Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

March 25, 2013

To State Member Banks, Bank
Holding Companies, Financial Holding
Companies, Savings and Loan Holding Companies,
and Foreign Banking Offices
in the Twelfth Federal Reserve District

SR 13-3 Interagency Guidance on Leveraged Lending

Applicability to Community Banking Organizations: This guidance applies to all institutions that originate or participate in leveraged lending activities, including community banking organizations supervised by the Federal Reserve with total consolidated assets of $10 billion or less.[1]

The Board of Governors of the Federal Reserve System, together with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, has issued the attached *Interagency Guidance on Leveraged Lending* (2013 leveraged lending guidance). This guidance outlines high-level principles related to safe–and–sound leveraged lending activities. This guidance applies to all financial institutions supervised by the Federal Reserve that engage in leveraged lending activities.[2]

Overview of Guidance

The 2013 leveraged lending guidance updates and replaces the 2001 *Interagency Guidance on Leveraged Financing* (2001 guidance).[3] Further, the 2013 leveraged lending guidance is intended to be consistent with sound industry practices and to expand on recent interagency guidance on stress-testing.[4]

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[1] The number of community banks with substantial involvement in leveraged lending is small; therefore, the Federal Reserve generally expects community banking organizations to be largely unaffected by this guidance.

[2] This includes bank holding companies, savings and loan holding companies, state member banks, and state-chartered branches and agencies of foreign banks.

[3] With the issuance of the 2013 leveraged lending guidance, SR letter 01-9, "Interagency Guidance on Leveraged Financing," is superseded.

[4] Refer to http://www.federalreserve.gov/bankinforeg/srletters/sr1207.htm, "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets."

In summary, the 2013 leveraged lending guidance addresses:

• ***Definition of leveraged lending***. The guidance encourages companies to develop and maintain a definition of leveraged lending that can be applied across all business lines. The guidance also includes examples of loan terms common in leveraged lending definitions.

• ***Participations Purchased***. The guidance notes that institutions of all sizes can have exposure to leveraged loans by acting as participants. In particular, an institution that acquires a loan participation should apply the same standards of prudence, credit assessment techniques, and in-house limits that would apply if the institution originated the loan. In addition, the guidance provides that loan participants should obtain copies of all loan documents and any other documents relevant to the credit.

• ***Methods for determining enterprise value***. The guidance notes that lenders often rely upon enterprise value 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. The guidance describes three common approaches (that is, asset, income, and market) for valuing closely-held businesses under conventional business appraisal theory and discusses the circumstances in which each approach is most appropriate.

• ***Pipeline management***. Market disruptions can substantially impede the ability of a loan underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses to the underwriter. Accordingly, the guidance indicates that institutions should (1) have strong risk management and controls over transactions in the distribution pipeline, including amounts to be held and those to be distributed, and (2) be able to differentiate transactions according to their tenor and investor class.

• ***Underwriting***. An institution's underwriting standards should be clear, written, and measurable, reflecting the institution's risk appetite. Accordingly, the guidance contains underwriting and risk management standards for leveraged loans and encourages originating institutions to be mindful of the reputational risk associated with poorly underwritten leveraged transactions.

• ***Stress Testing***. Institutions should conduct periodic loan- and portfolio-level stress tests on leveraged loan portfolios, including loans planned for distribution, and incorporate the results into enterprise-wide stress testing activities.

• ***Risk management and reporting***. Institutions should diligently monitor higher-risk credits, including leveraged loans. Accordingly, the guidance indicates that management should receive comprehensive reports about the characteristics and trends of the institution's leveraged lending portfolio at least quarterly and that the institution's board of directors should receive a summary of this information. Internal policies should identify the data fields to be captured by an institution's management information systems, which should yield accurate and timely reporting to management and the board of directors.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's website, at http://www.frbsf.org/banking/letters.

For additional information, please contact:

Federal Reserve Bank of San Francisco
Banking Supervision and Regulation
(213) 364-1026

Attachment:

Interagency Guidance on Leveraged Lending

Cross References:

SR 12-7 Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets

SR 98-25 Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations