Banking and Finance Law Daily Wrap Up, LOANS—Leveraged Lending Guidance Updated, (Mar. 21, 2013)

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To address the increased use of leveraged lending by financial institutions following the financial crisis, the Office of the Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corp. have updated their supervisory guidance that was issued in April 2001.

The agencies said they are taking this action because prudential underwriting practices have deteriorated, citing limits to lenders' recourse in the event of weakened borrower performance as one reason for the update. They also noted that management information systems at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis as another reason.

The revised guidance covers transactions characterized by a borrower with a degree of financial leverage that significantly exceeds industry norms. The designation of a financing as "leveraged lending" is typically made at loan origination, modification, extension, or refinancing. Although there is no one standard definition, the financial services industry uses a number of factors in determining whether there is a leveraged loan. These factors include: proceeds used for buyouts, acquisitions, or capital distributions; a ratio of total debt to EBITDA (earnings before interest, taxes, depreciation, and amortization); and high debt-to-net-worth ratios.

The guidance focuses on a number of areas: sound risk management; clearly defined underwriting standards; valuation standards that are periodically reevaluated; "pipeline management" that accurately measures exposures; information systems that timely report key analytics; realistic risk rating; and stress testing.

The agencies' updated guidance will not apply to asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. In addition, the guidance will not apply to "fallen angels" or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged. These loans would not be included within the scope of this guidance unless the credit is modified, extended, or refinanced. Finally the agencies stressed that community banks generally will be unaffected by the guidance because there are few community banks that undertake this type of lending.

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