

Atty. No. 10317A

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045

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FREDERICK C. SCHADRACK  
EXECUTIVE VICE PRESIDENT

November 15, 1989

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

SUBJECT: Interagency Definition of a "Highly Leveraged  
Transaction".

The three federal banking agencies have recently adopted a uniform interagency definition of a "highly leveraged transaction" (HLT) for supervisory purposes and are distributing the definition to their respective staffs as an examiner guideline. In order to keep you abreast of these developments, a copy of the interagency statement is enclosed for your information. We at the Federal Reserve believe that highly leveraged transactions deserve very close scrutiny and discipline, both with regard to existing and new credits. Consistent with this we expect all participants in such activities to pay particular attention to control, credit review, and related procedures.

This statement amends the Federal Reserve's existing guidelines which were mailed to you on March 13, 1989. 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 Examiner Gregory K. Carroll, Multinational Banking Department (Tel. No. (212) 720-5887).

Sincerely,

*Frederick C. Schadrack*

Enclosure

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Comptroller of the Currency  
Federal Deposit Insurance Corporation  
Federal Reserve Board

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The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System have jointly adopted a common definition of highly leveraged transactions (HLTs) as part of a coordinated effort to provide more effective supervision of bank involvement in these transactions.

BACKGROUND

As a result of growing public interest and increased supervisory concern about HLTs, the banking agencies have individually initiated supervisory activities and provided guidance to examiners about the special risks associated with this kind of financing. The regulators did not issue a definition of HLTs for supervisory purposes because bank involvement in HLTs was relatively recent and varied widely. In the absence of such a definition, banks adopted a wide range of definitions, some of which excluded transactions that were of interest to the supervisory agencies. Lack of a common definition created problems for supervisors, for banks themselves, which wanted to compare their own performance with that of their peers, and for investors and others interested in tracking the growth of bank involvement in highly leveraged financing.

In developing a common definition for HLTs, the agencies recognized that transactions, industries, and individual companies differ, and that several factors may be considered in classifying a transaction as an HLT. In the regulatory definition, the principal classification criterion is the purpose of the transaction. That is, transactions that involve a buyout, acquisition, or recapitalization of an existing business would be candidates for inclusion as an HLT. A second criterion for HLT classification is whether the transaction is accomplished with a significant debt increase and results in a high level of leverage.

The borrowing company's ability to deal with a substantially higher debt burden is of primary importance, but the relative level of that debt is also significant. The existence of higher debt levels requires companies to perform in a more rigid environment, in a more efficient manner, and with a lower margin for error.

The determination of what constitutes a significant debt increase or high leverage depends on a variety of factors that may not be consistent for all industries and companies and may be subject to change. Nonetheless, the regulatory agencies believe it is desirable to have a common definition of what constitutes an HLT. Adoption of a uniform definition by the three federal banking agencies will not only facilitate supervision of bank HLT activities, but also help banks by providing a common standard for tracking their own activities and comparing them with those of their peers.

(Over)



#### DEFINITION

For supervisory purposes, a bank or bank holding company is considered to be involved in a highly leveraged transaction (HLT) when credit is extended or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business. In addition to this purpose test, one of the following criteria must be met for the transaction to be considered an HLT:

- o The transaction at least doubles the subject company's liabilities and results in a leverage ratio higher than 50%.
- o The transaction results in a leverage ratio higher than 75%.
- o The transaction is designated an HLT by a syndication agent.


In those cases where a credit meets the purpose test but is not covered by any of the criteria above, the bank supervisory agencies may nevertheless designate the credit as an HLT. It is anticipated that this would be done infrequently and only in material cases.

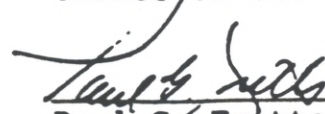
The agencies will include all obligations of, and claims on, HLT borrowers, regardless of perceived credit quality or secured status.

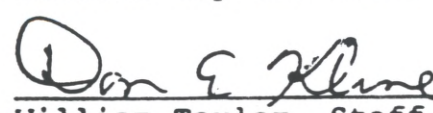
The leverage ratio is total liabilities divided by total assets. Total liabilities include all forms of debt and claims, including all subordinated debt and non-perpetual preferred stock. Total assets include intangible assets.

#### POLICY

The three federal banking agencies are distributing this definition of HLTs to all their examining personnel for use in supervising HLT activities in commercial banks. In addition, copies of the definition are being sent to banks to increase their understanding of how the regulators define these transactions.

  
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Dean S. Marriott  
Senior Deputy Comptroller  
Office of the Comptroller of the Currency

  
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Paul G. Fritts  
Director of Bank Supervision  
Federal Deposit Insurance Corporation

  
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for William Taylor, Staff Director  
Division of Banking Supervision and Regulation  
Federal Reserve System