BANK REGULATORY AGENCIES ISSUE PROPOSED JOINT GUIDANCE ON LEVERAGED LENDING

On March 26, 2012, the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC") and the Board of Governors of the Federal Reserve System (the "Federal Reserve" and together with the OCC and FDIC, the "Agencies") jointly proposed comprehensive guidance on leveraged lending (the "Proposed Guidance"). Applicable to all financial institutions,[1] the Proposed Guidance is intended to replace the current guidance issued in 2001 (the "2001 Guidance"),[2] which the Agencies believe does not adequately address changes seen within the leveraged lending market in the past decade. The Proposed Guidance applies to all financial institutions supervised by the Agencies (including bank holding companies), together with their subsidiaries and affiliates. To support that view, the Agencies cite certain industry practices which raise specific safety and soundness concerns, including lenders retaining limited financial protection under leveraged debt agreements through the absence of maintenance covenants and other features, approving loans with questionable repayment prospects, accepting repayment alternatives like payment-in-kind-toggle features that reduce the likelihood of future repayment, underwriting loans without clear, consistent or defined underwriting standards and producing inadequate internal reports and data analysis. Given the massive growth in leveraged finance, the Agencies contend strengthened policy guidance is essential to appropriately align supervisory expectations with the institutional and systemic risks that this form of lending now presents.

The Proposed Guidance outlines a comprehensive risk management framework composed of eight core subjects identified by the Agencies as the key elements of a sound leveraged lending platform. For each core subject, the Proposed Guidance highlights specific areas on which the Agencies will focus when reviewing a financial institution's leveraged finance activities and risk management program. The Proposed Guidance also includes the Agencies' minimum expectations for each core subject, and would mandate that banks meet certain requirements and/or implement standards to comply with minimum expectations. Below are brief summary descriptions of the individual core subjects that make up the proposed risk management framework:

[1] In the Proposed Guidance, "financial institution" is defined as "national banks, federal savings associations and Federal branches and agencies supervised by the OCC; state member banks, bank holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember insured banks and other institutions supervised by the FDIC."

[2] SR 01-9, "Interagency Guidance on Leveraged Financing," April 17, 2001, OCC Bulletin 2001-8, FDIC Press Release PR-28-2001.

- Adopt a leveraged finance definition sufficiently detailed for consistent application across all business lines;
- Meet general policy expectations for credit and underwriting standards relating to leveraged finance, such as adopting transaction and obligor limits and developing board-approved risk appetites for the entire financial institution and various asset segments, including leveraged lending;
- Adopt clear, written and measurable underwriting standards, as well as guidelines requiring credit agreement covenant protections, borrower reporting requirements, and compliance monitoring;
- Adopt valuation standards using reasonable, well-supported and clearly documented assumptions in combination with frequent comprehensive stress testing;
- Strengthen institutional pipeline management by increasing management oversight and adopting policies and procedures addressing accounting methodologies, hedging, stress testing and "hung" deals;
- Improve information management systems to monitor, assess and quantify risk exposures by providing greater access to real-time information, increasing the frequency of data collection and reporting, expanding loan-level and portfolio-level analysis and developing data using key analytics;
- Recalibrate risk ratings of leveraged loans to ensure consistency with previously issued regulatory guidance; and
- Address other key risk management areas in connection with leveraged finance, including performing credit analyses, adopting policies and procedures to manage problem loans and conflicts of interest, setting standards to evaluate and monitor deal sponsors, providing independent credit review and maintaining an independent compliance function.

The Proposed Guidance includes many different requirements but they are often simply variations on the same concept. For example, the Agencies make recommendations in multiple subject areas that financial institutions should generally (1) perform regular stress testing to assess potential risk exposure in adverse economic environments, (2) ensure frequent management oversight and develop clear lines of reporting and authority, (3) develop and maintain adherence to clearly written policies and procedures to prevent credit and risk exposures from exceeding institutional limits, (4) ensure the flow of information is adequate within each area and across different areas of the bank so management can make properly reasoned risk management decisions and (5) perform more frequent and more granular, detailed loan-level analyses to improve the bank's overall understanding of its risk exposures.

The overall impact of the Proposed Guidance on a particular financial institution will vary depending on the nature and scope of its leveraged lending activities.[3] Financial institutions engaged in leveraged finance will first need to identify areas of non-compliance with the Proposed Guidance. If the areas requiring remediation are relatively limited in scope and number, they can likely be corrected surgically with minimal financial impact. However, financial institutions engaged in disfavored practices or that have entirely deficient policies, procedures, standards or risk controls could face significant economic consequences. Remediation of those issues could require institution-wide responses like reorganizing or restructuring certain business lines, developing and implementing completely new underwriting and credit guidelines, establishing procedures for management oversight, lines of reporting and credit authorities, or designing systems for generating, analyzing and delivering data and other key information across the financial institution. Any of these or similar measures could require the allocation of significant resources.

If adopted as proposed, the Proposed Guidance could impact both financial institutions and potential borrowers. The Proposed Guidance could significantly restrict financial institutions from underwriting leveraged loans that do not include credit agreement covenant protections ("covenant-lite loans"). These restrictions may limit banks' ability to extend high yield loans, pushing them toward safer, lower yield alternatives, potentially putting those with already weak net interest margins under additional pressure. Potential borrowers could be impacted depending on their overall creditworthiness and risk profile. Borrowers with "marginal" or "high-risk" credit profiles, for whom covenant-lite and similar loans may be their only financing option, might only be able to seek financing from nonbank lenders or otherwise be pushed out of the market. Borrowers with attractive credit profiles could be the principal beneficiaries of the Proposed Guidance. As more banks shift toward safer, low yield loans and competition for the same borrowers increases, those borrowers could use the new competitive landscape as leverage to extract even lower rates.

The Proposed Guidance is available on the website for each of the OCC, the FDIC and the Federal Reserve. Comments on the Proposed Guidance must be submitted on or before June 8, 2012.

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If you have any questions regarding this memorandum, please contact David S. Katz (202-303-1149, dkatz@willkie.com), William E. Hiller (212-728-8228, whiller@willkie.com), Michael I. Zinder (212-728-8298, mzinder@willkie.com), Scott R. Tkacz (202-303-1145, stkacz@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New

[3] The Agencies state that the Proposed Guidance is not expected to impact most community banks because those institutions do not have any exposure to leveraged credits.

York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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