Update on Leveraged Lending Guidance; November 24, 2014

On November 7, the Federal Reserve, FDIC and OCC jointly published answers to Frequently Asked Questions ("FAQs") about the implementation of the March 2013 Interagency Guidance on Leveraged Lending. Highlights of the FAQs include the following:

Is leverage the main feature that will be considered by the agencies? Leverage is not the sole feature by which leveraged loans should be defined and leverage of 6x in a transaction will *not* be used by the agencies as a 'bright line' test for evaluating the risk in a transaction. Leverage is an important indicator, but it will be considered in relation to other loan characteristics.

Is the ability to amortize within 5-7 years a bright line test? No. A borrower's inability to fully amortize senior secured debt or to repay at least 50% of total debt over 5-7 years will not automatically result in a non-pass rating by the agencies. Regulators will look at factors such as whether a borrower has other means of financial support, the quality and accessibility of the borrower's liquid assets, whether the borrower has guarantor or sponsor support, the strength and stability of the borrower's cash flow sources and the borrower's ability to curtail discretionary expenses or dividends without negatively affecting business operations and growth prospects.

How will ABL facilities be treated? ABL facilities may be excluded when they are the dominant source of ongoing funding for a borrower, which refers to instances where term debt outside of the ABL is limited and/or secured by tangible collateral. However, ABLs that are part of a larger debt structure of a company should not be excluded from the leveraged definition (even if they are the only tranche of debt structure an institution holds) and should be captured within the institution's leveraged lending risk management framework.

What is included in "leverage"? Leverage multiples should be calculated at origination based on *committed* debt, including additional debt that a loan agreement may permit such as incremental capacity. Examiners may also scrutinize EBITDA addbacks that aren't sufficiently supported.

What counts as origination and who is an originator? An origination occurs on the date of a new extension of credit, amendment, refinancing or renewal. Arrangers are considered originators, but lenders who only buy participations are not. The guidance applies to all federally regulated institutions that originate or buy leveraged loans, regardless of whether the bank intends to hold or distribute the loan.

Can "special mention" loans be refinanced without scrutiny? An acceptable refinancing, modification, or renewal of a loan rated 'special mention' should demonstrate that action is being taken to correct or mitigate the agencies' concerns. Reducing pricing or extending maturity generally won't suffice. Any transaction that extends new funds to a borrower is a new origination.

What about "covenant-lite" loans? Designation of a loan as "covenant-lite" does not automatically result in a non-pass rating under that system, but loans with relatively few or weak loan covenants should have other mitigating factors to ensure appropriate quality.

Do best effort transactions fall under the guidance? Yes. The guidance is applicable to the origination and distribution of loans made on a "best efforts" basis as well as committed loans.

How does the guidance apply to international banks? For U.S. banks, the guidance applies regardless of the booking location of the loan. For foreign banks with U.S. charters, the guidance applies to all leveraged loans that are both originated and distributed in the U.S.

How does the guidance apply to indirect exposure to leveraged loans, such as investments in CLOs or loans to BDCs? The guidance applies to underlying loans in structured transactions only if an institution originates or retains credit risk in the individual loans. If an institution is only an investor in a CLO, the guidance does not apply. If an institution originates or participates in a loan to a CLO or BDC that holds leveraged loans, then that loan constitutes indirect exposure.