EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Examining Circular Subject: Highly Leveraged Transactions

TO: Deputy Comptrollers, Department and Division Heads, and All Examining Personnel.

BACKGROUND AND PURPOSE

Highly leveraged debt and equity transactions (HLTs) have become important sources of business for some commercial banks, as traditional large corporate lending opportunities become more scarce. Some banks have earned substantial fees and commissions generated by HLTs, and capital gains realized from some equity investments in HLTs have been exceptional.

The OCC supports national bank participation in lending and investment activities that are legal, creditworthy and consistent with sound banking principles; such activities include financing related to HLTs. However, due to the complex nature and level of risk associated with HLTs, the OCC expects boards of directors and management of national banks to ensure that their involvement in HLT transactions is governed by sound policies, careful credit and legal analyses, appropriate controls, and sound management information systems (MIS).

These are fundamental elements of any sound credit process, but they are especially important in view of the risk characteristics of many HLTs. These fundamentals apply not only to banks that originate credits but also to any national bank that participates in a highly leveraged transaction. The OCC has already begun focusing closer attention on these factors in its on-going supervisory activities for national banks.

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In early 1988, the OCC began a review of HLT activities at a number of multinational and regional banks, supplemented by discussions with investment bankers and other organizations that were active in leveraged financing. Based on that review, the OCC has developed the following guidelines for examiners to use during their analysis of a bank's HLT portfolio. The OCC plans soon to issue a summary report of the 1988 project, which will provide additional detailed information and insight into overall HLT activities.

Note: Because of the complexity of HLTs and legal restrictions on commercial bank financing activities, various parts of a HLT financing package may be arranged through the bank, its subsidiaries, or its parent bank holding company. Accordingly, OCC examiners will work closely with the Board of Governors of the Federal Reserve System in assessing a banking organization's total participation in and exposure to HLT activities.

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EXAMINATION GUIDELINES

The following guidelines will assist examiners in assessing the adequacy of a bank's policies, procedures and controls in financing HLTs. The guidelines are specifically intended to:

- Determine the extent and types of involvement in HLTs;
- Assess the adequacy of policy and controls;
- Assess the adequacy of MIS and other reporting systems;
- Determine the level of HLT exposure;
- Determine the nature and extent of mezzanine and bridge financing;
- Identify HLT concentrations and assess their potential impact upon the bank's overall condition;
- Assess the overall condition of the HLT portfolio and determine whether HLT exposures represent undue risks;
- Determine the nature and extent of asset sales, participations and other distribution efforts;
- Assess the impact of HLT exposures on adequacy of the ALLL;
- Determine the extent of direct and indirect equity investments; and
- Assess potential conflicts of interest, violations of law, and/or unsafe and unsound banking practices.

A. GENERAL POLICY STATEMENT

Examiners should determine whether a bank's board has adopted a written policy statement that clearly defines a highly leveraged transaction (HLT), as well as the bank's overall philosophy and objectives in financing HLTs. The policy should include:

- The purpose and use of such financing;
- Permissible lending and investment activities;
- Identification of industries suited for such financing;
- A recognition of the unique characteristics and risks associated with high levels of leveraging;
- A broad-based definition that captures the essence of HLTs and includes all credits and investments with similar characteristics and levels of risk;
- In-house limits on exposure for individual credits, specific industries, and the aggregate portfolio, to be reviewed at least annually by the board;
- A recognition of the need for independent credit reviews and assessments and management information systems (MIS) to monitor performance;
- A recognition of the need for well-defined standards and separate, specific guidelines for policy, approval, and review of HLT transactions; and
- An acknowledgment that all HLT-related fees, which may be large and take various forms, are to be recognized in accordance with Generally Accepted Accounting Principles (GAAP), unless otherwise specified in the Call Report instructions. The policy should recognize the accounting requirements for fees set forth in FAS 91 and OCC banking circulars on this subject.

Examiners should review the internal listing of HLTs and ensure that it captures all financing with similar levels of risk (e.g., LBOs, recapitalizations, cashouts, etc.). If some credits related to HLTs are not included, examiners should determine reasons for and significance of omissions.

B. LENDING POLICY

Examiners should determine whether the board has approved a separate policy for approving and reporting on HLTs. Such a policy should supplement policies used in the normal credit process. It should ensure that all loans identified as HLTs are reviewed and approved through a separate and distinct process.

The lending policy should include:

- Control features that specifically recognize the unique nature of these credits;
- MIS type and reporting frequency;
- Minimum risk ratings and underwriting criteria, such as standards for cash flow coverage and other repayment sources;
- Pricing considerations;
- Legal review requirements;
- Requirements for review by asset sales and distribution personnel;
- Requirements for interest rate protection; and
- Requirements for, at a minimum, semiannual review of the portfolio by line management.

C. PORTFOLIO ANALYSIS AND MIS

Examiners should determine whether a separate, specific MIS and analysis process has been established as part of the overall management and control of HLT financing. The process should be sufficiently detailed to provide management and the board with periodic information on the overall size, quality and performance of the HLT portfolio.

Examiners should review all MIS and reporting system data on HLTs. The systems should provide the following information and analysis:

- Concentration by industry and type of financing, e.g. leveraged buyout, recapitalization, cashout, etc.;
- Comparisons of current aggregate HIT exposure and significant additions to and deletions from previous totals;
- Information by originator;
- Risk rating of portfolio and significant changes in risk rating of aggregates and individual items;
- Portfolio aging and performance relative to expectations; and
- Listing of all refinancing and restructured transactions.

D. DISTRIBUTION AND PARTICIPATIONS

Asset sales, participations, syndication and other means of distribution are critical elements in the rapid growth of HLT financing. Many banks have a stated goal of creating assets and redistributing them to limit their risks by diversifying their portfolios.

The OCC expects both lead and purchasing banks to adopt formal policies and procedures on sales and distribution of participations in HLT financing. Management and the board should be familiar with the OCC's guidelines governing asset participations, purchases and sales and should ensure full compliance with those guidelines (see Banking Circular 181).

Examiners should review all policies and procedures that relate to HLT-related asset sales, distribution and syndication efforts. The policies should include:

- Credit standards and approval process for counterparty risk;
- An approved customer list;
- Sell-down guidelines and disclosure requirements;
- Repurchase guidelines;
- MIS and other reporting requirements;
- Controls on incentive or commission programs; and
- Accounting guidelines for such items as "strip" sales, fees and revaluation of assets.

E. INTERNAL REVIEWS

Independent assessments of the HLT portfolio are an important part of an institution's overall control and MIS process. The unique characteristics and risks of these loans make early detection of emerging trends and potential problems essential.

Examiners should assess the nature and extent of the bank's HLT review and control process. At a minimum, the process should provide for an annual review of all HLT credits as a separate portfolio. This process should supplement the bank's normal management review process for the loan portfolio. The review should include:

- Assessment of aggregate portfolio, industry and individual transaction limits;
- Testing and reaffirmation of underwriting criteria;
- Testing for compliance with policy and procedures;
- Testing of individual risk ratings;
- Assessment of aggregate risk rating levels and trends;
- Assessment of significant additions to and deletions from the HLT portfolio;
- Assessment of industry concentrations; and
- Identification of emerging trends and potential problems.

F. EQUITY INVESTMENTS

Many multinational banking companies have both direct and indirect equity investments in HLTs. The growth in this area has resulted in part from the large returns realized by some equity investors in HLTs. Intense competition for business has led banking companies to provide or arrange financing for all aspects of a proposed transaction, including equity positions.

Equity investments have been made by Small Business Investment Corporations (SBICs> owned by bank holding companies, and their affiliates. Indirect investments have been acquired through investment in specialized funds (LBO funds) whose sole purpose is to provide financing for HLTs for their own accounts. National banks generally have not made direct equity investments or investments in LBO funds because of the restrictions contained on such activities in the Glass Steagall Act.

Equity investments generally involve higher levels of risk than either senior or junior debt and should be governed by adequate policies, procedures, controls and MIS. At a minimum, policies should establish a approval and review process for such activities.

These policies should include:

- Aggregate and individual investment limits;
- Designated booking units;
- MIS and other reporting requirements;
- Investment criteria and documentation for investment decisions;
- Periodic valuation;
- An internal risk rating system;
- Independent review and affirmation of values and risk ratings; and
- Identification of possible conflicts of interest and other legal problems created by providing other tiers of debt in the transaction.

G. MEZZANINE FINANCING

Mezzanine financing represents those parts of a HLT's financing package that are neither equity nor senior debt. It has been extended through SBIC subsidiaries of banks or nonbank subsidiaries of bank holding companies.

Examiners should review policies for mezzanine financing to ensure that they generally include:

- Limits for both aggregate volume and individual transactions;
- Designated booking units;
- Credit approval and reporting processes;
- MIS and other reporting requirements;
- An internal risk rating system and requirements for periodic reviews; and
- Procedures for legal review of HLT transactions.

H. RESERVES

The potential impact of a bank's participation in financing HLTs should be carefully considered when reviewing the adequacy of the allowance for loan and lease losses (ALLL). The aggregate size and overall condition of the HLT portfolio should be specifically addressed in any review of the overall adequacy of the reserve.

Examiners should review the bank's methodology for incorporating the special risks related to HLT financing in its determination of the adequacy of the ALLL. Management is expected to use an internal risk rating system to assess its equity and mezzanine financing portfolio and to determine the need for valuation reserves.

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I. LEGAL REVIEWS AND POTENTIAL CONFLICTS OF INTEREST

Examiners should determine whether a bank's board of directors and management have established policies on HLTs to minimize risks posed by potential legal and conflict-of- interest issues. Policies should provide for legal review of all bank involvement with HLTs to determine that they are permissible for banking organizations and to address potential conflicts of interest.

The legal and regulatory issues raised by leveraged transactions are too numerous and complex to address fully in this issuance. Several examples illustrate this point:

- Conflicts of Interest -- Conflicts of interest may arise when a banking company is involved in financing a transaction and/or takes an equity interest in the transaction. When a banking company plays multiple roles in connection with an HLT, the interests of different customers, or the interests of the banks and its customers, may conflict.

- Equitable Subordination -- If a bank as senior lender exercises some measure of management control, a court could rank the bank's interest on a par with those of junior creditors. A bank may be more vulnerable to this risk if its holding company is also participating in the mezzanine and/or equity financing of an HLT.

- Securities Laws -- Equity interests and certain debt instruments used in HLTs may constitute "securities" for purposes of federal securities laws. When securities are involved, banks should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements. Banks should also establish procedures to restrict the internal dissemination of material nonpublic information about a HLT to persons who are involved in the transaction.

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