FEDERAL RESERVE BANK OF NEW YORK

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FREDERICK C. SCHADRACK
EXECUTIVE VICE PRESIDENT

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TO THE CHIEF EXECUTIVE OFFICERS OF
ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES
AND DOMESTIC OFFICES OF FOREIGN BANKS
IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: Examination Guidelines for the Review of Highly Leveraged Financings

The Board of Governors of the Federal Reserve System has recently issued general guidelines intended to strengthen and supplement existing review procedures used by examiners for evaluating the participation of banking organizations in highly leveraged financings. In response to numerous requests we are circulating the guidelines to interested banking organizations. If you have any questions regarding this matter, please contact Kathleen A. O'Neil, Vice President and Chief Financial Examiner (Tel. No. 212-720-5371) or Supervising Banking Examiner Gregory K. Carroll, Multinational Banking Department (Tel. No. 212-720-5887).

Sincerely,

Frederick C. Schadrack

Enclosure

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Attachment

EXAMINATION GUIDELINES REGARDING HIGHLY LEVERAGED FINANCING TRANSACTIONS

General comments regarding the definition of HLFs

- Examiners should review an organization's internal definition of HLFs to determine whether it reflects the risk factors associated with these transactions.

- For purposes of assessing an organization's HLF activities in examination and inspection reports, HLFs are defined as exposures that meet both of the following two conditions: First, credit is extended in connection with an acquisition by, or a restructuring of, the organization. Typically, such credits are extended to enable the employees, management, directors, or outside investors, acting individually or jointly, to gain effective control of an organization through the purchase of stock and/or acquisition of assets. Thus, the definition includes leveraged buyouts and similar transactions, as well as corporate mergers and acquisitions funded by debt. Significant company buybacks of stock and large cash dividends financed through borrowings may also be included. Second, the extension of credit results in "high leverage" or is made to an already highly leveraged organization. As a general guideline, high leverage is defined for this purpose as a total debt-to-total assets ratio exceeding 75 percent. In addition to this leverage benchmark, examiners may also take account of the norms and standards for leverage in a particular industry as well as the cash flow-to-debt service coverage for a particular transaction in determining what constitutes an HLF.

- Total exposure to individual HLF borrowers includes all loans, extensions of credit, and debt and equity securities relating to acquisitions or restructuring transactions, as well as any ordinary business loans to, or investments in, the same obligor. Total exposure also includes standby letters of credit, legally binding contractual commitments, and other financial guarantees.

- Loans or exposures to any obligor in which the total financing package (including extensions of credit by all participants) did not exceed $5 million at the time of origination may be excluded from the definition of HLFs.

- These guidelines are not meant to suggest that loans or exposures meeting the HLF definition should necessarily be criticized or deemed to involve excessive risks. Nor is the 75 percent debt-to-assets benchmark intended to reflect what is considered high or abnormal leverage in all industries. Rather, the definition is intended to provide guidance to examiners for identifying in the first

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instance certain exposures that may warrant further scrutiny and to do so on a consistent basis across banking organizations. The analysis of a borrower's financial position should take account of both the absolute level of the borrower's leverage ratio, as well as how the borrower's leverage compares to conditions and norms within the particular industry. Any criticism of exposures stemming from HLFs, like all other credits, should be based on the examiner's evaluation of all relevant credit factors, as well as on the guidelines set forth below.

Policies and procedures

- Examiners should review an organization's policies and procedures to ensure that: i) credit evaluation involves an independent assessment of the adequacy of the borrower's current cash flow and collateral values and the projected values under varying economic and interest rate assumptions, including the possibility of an economic decline; ii) the organization has established reasonable "in-house" limits regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations; iii) credit decisions on significant HLFs are made and monitored at appropriate senior management levels; iv) management reporting systems and controls are adequate to monitor the condition of individual HLF borrowers, as well as the organization's compliance with internal policies and lending limits; and v) timely and adequate reports are provided to senior management and boards of directors regarding the performance of significant HLF exposures and the organization's overall involvement in this activity.

- Credit standards and pricing policies should be reviewed to determine that they incorporate consideration of the tradeoff between risk and return.

- Each holding company subsidiary should establish appropriate credit review and approval procedures that call for a complete and independent assessment of loans or investments to be made by the subsidiary. Review and approval standards regarding mezzanine financing and equity positions should take account of the particular risks associated with these activities.

- "In-house" limits should be based on consolidated holding company exposure and take account of all extensions of credit, as well as holdings of debt and equity securities issued by HLF obligors. In addition, appropriate exposure limits should also be established for each subsidiary engaged in any aspect of an HLF. When a single HLF transaction involves loans or exposures to legally separate but related obligors, the exposures

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should be combined for determining compliance with internal exposure limits.

- Examiners should review the banking organization's internal guidelines or practices on what is considered to be an acceptable minimum level of: i) borrower cash flow in relation to debt service and fixed charge requirements; and ii) collateral protection.

- A banking organization's internal credit review and approval procedures should call for an evaluation of the continuity and experience of the borrower's management.

- Examiners should determine that all income, fees and commissions relating to HLFs are properly identified and recognized in accordance with generally accepted accounting principles. Internal reporting systems should monitor the amount and treatment of fees associated with HLFs.

- Examiners should ascertain whether banking organizations purchasing participations in HLFs apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. Examiners should also ensure that the purchasing institution obtains from the lead lender copies of all executed or proposed loan documents, legal opinions, title insurance policies, UCC searches and other relevant documents. The purchase of participations in HLFs originated by other banks should involve a full and independent credit review by the purchasing organization. Organizations holding participations should obtain adequate and timely information on the borrower and closely monitor the borrower's performance throughout the entire life of the exposure.

- Sales of participations in HLFs should be made on a non-recourse basis. Approval procedures and exposure or position limits should apply to any purchases of HLF loans as part of trading or market-making activities. Such purchases should be segregated in a separate trading account and be reported at the current market value, or the lower of cost or market value.

- A banking organization's policies and procedures should provide for legal review of involvement in HLFs to determine that the activities are consistent with applicable laws and regulations and that they are conducted in a manner that addresses the potential for conflicts of interest. Policies and procedures regarding loans to borrowers whose obligations are being underwritten by an affiliated securities firm should be carefully reviewed to determine compliance with the

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prudential framework set forth in the Board's Section 20 orders. Among other things, this framework requires the banking organization to establish appropriate limits for the consolidated holding company's overall exposure to any single underwriting client of a securities affiliate. Policies should also address the risks associated with equitable subordination. Examiners should determine whether the banking organization has a comprehensive documentation policy addressing the primary legal risk of fraudulent conveyance in LBO transactions.

- Major policies and procedures, including internal credit review and approval procedures and "in-house" exposure limits, should be reviewed periodically and approved by the board of directors.

Other examination considerations

- In evaluating individual loans and credit files, particular attention should be addressed to i) the overall performance and profitability of the industry over time, including during periods of economic or financial adversity; ii) the history and stability of the borrower's market share, earnings and cash flow, particularly over the most recent business cycle and the last economic downturn; iii) the reasonableness of earnings and cash flow projections; iv) the relationship between the borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage; and v) the reliability and stability of collateral values, including their sensitivity to varying economic scenarios, and the adequacy of collateral coverage.

- Particular attention should be paid to the adequacy of a borrower's cash flow. Banking organizations should make an independent and realistic assessment of the borrower's cash flow projections under varying economic and interest rate assumptions and be able to demonstrate that they have taken into account the potential effects of an economic downturn on a borrower's cash flow and collateral values before becoming involved in an HLF.

- A loan whose repayment is not predicated upon an identifiable and historically stable source of cash flow bears speculative qualities. Reliance for loan repayment on the sale of assets or subsidiaries whose values are not clearly supported by i) an historically demonstrated ability to produce adequate cash flow, ii) a firm sales contract or "take-out" commitment, or iii) a realistic cash-generating capacity based upon current economic conditions, is an inappropriate banking practice that could expose a bank to undue risks. Such loans should receive careful supervisory scrutiny and, under normal

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circumstances, should be subject to examiner comment or criticism. Ordinarily, unless conservatively projected cash inflows provide a reasonable margin above the total debt service requirements and other fixed expenditures of the borrower, classification of the credit is appropriate.

- When the proceeds of asset sales play an important role in reducing the debt, the methods used to determine asset valuations and projected sale proceeds should be carefully scrutinized. In addition, asset collateral coverage should be reassessed periodically throughout the life of the debt, and actual sales proceeds should be compared to projections made at origination of the HLF in order to monitor the reasonableness of the lender's assumptions concerning valuations.

- Repayment programs should specify the sources and timing of repayment, and any significant deviations from the programs should be evaluated.

- The amount of senior debt in relation to total financing should be carefully reviewed. In general, a bank's risk can be reduced if its position is senior to all other levels of debt and secured by a first lien on assets or all the stock of the borrower's operating entities. Ideally, the debt structure should permit the borrower to suspend payments on junior debt should circumstances so warrant.

- Special attention should be given to the risks associated with short-term bridge financing in connection with highly-leveraged restructurings. Such risks may be greater than normal because these loans are typically subordinated to other debt, may not be collateralized, and depend on the successful marketing of longer term securities or the sale of assets for repayment.

- Because of potential conflicts of interest that may affect lending practices, examiners should carefully review any loans and related documentation involving borrowers whose obligations are being underwritten by a securities affiliate.

- Examiners should determine the extent to which borrowers are protected from interest rate increases via interest rate caps or other hedging mechanisms. Generally, long-term loans to HLF obligors should involve some measure of protection for the borrower against increases in interest rates.

- In addition to reviewing the total volume of a banking organization's HLFs, examiners should assess the extent to which the organization's income comprises fees and commissions relating to HLFs. Examiners should also take

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account of the extent to which income is composed of gains on the sale of equity holdings.

- In addition to equity positions relating to particular HLFs, examiners should determine the extent of the banking organization's involvement in LBO funds.

- Examiners should review the timeliness and quality of reports to senior management and directors. Reports should address the performance of HLF obligors, the quality of the HLF portfolio, and the condition of the organization's overall HLF activities.

- Total HLF exposure should be treated as a potential concentration of credit and if, in the aggregate, it is sufficiently large in relation to capital, the total HLF exposure and a listing of the major HLF obligors should be included on the concentrations page in the examination report. A brief comment should describe the composition of these exposures (i.e., breakdown by number, outstandings, unused commitments, industry involvement, type and level of total criticized).

- If HLFs are not considered to be a concentration of credit, but are still considered a significant activity, the total exposure and the other information described in the previous item should be set forth in the confidential section of the examination or inspection report.

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