



FEDERAL RESERVE BANK
OF DALLAS

UZZIAH ANDERSON
ASSISTANT VICE PRESIDENT

DALLAS, TEXAS 75222

February 20, 1990

To the Chief Executive Officer of all State
Member Banks, Bank Holding Companies, Edge
Corporations, and Foreign Agencies in the
Eleventh Federal Reserve District

SUBJECT: Leveraged Buyouts and Related Transactions

In view of questions and comments regarding the recent interagency definition of leveraged buyouts and related transactions (so-called highly leveraged transactions), the three federal banking agencies are providing interpretive guidelines to their respective staff for implementing this supervisory definition. In order to keep you informed of these developments, a copy of the interagency statement is enclosed for your information.

This statement complements and, in certain limited respects, modifies the Federal Reserve's existing supervisory guidelines which were dated February 16, 1989, and October 25, 1989, copies of which are available by contacting the Supervision and Regulation Department at (214) 744-7486. Should you have any questions regarding this matter, please contact Marion White or Dan Kirkland at (214) 744-7490 or 744-7433, respectively.

Very truly yours,


Uzziah Anderson

Enclosure

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

February 6, 1990

HIGHLY LEVERAGED TRANSACTIONS INTERPRETATION

The Federal bank regulatory agencies have received a number of comments and inquiries regarding the recently adopted interagency definition of Highly Leveraged Transactions (HLTs). Most of the comments pertain to the points discussed below. The following discussion is intended to provide interpretive guidance for implementation of the HLT definition.

I. Purpose Test

The intent of the definition is to cover financing transactions involving the buyout, acquisition, or recapitalization of an existing business. It was not contemplated that acquisition or recapitalization of a single asset or lease, or a shell company formed to hold a single asset or lease, would be considered an HLT. However, the acquisition or recapitalization of a leasing corporation which invests in fleets of equipment for leasing, or a building company which invests in real estate projects should be included.

II. De Minimis Test

The preponderance of HLT exposure arises from transactions where the amount of the original transaction financing package is substantial. Therefore, the agencies have decided to adopt a \$20 million de minimis test. Loans and exposures to any obligor in which the total original financing package, including all obligations held by all participants, does not exceed \$20 million, may be excluded from HLT exposures. Nonetheless, there may be some banking organizations that in the aggregate have significant exposure to transactions below the de minimis level. It is expected that those organizations would continue to monitor closely these transactions as part of their aggregate HLT exposures.

III. Historical Cutoff Date

An HLT transaction not included in the Shared National Credit Program, that meets or exceeds the \$20 million de minimis test, may be excluded if it originated prior to January 1, 1987, the original terms and conditions of the credit are materially unchanged, the credit has not been criticized by examiners, and the financial condition of the debtor has not deteriorated.

IV. Responsibilities of Agent Banks

To ensure consistent application of the definition, the agent or lead bank is responsible for determining whether or not a transaction qualifies as an HLT. The agent or lead bank is charged with the timely notification to participants regarding the status of the transaction and of any change in that status, i.e., designation as an HLT or delisting as an HLT.

The responsibility of the agent or lead bank to determine HLT status does not preclude a participant bank from designating a transaction as an HLT or relieve a participant from performing its own credit analysis. Examiners will review transactions for compliance with the HLT definition in the context of the Shared National Credit Program and during regular on-site examinations.

V. The 75% Total Liabilities to Total Assets (Leverage) Test

Under the 75% leverage test, the determination of whether the exposure to a company is designated an HLT depends on the composition of the company's total liabilities after the transaction. If a significant portion of the liabilities (generally 25% or more of total liabilities) derives from buyouts, acquisitions, or recapitalizations, either past or present, then all exposure to the company is designated an HLT. If, after the transaction, debt related to buyouts, acquisitions, or recapitalizations, either past or present, represents less than 25% of total liabilities, then the exposure to the company need not be designated an HLT.

When calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

VI. The 50% Total Liabilities to Total Assets (Leverage) Test

The purpose of this criterion is to capture transactions in which a company must suddenly deal with a substantially higher debt burden. The greatest risk in a credit exposure is not necessarily the absolute level of debt but may be the impact on a company of significant new debt. A key HLT success factor is ability to handle a sudden, large increase in debt.

A "doubling of liabilities" is intended to capture those transactions where new debt is used to facilitate the buyout, acquisition, or recapitalization of a business. For example, if Company A acquires Company B resulting in a leverage ratio exceeding 50% and if their combined liabilities double as a result of new debt incurred to effect the combination, this would be an HLT. If liabilities simply double in dollar amount as a result of the combination, this is not necessarily an HLT.

Again, when calculating a company's leverage for the purpose of this test, captive finance company subsidiaries and subsidiary depository institutions should be excluded from the consolidated organization.

VII. Risk Protection and Cash Management Products

It is recognized that credit exposure arises from claims related to foreign exchange contracts, interest rate swaps, or other risk protection or cash management products. Because these are generally risk protection products, and their credit equivalent exposure is normally small relative to other types of obligations, these may normally be excluded from HLT exposure. It is expected, however, that internal management information and control systems be in place to capture these exposures.

VIII. Delisting Criteria

The agencies recognize that HLTs are dynamic and may change significantly during their lives. The initial guidelines instructed examiners to review delisting policies and criteria utilized by individual banks. The agencies believe that more formal delisting guidelines would promote consistency.

(a) General Criteria -- Before an HLT may no longer be listed as such, a company must demonstrate an ability to operate successfully as a highly leveraged company over a period of time. Under normal circumstances, two years should be sufficient for the credit to show performance and to validate the appropriateness of projections. The organization should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, status of asset sales, if applicable, reduction in leverage, and industry risk.

(b) Specific Criteria -- In addition to these general criteria, the following will apply:

(1) For exposures that were included because of the 75% leverage test, leverage must be reduced below 75% and the company must have a demonstrated ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

(2) For those exposures that arose under the "doubling of liabilities to greater than 50%" leverage criteria, delisting is acceptable based upon the general criteria in (a) above and a demonstrated ability to satisfactorily continue to service the debt.

It is expected that banks will maintain records of delisted exposures and reasons for delisting. After delisting, any significant changes in the obligor's financial condition should cause the exposure to be reviewed for relisting. Records pertaining to delisting and relisting of HLTs will be reviewed by examiners in the context of the Shared National Credit Program and/or regular on-site examinations.

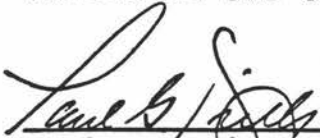
If the HLT is shared, the lead or agent bank should inform all participants and its principal regulator of the decision to delist or relist.

IX. Regulatory Intent

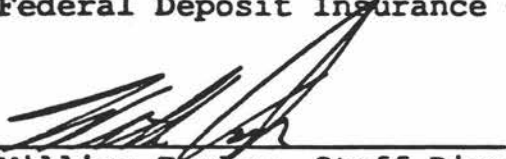
This interpretive document is intended to clarify the regulatory HLT definition. The agencies recognize the complexities of establishing such a definition, but believe its use will provide an effective and more consistent basis for comparison among banking organizations. It is anticipated that the vast majority of transaction dollars will be captured and reviewed under the interagency Shared National Credit Program, which will help ensure consistent treatment.



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