§ 1016.5(a)—Disclosure (institution)—Annual privacy notice to customers requirement—A national bank or Federal savings association must provide a clear and conspicuous notice to customers that accurately reflects its privacy policies and practices not less than annually during the continuation of the customer relationship.

§ 1016.8—Disclosure (institution)—Revised privacy notices—If a national bank or Federal savings association wishes to disclose information in a way that is inconsistent with the notices previously given to a consumer, the national bank or Federal savings association must provide consumers with a clear and conspicuous revised notice of the national bank's or Federal savings association's policies and procedures and a new opt out notice.

§ 1016.7(a)—Disclosure (institution)—Form of opt out notice to consumers; opt out methods—Form of opt out notice—If a national bank or Federal savings association is required to provide an opt-out notice under § 1016.10(a), it must provide a clear and conspicuous notice to each of its consumers that accurately explains the right to opt out under that section. The notice must state:

- That the national bank or Federal savings association discloses or reserves the right to disclose nonpublic personal information about its consumer to a nonaffiliated third party;
- That the consumer has the right to opt out of that disclosure; and
- A reasonable means by which the consumer may exercise the opt out right.

A national bank or Federal savings association provides a reasonable means to exercise an opt out right if it:

- Designates check-off boxes on the relevant forms with the opt out notice;
- Includes a reply form with the opt out notice;
- Provides electronic means to opt out; or
- Provides a toll-free number to opt out.

§§ 1016.10(a)(2) and 1016(c)—Consumers must take affirmative actions to exercise their rights to prevent financial institutions from sharing their information with nonaffiliated parties—

- Opt out—Consumers may direct that the national bank or Federal savings association not disclose nonpublic personal information about them to a nonaffiliated third party, other than permitted by §§ 1016.13–1016.15.
- Partial opt out—Consumer also may exercise partial opt out rights by selecting certain nonpublic personal information or certain nonaffiliated third parties with respect to which the consumer wishes to opt out.

§§ 1016.7(h) and 1016(i)—Reporting (consumer)—Consumers may exercise continuing right to opt out—Consumer may opt out at any time—A consumer may exercise the right to opt out at any time. A consumer's direction to opt out is effective until the consumer revokes it in writing or, if the consumer agrees, electronically. When a customer relationship terminates, the customer's opt out direction continues to apply.

Type of Review: Extension of a currently approved collection.

Affected Public: Businesses or other for-profit; individuals.

Estimated Annual Number of Institution Respondents: Initial Notice, 3; Annual Notice and Change in Terms, 1,793; Opt-out Notice, 897.

Estimated Average Time per Response per Institution: Initial Notice, 80 hours; Annual Notice and Change in Terms, 8 hours; Opt-out Notice, 8 hours.

Estimated Subtotal Annual Burden Hours for Institutions: 21,760 hours.

Estimated Annual Number of Consumer Respondents: 2,526,802.

Estimated Average Time per Consumer Response: 0.25 hours.

Estimated Subtotal Annual Burden Hours for Consumers: 631,701 hours.

Estimated Total Annual Burden Hours: 653,461 hours.

Comments: The OCC issued a 60-day **Federal Register** notice on January 14, 2013. 78 FR 2720. No comments were received. Comments continue to be invited on:

(a) Whether the collection of information is necessary for the proper performance of the functions of the OCC, including whether the information has practical utility;

(b) The accuracy of the OCC's estimate of the information collection burden;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the collection on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Dated: March 18, 2013.

Michele Meyer,

Assistant Director, Legislative and Regulatory Activities Division.

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket ID OCC–2011–0028]

FEDERAL RESERVE SYSTEM

[OP–1438]

FEDERAL DEPOSIT INSURANCE CORPORATION

Interagency Guidance on Leveraged Lending

AGENCY: The Office of the Comptroller of the Currency (OCC), Department of the Treasury; Board of Governors of the Federal Reserve System (Board); and the Federal Deposit Insurance Corporation (FDIC).

ACTION: Final guidance.

SUMMARY: The OCC, Board, and the FDIC (collectively, the ''agencies'') are issuing final guidance on leveraged lending. This guidance outlines for agency-supervised institutions high-level principles related to safe-and-sound leveraged lending activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credits awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution. This guidance applies to all financial institutions supervised by the OCC, Board, and FDIC that engage in leveraged lending activities. The number of community banks with substantial involvement in leveraged lending is small; therefore, the agencies generally expect community banks to be largely unaffected by this guidance.

DATES: This guidance is effective on March 22, 2013. The compliance date for this guidance is May 21, 2013.

FOR FURTHER INFORMATION CONTACT:

OCC: Louise A. Francis, Commercial Credit Technical Expert, (202) 649–6670, *louise.francis@occ.treas.gov;* or Kevin Korzeniewski, Attorney, Legislative and Regulatory Activities Division, (202) 649–5490, 400 7th Street SW., MS 7W–2, Washington, DC 20219.

Board: Carmen Holly, Supervisory Financial Analyst, Policy Section, (202) 973–6122, *carmen.d.holly@frb.gov;* Robert Cote, Senior Supervisory Financial Analyst, Risk Section, (202) 452–3354, *robert.f.cote@frb.gov;* or Benjamin W. McDonough, Senior Counsel, Legal Division, (202) 452–2036, *benjamin.w.mcdonough@frb.gov;* Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

FDIC: Thomas F. Lyons, Senior Examination Specialist, Division of Risk Management Supervision, (202) 898–6850, *tlyons@fdic.gov;* or Gregory S. Feder, Counsel, Legal Division, (202) 898–8724, *gfeder@fdic.gov;* 550 17th Street NW., Washington, DC 20429.

SUPPLEMENTARY INFORMATION:

I. Background

On March 30, 2012, the agencies requested public comment on the joint Proposed Guidance on Leveraged Lending (the proposed guidance) with the comment period closing on June 8, 2012.[1] The agencies have reviewed the public comments, and are now issuing final guidance (final guidance) that includes certain modifications discussed in more detail in section II of this **SUPPLEMENTARY INFORMATION**.

As addressed in the final guidance, the agencies expect financial institutions to properly evaluate and monitor underwritten credit risks in leveraged loans, to understand the effect of changes in borrowers' enterprise values on credit portfolio quality, and to assess the sensitivity of future credit losses to these changes in enterprise values.[2] Further, in underwriting such credits, financial institutions should ensure borrowers are able to repay credits when due, and that borrowers have sustainable capital structures, including bank borrowings and other debt, to support their continued operations through economic cycles. Financial institutions also should be able to demonstrate they understand the risks and the potential impact of stressful events and circumstances on borrowers' financial condition. Recent financial crises underscore the need for financial institutions to employ sound underwriting, to ensure the risks in leveraged lending activities are appropriately incorporated in the allowance for loan and lease losses and capital adequacy analyses, monitor the sustainability of their borrowers' capital structures, and incorporate stress-testing into their risk management of leveraged loan portfolios and distribution pipelines. Financial institutions unprepared for such stressful events and circumstances can suffer acute threats to their financial condition and viability. This final guidance is intended to be consistent with sound industry practices and to expand on recent interagency issuances on stress-testing.[3]

II. Discussion of Public Comments Received

The agencies received 16 comment letters on the proposed guidance. Comments were submitted by bank holding companies, commercial banks, financial trade associations, financial advisory firms, and individuals. Generally, most comments expressed support for the proposed guidance; however, several comments recommended changes to and clarification of certain provisions in the proposed guidance.

The comments highlighted the following as primary issues of concern or interest or areas that could benefit from further explanation:

- The potential effect of the proposed guidance on community and mid-sized financial institutions;
- Definition of leveraged lending;
- Proposed exclusions for ''fallen angels'' and asset-based loans, and investment grade borrowers;
- Reporting requirements of deal sponsors;
- Proposed alternatives to the de-levering expectations;
- Effect of covenant-lite and payment-in-kind (PIK)-toggle loan structures;
- Methods used to determine enterprise value;
- Potential overall management information systems (MIS) burden presented by the proposed guidance; and
- Fiduciary responsibility of a financial institution for loans that it originates.

In response to these comments, the agencies have clarified and modified certain aspects of the guidance as discussed in the following section of this Supplemental Information.

A. Terminology

One purpose of the final guidance is to update and replace guidance issued in April 2001, titled ''Interagency Guidance on Leveraged Financing'' (2001 guidance). The 2001 guidance covered broad risk management issues associated with leveraged finance activities. This final guidance focuses on leveraged lending activities conducted by financial institutions. Therefore, to promote clarity and consistency, the agencies have used the term ''leveraged lending'' in the final guidance in place of all references to ''leveraged finance'' that appeared in the proposed guidance. This change is intended to focus the applicability and scope of the final guidance on specific types of leveraged lending transactions; those leveraged loans originated by financial institutions.

B. Scope

Several comment letters expressed concern about the potential effect of the proposed guidance on community banks and mid-sized institutions. The comments stressed that small financial institutions also can have exposure to leveraged loans. All of the comments expressed concern that the definition of leveraged lending used in the proposed guidance would encompass a significant number of portfolio loans originated by financial institutions, particularly small and mid-sized banks, including, but not limited to, traditional asset-based lending portfolios. One comment expressed concern that the guidance could be misinterpreted to require community banks to document and bear the burden of proof as to why certain transactions are not considered leveraged lending. Another comment noted that community banks with an insignificant amount of leveraged lending should not have to follow the same risk management framework as financial institutions with significant amounts of leveraged lending, as defined in the proposed guidance. Some comments suggested that the proposed guidance should exclude financial institutions under a certain asset or capital size, or exclude transactions under a certain dollar threshold.

In response to these comments, the agencies have decided to apply the final guidance to all financial institutions that originate or participate in leveraged lending transactions. However, the agencies agree with comments that a financial institution that originates a small number of less complex leveraged loans should not be expected to have policies and procedures commensurate with those of a larger financial

[1] *See* 77 FR 19417 ''Proposed Guidance on Leveraged Lending'' dated March 30, 2012 at *https://www.federalregister.gov/articles/2012/03/30/2012-7620/proposed-guidance-on-leveraged-lending.*

[2] For purposes of this final guidance, the term ''financial institution'' or ''institution'' includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

[3] *See* interagency guidance ''Supervisory Guidance on Stress-Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets,'' Final Supervisory Guidance, 77 FR 29458 (May 17, 2012), at *http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm,* and the joint ''Statement to Clarify Supervisory Expectations for Stress-Testing by Community Banks,'' May 14, 2012, by the OCC at *http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf;* the Federal Reserve at *www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf;* and the FDIC at *http://www.fdic.gov/news/news/press/2012/pr12054a.pdf.* See also FDIC Final Rule, Annual Stress Test, 77 FR 62417 (Oct. 15, 2012) (to be codified at 12 CFR part 325, subpart C).

institution with a more complex leveraged loan origination business. Therefore, the final guidance addresses mainly the latter type of leveraged lending. However, any financial institution that participates in rather than originates leveraged lending transactions should follow applicable supervisory guidance regarding purchased participations. To clarify the supervisory expectations for these types of loans, the agencies have incorporated the section on ''Participations Purchased'' from the 2001 guidance into the final guidance.

Although the agencies elected to adopt a definition of leveraged lending that encompasses all business lines, the agencies do not intend for this guidance to apply to small portfolio commercial and industrial loans, or traditional asset-based lending loans. The agencies have added language to the final guidance to clarify these concerns.

C. Definition

The agencies received five comments regarding the proposed definition of a leveraged lending transaction. A number of comments expressed concern over a perceived ''bright line'' approach to defining leveraged loans and proposed that institutions should be able to set their own definitions based on the characteristics of their portfolios. The agencies agree that various industries have a range of acceptable leverage levels and that financial institutions should do their own analysis to define leveraged lending. The proposed guidance addressed this issue by providing common definitions of leveraged lending and directing an institution to define leveraged lending in its internal policies. The proposed guidance also indicated that numerous definitions of leveraged lending exist throughout the financial services industry. However, the proposed guidance stated that institutions' policies should include criteria to define leveraged lending in a manner sufficiently detailed to ensure consistent application across all business lines and that are appropriate to the institution. Therefore, the agencies believe the definition of leveraged lending described in the proposed guidance was appropriate, and have retained that definition in the final guidance.

In addition, the agencies received comments on using earnings before interest, taxes, depreciation, and amortization (EBITDA) as a measure to define leverage. Some comments expressed concern that small banks focus on the balance sheet measure of leverage (total debt to tangible net worth) rather than the cash flow measure of leverage presented in the proposed guidance definition. Other comments viewed the ratio as a ''bright line'' and suggested that financial institutions should develop their own definition and leverage measure based on an institution's business lines. The agencies agree that each financial institution should establish its metrics for defining leveraged loans and include those indicators in its credit policies. However, the EBITDA-based leverage measure presented in the proposed guidance represented the supervisory measure that may be used as an important factor to be considered in defining leveraged loans based on each institution's credit products and characteristics. The agencies believe that having a consistent definition for supervisory purposes will help to ensure a consistent application of the guidance. Accordingly, the agencies are retaining this definition from the proposed guidance in the final guidance.

D. Information and Reporting

The agencies received a number of comments about the discussion in portions of the proposed guidance on management information systems (MIS) that financial institutions should implement. Comments stated it would be burdensome for small financial institutions to implement the same reporting mechanisms as large financial institutions. Another comment suggested that smaller as well as mid-sized institutions should discuss the risks with their regulators to implement appropriate procedures.

To clarify supervisory expectations for MIS requirements, the final guidance notes that information and reporting should be tailored to the size and scope of each financial institution's leveraged lending activities. The agencies would expect a global, complex financial institution with significant origination volumes or exposures to leveraged lending to have more complex MIS than a community bank with only a few exposures. Moreover, the final guidance notes that each institution should consider appropriate, cost-effective measures for monitoring leveraged lending given the size and scope of that institution's leveraged lending activities.

E. Additional Comments

One comment requested that the definition of leveraged lending be modified so as not to include ''fallen angels.'' These are loans that do not meet the definition of leverage loans at origination, but migrate into the definition at a later date due to changes in the borrower's financial condition. The comment suggested that the inclusion of these loans in the definition would skew reporting and tracking of the portfolio, duplicate monitoring activities, and increase costs without any benefit to financial institutions or to the regulators. The agencies agree that ''fallen angels'' should not be included as leveraged lending transactions, but should be captured within the financial institution's broader risk management framework. Therefore, the agencies have stated in the final guidance that a loan should be designated as leveraged only at the time of origination, modification, extension, or refinance.

One comment suggested that the sponsor evaluation standards in the proposed guidance are administratively burdensome and that financial assessments of deal sponsors by lenders should be limited to those sponsors that provide a financial guaranty. The agencies agree that the ability to obtain financial reports on sponsors may be limited in the absence of a formal guaranty. Accordingly, the final guidance removes the statement that an institution generally should develop guidelines for evaluating deal sponsors and instead focuses on deal sponsors that are relied on as a secondary source of repayment. In those instances, the final guidance notes that a financial institution should document the sponsor's willingness and ability to support the credit.

Some comments also suggested exclusions for both asset-based loans and ''investment-grade'' borrowers. As stated previously, the agencies acknowledge that traditional asset-based lending is a distinct product line and is not included in the definition of a leveraged loan unless the loan is part of the entire debt structure of a leveraged obligor; therefore, the agencies have clarified this point in the final guidance. In terms of a borrower's creditworthiness, the agencies do not believe it would be appropriate to exclude high-quality borrowers from the guidance. Prudent portfolio management of leveraged loans, which is a goal of this guidance, covers all loans, including those made to the most creditworthy borrowers. Importantly, the agencies strongly support the efforts of financial institutions to make loans available to creditworthy borrowers, particularly in small and mid-sized institutions that extend prudent commercial and industrial loans. All loans and borrowers except those excluded in the final guidance will be subject to the definitions as outlined in the guidance.

The agencies also received comments concerning the ability of borrowers to repay 50 percent of the total debt exposure over a five-to-seven year period. Some comments viewed this measure as a restrictive ''bright line'' while others proposed alternatives.

The measure in the proposed guidance was meant as a general guide to reflect that institutions should establish, in their policies, expectations and measures for reducing leverage over a reasonable period of time. The final guidance retains the expectation of reasonable de-levering, and the agencies have revised the *Underwriting Standards* section of the final guidance to state that institutions should consider reasonable de-levering abilities of borrowers, such as whether base case cash flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. In addition, the agencies have revised the *Risk Rating Leveraged Loans* section of the final guidance to include the measure as an example, stating that in the context of risk rating of leveraged loans, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity.

One comment referred to covenant-lite and PIK-toggle loan structures, and recommended that the agencies impose tighter controls around loans with such features. The agencies believe these types of structures may have a place in the overall leveraged lending product set; however, the agencies recognize the additional risk in these structures. Accordingly, although the final guidance does not have a different treatment for such arrangements, the agencies will closely review such loans as part of the overall credit evaluation of an institution.

One comment suggested that the agencies impose more conservative guidelines for determining enterprise value. The comment recommended that the agencies require financial institutions to use business appraisers and to follow Internal Revenue Service (IRS) appraisal guidelines when the institution is estimating the enterprise value of a firm. The intent of the agencies is not to impose real property appraisal and valuation standards to enterprise valuation methods or to require a formal business appraisal for all loans relying on enterprise value as a source of repayment. The goal of the final guidance is to clarify those methods considered credible for determining enterprise value based on common practices in the industry. These methods, if conducted properly, produce reliable results. Accordingly, the final guidance does not require that an evaluation be conducted by a business appraiser in determining enterprise value. The agencies' expectation is that a financial institution's internal policies should address the source and method of any enterprise value estimate.

The agencies received four comments regarding the burden imposed by the proposed guidance, stating that implementation will add to the high costs that financial institutions already face. One comment noted there was no cost benefit analysis provided with the proposed guidance. To address these concerns, the final guidance emphasizes that an institution needs to have sound risk management policies and procedures commensurate with its origination activity in and exposures to leveraged lending. Moreover, the final guidance notes that a financial institution's risk management framework for leveraged lending should be consistent with the institution's risk appetite, and complexity of exposures. The agencies believe the implementation of any additional systems or processes needed to promote safe-and-sound leveraged lending should be considered a component of an institution's overall credit risk management program.

One comment noted that financial institutions in a credit transaction do not have fiduciary responsibilities to loan participants when underwriting and syndicating leveraged loans. The agencies agree and have not included a reference to fiduciary responsibility in the final guidance.

III. Administrative Law Matters

A. Paperwork Reduction Act Analysis

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320, Appendix A.1), the agencies reviewed the final guidance. The agencies may not conduct or sponsor, and an organization is not required to respond to, an information collection unless the information collection displays a currently valid Office of Management and Budget (OMB) control number. The OCC and FDIC have submitted this collection to OMB for review and approval under 44 U.S.C. 3506 and 5 CFR part 320. The Board reviewed the final guidance under the authority delegated to it by OMB. While this final guidance is not being adopted as a rule, the agencies have determined that certain aspects of the guidance constitute collections of information under the PRA. These aspects are the provisions that state that a financial institution should have (i) Underwriting policies for leveraged lending, including stress-testing procedures for leveraged credits; (ii) risk management policies, including stress-testing procedures for pipeline exposures; and, (iii) policies and procedures for incorporating the results of leveraged credit and pipeline stress tests into the firm's overall stress-testing framework. The frequency of information collection is estimated to be annual.

Respondents are financial institutions with leveraged lending activities as defined in the guidance.

Report Title: Guidance on Leveraged Lending.

Frequency of Response: Annual.

Affected Public: Financial institutions with leveraged lending.

OCC:

OMB Control Number: To be assigned by OMB.

Estimated number of respondents: 25.

Estimated average time per respondent: 1,350.4 hours to build; 1,705.6 hours for ongoing use.

Estimated total annual burden: 33,760 hours to build; 42,640 hours for ongoing use.

Board:

Agency information collection number: FR 4203.

OMB Control Number: To be assigned by OMB.

Estimated number of respondents: 41.

Estimated average time per respondent: 1,064.4 hours to build; 754.4 hours for ongoing use.

Estimated total annual burden: 43,640 hours to build; 30,930 hours for ongoing use.

FDIC:

OMB Control Number: To be assigned by OMB.

Estimated number of respondents: 9.

Estimated average time per respondent: 986.7 hours to build; 529.3 hours for ongoing use.

Estimated total annual burden: 8,880 hours to build; 4,764 hours for ongoing use.

The estimated time per respondent is an average that varies by agency because of differences in the composition of the financial institutions under each agency's supervision (for example, size distribution of institutions) and volume of leveraged lending activities.

The agencies received two comments in response to the information collection requirements under the PRA. Both comments mentioned how substantially burdensome the guidance will be to implement. The agencies recognize that the amount of time required of any institution to comply with the guidance may be higher or lower than the estimates, but believe that the numbers stated are reasonable averages.

One comment also noted the absence of a cost-benefit analysis and questioned whether the additional information systems required undermines the utility of the information collection. In response to the general comments about burden, the agencies have made various modifications to the proposed guidance, including clarifying the application of the guidance to community banks and other smaller institutions that are involved in leveraged lending. In the **SUPPLEMENTARY INFORMATION** section, the agencies also highlighted their expectations that MIS and other reporting activities would be tailored to the size and the scope of an institution's leveraged lending activities. In addition, the implementation of any new systems would be part of an institution's overall credit risk management program. These comments are discussed in more detail in the general comment summary in Section II of the **SUPPLEMENTARY INFORMATION.**

Comments continue to be invited on:

(a) Whether the collection of information is necessary for the proper performance of the Federal banking agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Comments on these questions should be directed to:

OCC: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by email if possible. Comments may be sent to: Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, Attention: 1557–NEW, 400 7th Street SW., Suite 3E–218, Mail Stop 9W–11, Washington, DC 20219. In addition, comments may be sent by fax to (571) 465–4326 or by electronic mail to *regs.comments@occ.treas.gov.* You may personally inspect and photocopy comments at the OCC, 400 7th Street SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 649–6700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

All comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

Additionally, please send a copy of your comments by mail to: OCC Desk Officer, 1557–NEW, U.S. Office of Management and Budget, 725 17th Street NW., #10235, Washington, DC 20503, or by email to: *oira submission@omb.eop.gov.*

FDIC: Interested parties are invited to submit written comments. All comments should refer to the name of the collection, ''Guidance on Leveraged Lending.'' Comments may be submitted by any of the following methods:

- *http://www.FDIC.gov/regulations/laws/federal/propose.html.*
- *Email: comments@fdic.gov.*
- *Mail:* Gary Kuiper (202) 898–3877, Federal Deposit Insurance Corporation, 550 17th Street NW., NYA–5046, Washington, DC 20429.
- *Hand Delivery:* Comments may be hand-delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

As the final guidance discusses the importance of stress-testing as part of an institution's risk management practices for leveraged lending activity, the agencies note that they expect to review an institution's policies and procedures for stress-testing as part of their supervisory processes. To the extent they collect information during an examination about a financial institution's stress-testing results, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA), 5 U.S.C. 552(b)(8).

B. Regulatory Flexibility Act Analysis

The final guidance is not a rulemaking action. Thus, the Regulatory Flexibility Act (5 U.S.C. 603(b)) does not apply to the guidance. However, the agencies have considered the potential impact of the guidance on small banking organizations. For the reasons discussed in sections I and II of this Supplementary Information, the agencies are issuing the guidance to emphasize the importance of properly underwriting leveraged lending transactions and incorporating those exposures into stress and capital tests for institutions with significant exposures to these credits.

The agencies received comments about the potential burden of this guidance on small banking organizations. The final guidance is intended for banking organizations supervised by the agencies with substantial exposures to leveraged lending activities, including national banks, federal savings associations, state nonmember banks, state member banks, bank holding companies, and U.S. branches and agencies of foreign banking organizations. Given the average dollar size of leveraged lending transactions, most of which exceed $50 million, and the agencies' observations that leveraged loans tend to be held primarily by very large or global financial institutions, the vast majority of smaller institutions should not be affected by this guidance as they have limited exposure to leveraged credits.

Interagency Guidance on Leveraged Lending

The text of the guidance is as follows:

Purpose

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively the ''agencies'') are issuing this leveraged lending guidance to update and replace the April 2001 Interagency guidance [1] regarding sound practices for leveraged finance activities (2001 guidance).[2] The 2001 guidance addressed expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions,

[1] OCC Bulletin 2001–18; *http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001–18.html;* Board SR Letter 01–9, ''Interagency Guidance on Leveraged Financing'' April 9, 2001; *http://www.federalreserve.gov/boarddocs/srletters/2001/sr0109.html;* and, FDIC Press Release PR–28–2001; *http://www.fdic.gov/news/news/press/2001/pr2801.html.*

[2] For the purpose of this guidance, references to leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and non-bank investors. References to leveraged lending and leveraged loan transactions and credit agreements refer to all debt with the exception of bond and high-yield debt held by both bank and non-bank investors.

and the importance of stress-testing exposures and portfolios.

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans.[3] For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system. This guidance is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner.

Since the issuance of the 2001 guidance, the agencies have observed periods of tremendous growth in the volume of leveraged credit and in the participation of unregulated investors. Additionally, debt agreements have frequently included features that provided relatively limited lender protection including, but not limited to, the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind (PIK)-toggle features in junior capital instruments, which lessened lenders' recourse in the event of a borrower's subpar performance. The capital structures and repayment prospects for some transactions, whether originated to hold or to distribute, have at times been aggressive. Moreover, management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, with many institutions holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

This guidance updates and replaces the 2001 guidance in light of the developments and experience gained since the time that guidance was issued. This guidance describes expectations for the sound risk management of leveraged lending activities, including the importance for institutions to develop and maintain:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound MIS that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and,
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Applicability

This guidance updates and replaces the existing 2001 guidance and forms the basis of the agencies' supervisory focus and review of supervised financial institutions, including any subsidiaries or affiliates. Implementation of this guidance should be consistent with the size and risk profile of an institution's leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions should consider all aspects and sections of the guidance.

In contrast, the vast majority of community banks should not be affected by this guidance as they have limited involvement in leveraged lending. Community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator the implementation of cost-effective controls appropriate for the complexity of their exposures and activities.[4]

Risk Management Framework

Given the high risk profile of leveraged transactions, financial institutions engaged in leveraged lending should adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices. This guidance outlines the agencies' minimum expectations on the following topics:

- Definition of Leveraged Lending
- General Policy Expectations
- Participations Purchased
- Underwriting Standards
- 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

Definition of Leveraged Lending

The policies of financial institutions should include criteria to define leveraged lending that are appropriate to the institution.[5] For example, numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined

[3] For purposes of this guidance, the term ''financial institution'' or ''institution'' includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

[4] The agencies do not intend that a financial institution that originates a small number of less complex, leveraged loans should have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance provided in the ''Participations Purchased'' section of this document.

[5] This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. Asset-based lending is a distinct segment of the loan market that is tightly controlled or fully monitored, secured by specific assets, and usually governed by a borrowing formula (or ''borrowing base'').

levels appropriate to the industry or sector.[6]

- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.[7]

A financial institution engaging in leveraged lending should define it within the institution's policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. A financial institution's definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the institution from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending should address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by its board of directors;
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, the agencies expect that financial institutions with significant leveraged transactions will implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;[8]
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see ''Underwriting Standards'' section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds.[9] They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for:

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- Carefully monitoring the borrower's performance throughout the life of the loan; and,
- Establishing appropriate risk management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, an institution's underwriting standards should consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles;
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base case cash flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term.[10] Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction;
- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include

[6] Cash should not be netted against debt for purposes of this calculation.

[7] The designation of a financing as ''leveraged lending'' is typically made at loan origination, modification, extension, or refinancing. ''Fallen angels'' or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included within the scope of this guidance, unless the credit is modified, extended, or refinanced.

[8] Flex terms allow the arranger to change interest rate spreads during the syndication process to adjust pricing to current liquidity levels.

[9] Refer to other joint agency guidance regarding purchased participations: OCC Loan Portfolio Management Handbook, *http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf,* Loan Participations, Board ''*Commercial Bank Examination Manual,'' http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf,* section 2045.1, Loan Participations, the Agreements and Participants; and FDIC Risk Management Manual of Examination Policies, section 3.2 (Loans), *http://www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit,* Loan Participations, (last updated Feb. 2, 2005).

[10] In general, the base case cash flow projection is the borrower or deal sponsor's expected estimate of financial performance using the assumptions that are deemed most likely to occur. The financial results for the base case should be better than those for the conservative case but worse than those for the aggressive or upside case. A financial institution may make adjustments to the base case financial projections, if necessary. The most realistic financial projections should be used when measuring a borrower's capacity to repay and de-lever.

standards for evaluating various types of collateral, with a clear definition of credit risk management's role in such due diligence;

- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods;
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Institutions looking to rely on sponsor support as a secondary source of repayment for the loan should be able to provide documentation, including, but not limited to, financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit extension;
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6X Total Debt/EBITDA raises concerns for most industries;
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and,
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured, standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which a financial institution should consider separate underwriting and risk rating guidance.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) Evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The ''capitalized cash flow'' method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The ''discounted cash flow'' method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the ''discount rate'') that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets should be tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the institution should establish limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates should be clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods should be appropriate for the borrower's industry and condition.

Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, financial institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those to be distributed. A financial institution should be able to differentiate transactions according to tenor, investor class (for example, pro-rata and institutional), structure, and key borrower characteristics (for example, industry).

In addition, an institution should develop and maintain:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from pipeline exposures;
- Written policies and procedures for defining and managing distribution failures and ''hung'' deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing). The financial institution's board of directors and management should establish clear expectations for the disposition of pipeline transactions that have not been sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be reported to management and the board of directors;
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital;
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication and distribution variances, and reporting of recourse sales to achieve distribution;
- Reports that include individual and aggregate transaction information that accurately risk rates credits and portrays risk and concentrations in the pipeline;
- Limits on aggregate pipeline commitments;
- Limits on the amount of loans that an institution is willing to retain on its own books (that is, borrower, counterparty, and aggregate hold levels), and limits on the underwriting risk that will be undertaken for amounts intended for distribution;
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles;
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures, which should address acceptable types of hedges and the terms considered necessary for providing a net credit exposure after hedging; and,
- Plans and provisions addressing contingent liquidity and compliance with the Board's Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

Reporting and Analytics

The agencies expect financial institutions to diligently monitor higher risk credits, including leveraged loans. A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors. Policies and procedures should identify the fields to be populated and captured by a financial institution's MIS, which should yield accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment (that is, permanent, or temporary), and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed;
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative;
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Risk Rating Leveraged Loans

Previously, the agencies issued guidance on rating credit exposures and credit rating systems, which applies to all credit transactions, including those in the leveraged lending category.[11]

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior

[11] Board SR Letter 98–25 ''Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations;'' OCC Comptroller's Handbooks ''Rating Credit Risk'' and ''Leveraged Lending'', and FDIC Risk Management Manual of Examination Policies, ''Loan Appraisal and Classification.''

secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, the agencies believe that it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual status.

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. A financial institution's policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether

• Cash flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;

• Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;

• Projections exhibit an adequate margin for unanticipated merger-related integration costs;

• Projections are stress tested for one or more downside scenarios, including a covenant breach;

• Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance;

• Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;

• Collateral liquidation and asset sale estimates are based on current market conditions and trends;

• Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;

• Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and,

• The borrower is adequately protected from interest rate and foreign exchange risk.

Problem Credit Management

A financial institution should formulate individual action plans when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment should develop guidelines for evaluating the qualifications of financial sponsors and should implement processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

• The sponsor's historical performance in supporting its investments, financially and otherwise;

• The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;

• Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);

• 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;

• The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,

• Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Credit Review

A financial institution should have a strong and independent credit review function that demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, the institution's credit review function should assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. Such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution should staff its internal credit review function appropriately and ensure that the function has sufficient resources to ensure timely, independent, and accurate assessments of leveraged lending transactions. Reviews should evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Internal credit reviews should include the review of the institution's leveraged lending practices, policies, and procedures to ensure that they are consistent with regulatory guidance.

Stress-Testing

A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.[12] The sophistication of stress-testing practices and sensitivity analyses should be consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution should develop appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Policies and procedures should clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest, and provide for reporting, tracking, and resolution of any conflicts of interest that occur.

Reputational Risk

Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions which over time have significantly higher default or loss rates and performance issues may also see its reputation damaged.

Compliance

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure potential conflicts are avoided and laws and regulations are adhered to, an institution's independent compliance function should periodically review the institution's leveraged lending activity. This guidance is consistent with the principles of safety and soundness and other agency guidance related to commercial lending.

In particular, because leveraged transactions often involve a variety of types of debt and bank products, a financial institution should ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the Bank Holding Company Act Amendments of 1970[13] prohibits certain forms of product tying by financial institutions and their affiliates. The intent behind Section 106(b) is to prevent financial institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

In addition, equity interests and certain debt instruments used in leveraged transactions may constitute ''securities'' for the purposes of federal securities laws. When securities are involved, an institution should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

Dated: February 19, 2013.

Thomas J. Curry,

Comptroller of the Currency.

Board of Governors of the Federal Reserve System, March 8, 2013.

Robert deV. Frierson,

Secretary of the Board.

Dated at Washington, DC, this 11th day of March, 2013.

Federal Deposit Insurance Corporation.

Valerie J. Best,

Assistant Executive Secretary.

[FR Doc. 2013–06567 Filed 3–21–13; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

Community Volunteer Income Tax Assistance (VITA) Matching Grant Program—Availability of Application Packages

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice.

SUMMARY: This document provides notice of the availability of the application package for the 2014 Community Volunteer Income Tax

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[12] *See* interagency guidance ''Supervisory Guidance on Stress-Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets,'' Final Supervisory Guidance, 77 FR 29458 (May 17, 2012), at *http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm,* and the joint ''Statement to Clarify Supervisory Expectations for Stress-Testing by Community Banks,'' May 14, 2012, by the OCC at *http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf;* the Board at *www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf;* and the FDIC at *http://www.fdic.gov/news/news/press/2012/pr12054a.pdf.* See also FDIC Final Rule, Annual Stress Test, 77 FR 62417 (Oct. 15, 2012) (to be codified at 12 CFR part 325, subpart. C).

[13] 12 U.S.C. 1972.