LEVERAGED LENDING MANAGEMENT

Introduction

This Directive details the Banking Supervision Department's expectations from banking corporations regarding appropriate and cautious risk management in their leveraged lending activities. As detailed below in the directive, banking corporations are required to maintain, among other things:

(a) A transaction structure reflecting a sound business premise, appropriate capital structure, and reasonable leverage. These elements of safe and sound loan structure, together with supportable performance projections, need to clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether the loan is underwritten to hold or distribute;

(b) A definition of leveraged lending that facilitates consistent application across all business lines;

(c) Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinated debt;

(d) A credit limit and concentration framework consistent with the banking corporation's risk appetite;

(e) A sound MIS (management information system) that enables management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines; and

(f) Guidelines for conducting periodic leveraged-lending portfolio stress tests, in order to quantify the potential impact of economic and market conditions on the banking corporation's asset quality, earnings, liquidity, and capital.

Risk management framework

2. Given the high risk profile of leveraged transactions, banking corporations engaged in leveraged lending are required to adopt a risk management framework that includes an intensive and frequent review and monitoring process. The foundation of this framework is to be written risk objectives, risk acceptance criteria, and risk controls. This guideline describes the Banking Supervision Department's minimum expectations regarding:

a. Definition of leveraged lending
b. General policy expectations
c. Review by board of directors
d. Underwriting standards
e. Valuation standards
f. Reporting and quantitative analysis
g. Classification of leveraged loans
h. Credit analysis
i. Deal sponsors
j. Credit review
k. Stress testing

Definition of leveraged lending

3. A banking corporation's credit policy document shall define what a leveraged loan is, using clear and objective criteria. The generally accepted definitions in the financial services industry mostly include a combination of the following features:[1]

(a) Proceeds are used for buyouts, acquisitions, or capital distributions
(1) Buyout—the purchase or buyback, by the borrower, of the borrower's issued capital (including an employee stock ownership plan);
(2) Acquisition of another corporation—the purchase of any capital rights in another corporation, or the purchase of all, or a significant share, of the assets of another corporation;
(3) Capital distribution—a dividend payment or other transaction whose goal is to increase shareholder value;
A banking corporation shall determine materiality thresholds and minimum leverage ratios for transactions listed in this subsection. Transactions below such thresholds or the leverage ratios set are not required to be classified as leveraged lending.

(b) The ratio between a borrower's total debt to the borrower's EBITDA (earnings before interest, taxes, depreciation and amortization) exceeds the levels set by the bank, *inter alia* taking into account accepted levels in the specific industry or sector.[2]

(c) A borrower with a high debt to net worth ratio.

(d) The borrower's post-financing leverage, as measured by leverage ratios (such as debt to assets, debt to net worth, debt to cash flow, or other similar standards common to particular industries or sectors) is significantly higher than industry norms or historical levels.

4. A banking corporation is to define leveraged lending within the framework of its policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. The definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the banking corporation 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.

5. To eliminate any doubt, it is clarified that "credit for a capital transaction" included within the framework of calculating the quantitative limitation in Section 4(a) of Proper

[1] The designation of a financing as "leveraged lending" is typically made at loan origination, modification, extension, or refinancing. 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 directive, unless the credit is modified, extended, or refinanced.

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

Conduct of Banking Business Directive 323, shall be considered "leveraged lending" for the purposes of this directive.

General policy guidelines

6. A banking corporation's policies and procedures for leveraged lending shall address the following issues:

(a) Defining the banking corporation's risk appetite, including clearly defined amounts of leveraged lending that the banking corporation is willing to underwrite (for example, pipeline limits[3]) and is willing to retain (for example, transaction and aggregate hold levels). The banking corporation'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 requires approval by its board of directors;

(b) 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.

(c) Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in the banking corporation's allowance for credit losses and capital adequacy analysis;

(d) Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;

(e) Guidelines for appropriate oversight by senior management, including adequate and periodic reporting to the board of directors;

(f) Expected risk-adjusted returns for leveraged transactions;

(g) Minimum underwriting standards (see "Underwriting Standards" section below); and,

(h) Effective underwriting practices for primary loan origination and secondary loan acquisition.

Periodic review by board of directors

7. A banking corporation's board of directors shall discuss the banking corporation's leveraged lending policy at least once per year. The discussion shall cover *inter alia*:

(a) The banking corporation's policies regarding provision of leveraged lending (type of corporation, proportion of financing, types of credit, types of collateral, collateral margins, etc.)

(b) The scope of aggregate and desired exposure of the banking corporation's capital to leveraged lending and to credit for the acquisition of means of control, and the desired share of exposure to such credit at an individual corporation.

(c) Credit for the purchase of means of control in corporations controlling other corporations in which the banking corporation financed the purchase of control.

(d) Nonrecourse credit for the purchase of means of control.

[3] Pipeline transactions—as per the provisions of Proper Conduct of Banking Business Directive 311 regarding "Credit Risk Management".

8. Once per half-year, the board of directors shall hold a discussion regarding the state of the overall leveraged lending portfolio, including the meeting of financial covenants and a detailed discussion of all credit above a minimum amount to be set by the board of directors.

Underwriting standards

9. A banking corporation's underwriting standards should be clear, written and measurable, and should accurately reflect the banking corporation's risk appetite for leveraged lending transactions. Poorly underwritten transactions, together with an inadequate debt structure and limited financial covenants, are likely to ultimately lead to classification of the debt as problematic, and even to difficulty in reorganizing it. A banking corporation should set clear underwriting limits regarding leveraged transactions, including the size that the banking corporation will arrange both individually and in the aggregate for distribution.

10. The originating banking corporation should be mindful of the 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. A banking corporation that fails to meet its legal responsibility in underwriting and distributing transactions is liable to damage its reputation in the market and to impair its competitiveness. Similarly, a banking corporation that markets transactions that over time display rates of failure or loss that are markedly high and that are problematic in terms of meeting obligations, is also liable to be exposed to damage to its reputation.

11. At a minimum, a banking corporation's underwriting standards should consider the following:

(a) 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 banking corporation's own portfolio or with the intent to distribute.
(b) A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period. As a general guide, banking corporations 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.[4] Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction;
(c) Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, with a clear definition of the credit risk management function's role in such due diligence (in this

[4] 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 banking corporation 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.

regard, see also Section 44 of Proper Conduct of Banking Business Directive 311, relating to the involvement of the risk management function in the credit approval process);

(d) Standards for evaluating expected risk-adjusted returns.

(e) 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;

(f) Expectations for the degree of support provided by the sponsor[5] (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Banking corporations relying on sponsor support as a secondary source of repayment for the loan are 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;

(g) Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;

(h) Credit agreement covenant protections, including financial performance (such as debt to cash flow ratio, interest coverage, or fixed charge coverage ratio[6]), 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 6 times Total Debt/EBITDA raises concerns for most industries;

(i) Covenants ensuring the ability to demand loan repayment in a case of transferring the acquired company’s activities to activities in new risk areas (such as activity abroad in high-risk industries or geographic areas).

(j) 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 and examinations, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and,

(k) Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Valuation Standards

12. Banking corporations 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. Banking corporations may also view enterprise value as a useful benchmark for assessing a

[5] The term “sponsor” refers to a person (or other entity) who stands behind the transaction. For example, the controlling shareholder in a holding company, when the holding company is the borrower.

[6] The ratio of earnings before taxes, interest payments, and noncash expenses to fixed costs. In this regard, fixed costs generally include CAPEX (capital expenditure), taxes, principal and interest payments, and required dividend payments.

sponsor's economic incentive to provide financial support. Given the specialized and professional 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 and skilled persons.

13. 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.

14. 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.

15. When a borrower is experiencing a financial downturn or facing adverse market conditions, a lending banking corporation 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 loan 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 banking corporation 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.

16. Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, banking corporations 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 a banking corporation's leveraged lending activities, the banking corporation 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 banking corporation's appropriate decision-makers and risk oversight units. Further, a banking corporation's valuation methods should be appropriate for the borrower's industry and condition.

Reporting and Quantitative Analytics

17. Banking corporations are required to diligently monitor the credit in the leveraged lending portfolio. The banking corporation's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the banking corporation's board of directors. Policies and procedures should identify the fields to be populated and captured by a banking corporation's Management Information System, which should generate accurate and timely reporting to management and the board of directors that is to include:

(a) Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
(b) Risk rating distribution and migration analysis;
(c) A list of those borrowers who have been removed from the leveraged portfolio due to, for example, improvements in their financial characteristics and overall risk profile;
(d) Industry mix and maturity profile;
(e) Metrics derived from probabilities of default and loss given default, if such exist;
(f) Portfolio performance measures, including noncompliance with covenants, debt restructurings, non-accruing loans, and charge-offs;
(g) Amount of impaired assets and the amount of the allowance for credit losses attributable to leveraged lending;
(h) The aggregate level of policy exceptions and the performance of that portfolio;
(i) Exposures by collateral type, including unsecured transactions and those where enterprise value is 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;
(j) Secondary market pricing data and trading volume, when available;
(k) Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to a borrower or group of borrowers as defined in Proper Conduct of Banking Business Directive 313. The banking corporation is to identify, aggregate, and monitor these potential related exposures;
(l) Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
(m) Total and segmented leveraged lending exposures to borrowers and counterparties, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of a borrower's total indebtedness. The report should also consider exposures booked in other business units throughout the banking corporation, including indirect exposures such as credit default swaps and

total return swaps. Additionally, the banking corporation is to consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating banking corporation or its subsidiaries or affiliates.

Classification of Leveraged Loans

18. Classification of loans, including classification of leveraged lending, is regulated in Reporting to the Public directives. The classification 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, it is commonly assumed, in general, 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. 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 classified even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard classification is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the banking corporation is not merely masking repayment capacity problems by extending or restructuring the loan.

19. If the primary source of repayment becomes inadequate, a banking corporation should avoid considering 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. In such cases, when the loan is not well collateralized and is in collection proceedings, banking corporations will classify it as an impaired loan that is non-accruing (in accordance with the provisions of the Reporting to the Public directives), and when a portion of the loan is not well protected by pledged assets, or a well-supported enterprise value, an allowance or charge-off will be made in respect of that portion.

Credit Analysis

20. 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 banking corporation’s policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether:

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

(b) 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;

(c) Projections exhibit an adequate margin for unanticipated merger-related integration costs;

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

(e) Transactions are reviewed at least quarterly to determine if there has been 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;

(f) Enterprise and collateral valuations are timely, and consider potential value erosion;

(g) Collateral liquidation and asset sale estimates are based on current market conditions and trends;

(h) Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;

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

(j) The borrower is adequately protected from interest rate and foreign exchange risk.

Deal Sponsors

21. A banking corporation may not rely on sponsor support, even as a secondary source of repayment, without receiving a formal guarantee from the sponsor. Furthermore, reliance on a deal sponsor requires proven economic capacity. The assessment of the sponsor’s economic capacity is to include at least the following components:

(a) Periodic reviews of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals;

(b) Consideration of the sponsor's contractual investment limitations;

(c) Consideration of the sponsor's dividend distribution and capital contribution practices;

A banking corporation relying 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.

Credit Review

22. A credit review function shall assess the performance of the leveraged lending portfolio more frequently and in greater depth than other segments in the loan portfolio, and at least once yearly. For some banking corporations, 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. Such assessments should be performed by employees with the expertise and experience for these types of loans and the borrower's industry. The depth of such reviews should be in accordance with the provisions of Section 78a(3) of Directive 311. In addition, the banking corporation’s common practices, policies, and procedures in all areas relating to leveraged lending are to be reviewed, with the goal of ensuring that they are consistent with this Directive.

Stress-Testing

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

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