risks associated with leveraged lending activities and discusses OCC's risk management expectations for banks that engage in them. It reaffirms and expands existing policy guidance contained in the following publications:

- Banking Circular 181 - "Purchases of Loans in Whole or in Part - Participations" (August 2, 1984)
- Examining Circular 245 - "Highly Leveraged Transactions" (December 14, 1988)
- "Loan Portfolio Management" booklet of the Comptroller's Handbook (April 1998)
- OCC Bulletin 99-2 - "Risk Management of Financial Derivatives and Bank Trading Activities" (January 25, 1999).

Contents
Page
Background and Scope2
Risks Associated with Leveraged Lending Activities3

Risk Management..... ..8
Conclusion..... ..9

Background and Scope

Numerous definitions of "leveraged lending" have developed in the financial services industry; however, this Advisory Letter is broadly directed at credit arrangements that exhibit one or more of the following characteristics:

- The borrower's debt to equity is significantly above the norm for its industry.
- The borrower is in an industry that typically uses significant financial leverage (e.g., hedge funds [Note:The term "hedge fund" generally refers to private investment partnerships that use some form of leverage (either through derivative transactions or direct borrowing) to accomplish their investment objectives. Most hedge funds are structured as limited partnerships. They are largely exempt from federal securities law and regulation by limiting their securities sales to fewer than 100 "qualified" purchasers.]).
- Loans or portions of loan arrangements (tranches) are structured with:
 - minimal principal amortization or deferred repayment plans, "enterprise value" or its equivalent used to augment or otherwise mitigate deficient equity and collateral values, repayment primarily dependent on refinancing or recapitalization; and/or primary and secondary repayment sources closely linked to achieving aggressive growth projections .

Lending arrangements used to finance mergers and acquisitions, business recapitalizations, equity buyouts, and build-outs or expansion of a business or business line(s) frequently contain one or more of these characteristics.

Leveraged lending, in one form or another, has been around for years. While it is more prevalent in certain industries and with larger companies, banks provide leveraged financing to a variety of borrowers for a variety of reasons. Leverage is commonly

employed as an alternative to equity when financing business expansions and acquisitions.

It can serve to support business growth and increase returns to investors by financing business operations that generate incremental profits against a fixed equity investment. However, when the use of increased debt does not generate sufficient cash flows or asset values, both primary and secondary repayment sources may be quickly and seriously impaired. As a result of this increased risk, leveraged lending requires more intense account and portfolio management than many other types of lending.

Risks Associated with Leveraged Lending

High debt levels increase the risk of default. Leveraged borrowers' higher debt levels relative to their equity, income, or cash flow make it more difficult for them to withstand adverse economic conditions or business plan variances, to take advantage of new business opportunities, or to make necessary capital expenditures.

In addition to these more general factors, other features are found in today's leveraged lending activities that heighten risk and warrant more intensive risk analysis, monitoring, and management. These include:

- Debt Structures and Collateral - Many of today's leveraged loans are structured with a revolving credit facility and several term loan tranches with successively longer repayment terms. The revolving debt portion is typically secured by a traditional borrowing base of working assets with the term tranches collateralized by fixed assets. However, as overall debt levels increase, and the borrower's needs exceed conventional collateral advance formulas, some banks are increasing advance rates on working assets, are using working assets to secure long-term debt, and are relying on fixed asset collateral coverage to secure revolving facilities. These practices dilute the lender's overall collateral protection. In many cases these structured transactions contain cross-collateralization and cross-default provisions, which further dilute collateral protection.

Bankers and examiners need to incorporate the entire leveraged lending structure into their loan quality analysis and to evaluate cash flows, working

assets, and other collateral (including "enterprise value") against all the debt they support. Collateral values, advance rates, and cross-collateral and default agreements must be analyzed within the context of repayment sources, schedules, and priorities (under both normal and default conditions). Consideration should be given to requiring interest rate protection on all or part of the debt. Where repayment terms are overly liberal or structural protections are weak, the loan will warrant increased scrutiny and may warrant special mention or classification.

- Repayment Terms - Longer tenors, deferred or back-ended principal amortization, and single payment notes are common in leveraged lending structures. In many cases, the economic benefit of the asset or activity financed with increased leverage will not be immediately realized by the borrower. As a result, principal repayment requirements are deferred or otherwise set to coincide with the realization of expected repayment sources. This often occurs when lenders finance capital intensive or expanding businesses that must expend significant amounts of cash to fund long-term capital investments. It also occurs when lenders finance merger and acquisition activities, and in transactions where asset prices and business valuations are unproven or increasing relative to historical income and cash generation capability. Longer tenors can be appropriate when they are coordinated with the economic use and value of the asset financed, as well as the level and timing of expected cash flows. However, they are not appropriate when used to mask credit weaknesses related to the borrower, liberalize repayment terms for projects that have been "over-financed," or provide permanent capital.

Lenders granting loans with extended principal repayment requirements should ensure that lending agreements provide sufficient protections and controls (covenants, excess cash flow recapture requirements, limitations on discretionary expenditures, etc.) over borrowers and their cash. Lenders should conduct ongoing analysis of borrower cash flows and control the borrower's use of cash that might otherwise be used to amortize debt. Examiners should

expect leveraged loans to be repaid within reasonable terms. Examiners should also carefully review uses of cash by the borrower to ensure that funds otherwise available to amortize debt are not being used by the borrower for discretionary purposes (dividends, distributions, repayment of subordinate debt, capital expenditures, etc.) at the expense of debt repayment. When extended principal repayment requirements are coincident with unsupported and/or inflated cash flow and asset value projections, special mention or classification may be warranted.

- Reliance on "Enterprise Value" - Enterprise value, which is basically the estimated value of the obligor as a going concern, is increasingly being used by banks to support leveraged lending arrangements where committed amounts exceed the obligor's underlying tangible asset values. Historically, these under-collateralized positions have required accelerated or prioritized repayment, or have been held by subordinated lenders. Enterprise values can be highly volatile as they are subject to influences both within and beyond the control of the parties (e.g., interest rates, conditions in the industry, economy, or capital markets). Moreover, enterprise value is especially susceptible to decline when most needed by the lender, e.g., in problem situations, or in an economic downturn.

The standards that bankers and examiners employ to establish enterprise values should be comparable to those applied to evaluating other types of collateral. When enterprise value represents an abundance of caution, internal valuations may be appropriate. However, when enterprise values are relied upon to augment otherwise insufficient collateral coverage, the frequency, formality, and independence of the valuation process should be increased. In such cases banks should engage qualified, independent parties to conduct these business valuations.

- Reliance on Refinancing or Recapitalization - The lending market is currently liquid, reflecting strong demand for loan assets by banks and institutional

investors. Additionally, a strong equity market has made it attractive for firms to issue equity. As a result, many borrowers are negotiating deal structures that rely on loan refinancing or a capital issuance as the primary repayment source. Often, there is no clearly defined and realistic alternative source of repayment. Such loan arrangements that rely on refinancing or equity issuance in the capital markets carry the added element of market risk. Market liquidity and receptiveness can dissipate quickly for reasons beyond the control of the lender or borrower.

Loans that rely on refinancing or recapitalization as a source of repayment should be closely scrutinized. Because these repayment sources may be beyond the control of the borrower, the loans should have other reliable sources of repayment. Bankers and examiners should carefully analyze loans with repayment terms that continually rely on refinancing or fail to achieve successful recapitalizations. Such loans are speculative and may warrant special mention or classification.

- Interdependent Repayment Sources - Leveraged loans are often underwritten with collateral liquidation, asset sales, or refinance or recapitalization as secondary sources of repayment. The values assigned to such sources are often directly linked to the strength of cash flow. Because of this relationship, the value of secondary repayment sources may diminish in tandem with cash flow, increasing the risk of loss in the event of default. Risk is increased even further when both primary and secondary repayment sources depend on achieving performance levels (sales, income, cash flows, asset values, etc.) above those demonstrated historically.

Bankers and examiners should analyze the extent to which primary and secondary sources of repayment are related in order to assess both the risk of default and the risk of loss in the event of default in leveraged transactions. Special attention should be paid to loans where repayment

relies on projected cash flows, profits, or asset values that exceed historical levels. Both historical and projected factors must be considered in the evaluation of expected borrower performance. These performance, repayment, and collateral value projections should be thoroughly evaluated for reasonableness and stress tested at loan inception and on an ongoing basis. This includes comparing actual performance with projections and identifying the reasons for significant variances.

Management should ensure that leveraged loans receive thorough, timely, ongoing analysis and supervision. They should specifically review the frequency and quality of credit analysis and account monitoring activities by both lenders and credit risk control units to ensure that business development and cost containment objectives, or complacency, have not resulted in less timely, more cursory analysis and monitoring.

- Reliance on Equity Sponsors and Agent Banks - Some banks participate in leveraged loan transactions based on the strength and reputation of equity sponsors. They believe that major equity sponsors will support their transactions (e.g., provide additional equity, halt dividends, further subordinate rights to senior lenders, etc.) in order to protect their investments and reputations. As a result, lenders sometimes place too much reliance on this informal support.

Informal equity sponsor support is not a replacement for a thorough analysis of the credit on its own merits. Any reliance on sponsors should be fully supported by appropriate documentation and analysis of the sponsor's record of supporting previous deals, and their capacity and willingness to support the relationship under review.

Also, bankers and examiners are reminded that Banking Circular 181 (Purchase of Loans in Whole or in Part - Participations) requires a

purchasing bank to perform sufficient independent due diligence to make a fully informed credit decision. When that is not done, management of the purchasing bank should be criticized.

- Distribution "Fails" and Loans Held for Sale - Market disruption may impede the ability of an agent bank to consummate syndications or otherwise sell down loan exposures. As a result, the bank, as agent, may have to hold higher-than-planned exposure levels.

Banks should develop procedures for defining and managing distribution fails, which are generally defined by an inability to sell down the exposure within a reasonable distribution period (generally 90 days). When banks hold significantly greater exposures than originally intended, bankers and examiners must evaluate their effect on overall portfolio risk levels, and the adequacy of capital and the Allowance for Loan and Lease Losses.

Agent banks should clearly define their hold level before syndication efforts begin. Generally Accepted Accounting Practices require that loans originated with the intent to sell must be carried on the bank's books at the lower of cost or market.

The OCC has observed increased use of "market flex" language in lending agreements between agents and borrowers. Market flex language allows agents and/or arrangers to change pricing and other terms, if necessary, to ensure a successful syndication.

If used prudently, market flex language should allow loan terms and pricing to more accurately reflect risk, and enhance the distribution process.

- Hedge Funds - Banks may extend credit to hedge funds both via direct lending and through counterparty trading exposure from derivatives contracts. Unlike conventional borrowers, hedge funds can make material changes to their investment strategies and risk profile at any time. As a result, their financial statements may be of less value for credit analysis and monitoring. Banks, therefore, tend to focus on more qualitative assessments of hedge funds, such as the equity investment and track record of the

principals, business strategies, redemption policies, and the quality of risk management systems. To control the risks inherent in leveraged investment positions and the potentially high volatility of hedge fund cash flows, banks also typically seek marketable securities as collateral for these credit exposures.

Banks should not lend to hedge funds without first establishing and enforcing comprehensive risk management systems to monitor and control the elevated risk associated with these borrowers. In particular, banks should require the borrower to provide specific, timely information in order to evaluate credit risks properly. Further, banks should use covenants that allow them the flexibility to take corrective action should the borrower's risk profile change and/or financial position deteriorate. Hedge fund credit exposures also require continuous monitoring, both to maintain appropriate collateral margins as well as to assess changes in the risk profile. For more detailed information on credit risk management for trading counterparties, see OCC Bulletin 99-2 (Risk Management of Financial Derivatives and Bank Trading Activities), dated January 25, 1999. For specific information about risk management guidelines for banks to consider in their relationships with highly leveraged institutions, see the report dated January 28, 1999, by the Basle Committee on Banking Supervision entitled "Banks' Interactions with Highly Leveraged Institutions."
[Note: Available on the World Wide Web at <http://www.bis.org/publ/index.htm>]

Risk Management

OCC's risk management expectations for banks engaged in leveraged lending activities are contained in Examining Circular 245 and summarized below.

- Board approved policy statement that defines leveraged lending activities and establishes clear overall objectives and limits;
- Specific underwriting standards for leveraged loans;
- Consistent methodologies for evaluating collateral and business values;

- Reports that aggregate company-wide leveraged lending activities, including any specialized loans managed outside a dedicated leveraged lending department;
- MIS that provides timely information to manage the risks in leveraged lending activities (e.g., exposure levels, concentrations, risk rating trends, exception tracking, refinancing risk exposure, portfolio variance, and syndication performance);
- Methods for incorporating risks in leveraged lending activities into the Allowance for Loan and Lease Loss analysis;
- Internal review function that provides an independent assessment of the credit risk and asset quality of leveraged lending activities at both the individual transaction and portfolio level;
- Formal policies and procedures for leveraged lending sales and other distribution or syndication activities. The distribution policy should define what constitutes a "failed transaction";
- Process to identify potential conflicts of interest, the applicability of securities laws, and other legal issues.

Banks engaging in leveraged lending should ensure that their policies, procedures, and risk management practices are consistent with these expectations. Because leveraged lending is a high risk activity, the lack of a comprehensive risk management process may be considered an unsafe and unsound banking practice. Examiners should use the guidance contained in OCC Examining Circular 245 in conjunction with the " Loan Portfolio Management" booklet of the Comptroller's Handbook, and other applicable supervisory guidance to assess the quantity of risk and the quality of risk management by banks engaging in leveraged lending activities. Supervisory strategies for banks engaging in significant leveraged lending should explicitly provide for close examination review of the activity. Significant weaknesses in loan structures, other underwriting elements, or risk management processes should be: (1) communicated to bank management, (2) described in examination reports, (3) discussed with directors, and (4) where appropriate, corrective measures should be required.

Conclusion

Managing the risks inherent in leveraged lending is a complex task. In addition to exercising the risk selection, underwriting, credit administration, and portfolio management discipline required to safely manage the risks associated with lending in general, management must exercise additional diligence to properly identify, measure, manage, and control the higher and unique risks associated with leveraged lending.

Originating Office

Questions concerning this letter should be addressed to the Credit Risk Policy Division at (202) 874-5170.

David D. Gibbons
Deputy Comptroller, Credit Risk