

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N. Y. 10045

AREA CODE 212 720-6375

CHESTER B. FELDBERG  
EXECUTIVE VICE PRESIDENT

*Attn. No. 105/3(c)*

February 6, 1992

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: Highly Leveraged Transactions

On July 10, 1991, the staffs of the three Federal bank regulatory agencies requested public comment on all aspects of the Highly Leveraged Transaction ("HLT") definition and criteria. In response to these comments, and in recognition that it has served its intended purpose, the HLT definition will be discontinued, for regulatory reporting purposes, effective July 1, 1992. The enclosed interagency document explains the rationale for the phase-out of the regulatory definition, and outlines a modified version, effective January 21, 1992, which is to be used for the March 31 and June 30 reporting periods. A more detailed explanation will be published in the Federal Register within the next two weeks and a copy forwarded to you at that time.

The modified definition, which will also be used during the 1992 Shared National Credit Program, involves among other things, the following revisions: (1) shortens the existing delisting timeframes, (2) allows HLTs that meet certain criteria and exhibit superior cash flow to be delisted, and (3) exempts credits that are emerging from protection under Chapter 11 bankruptcy from the designation, if the leverage ratio is below 75% at the time of reorganization. As with other specific types of credit concentrations, examiners will continue to review and report weaknesses in loans or groups of loans in the context of the examination program.

The enclosed interagency document supplements the Federal Reserve's existing supervisory guidelines and interpretations on the HLT definition, dated February 16, 1989, October 25, 1989, February 6, 1990 and February 15, 1991.

(Over)

Chief Executive Officers  
February 6, 1992

A-10513 (c)

Copies of these documents are available from the Circulars Division of this Bank (Tel. No. (212) 720-5216). If you have any questions regarding this matter, please contact Andrew Collins, Examiner, Domestic Banking Department (Tel. No. (212) 720-7535).

Yours sincerely,



Chester B. Feldberg  
Executive Vice President

Enclosure

A-10513(c)

**Comptroller of the Currency  
Federal Deposit Insurance Corporation  
Federal Reserve Board**

January 21, 1992

**Highly-Leveraged Transactions**

To address concerns with the supervisory definition of highly-leveraged transactions (HLTs), the federal bank regulatory agencies published a request for comment in the Federal Register on July 10, 1991. The agencies sought comment on all aspects of the HLT definition and criteria, as well as comments on specific issues raised by questions which the agencies had received.

Upon reviewing the current status of the HLT definition, considering over 260 comments received from the public, and evaluating various options, the agencies intend to phase out use of the definition and to discontinue regulatory reporting of HLTs by banking organizations effective after the June 30, 1992 reporting date.

In making a decision to phase out use of the HLT definition, the agencies determined that the definition has largely accomplished its original purposes. In particular, the HLT definition encouraged financial institutions to focus attention on the need for internal control and review mechanisms to monitor this type of financing transaction. It also highlighted the need for financial institutions to structure highly-leveraged credits in a way that is consistent with the risks involved.

Furthermore, circumstances have changed since the definition was implemented. Merger and acquisition activity has declined significantly. Companies have more recently been improving their capitalization and credit standing by deleveraging and issuing equity. Also, the agencies recognize that the HLT definition may be having an undue effect on pricing and availability of credit to certain highly-leveraged borrowers.

Although the banking agencies plan to discontinue use of the supervisory HLT definition and related reporting, all highly-leveraged credits will continue to be closely reviewed in the examination process. As with any commercial loan, an examiner will continue to thoroughly review the borrower's financial condition, income, and cash flow; the value of any collateral or guarantees; the quality and continuity of the borrower's management; and the borrower's ability to service its debt obligations. Guidance previously issued by each agency for assessing individual credits that finance corporate restructurings and for evaluating internal processes for initiating and reviewing such credits will continue to be used by examiners for this purpose. Due to the complex nature and level of risk associated with such financings, boards of directors and

management at banking organizations will be expected to continue to monitor carefully their bank's risk exposure to these credits.

In response to concerns expressed in comment letters, the agencies are also making certain interim revisions to the HLT definition. Revisions are effective with first quarter reporting by banking organizations. They include (1) reducing the timeframes for delisting credits from HLT status; (2) allowing banking organizations to delist certain companies from HLT status that adequately service debt and clearly demonstrate superior cash flow, relative to their respective industry or peer groups; (3) delisting each company (with a previous HLT designation) emerging from Chapter 11 bankruptcy from the HLT designation whose leverage, after reorganization, is less than 75 percent; and (4) excluding certain loans from HLT reporting that are fully-collateralized with cash or cash equivalents.

To implement these revisions, the following changes are being made to the HLT definition:

\* All delisting criteria will be replaced with the following:

HLT exposure of a given borrower may be removed from HLT status upon satisfying one of the following criteria:

(a) Credits of a company emerging from protection under Chapter 11 of the U.S. Bankruptcy Code at the consummation of a court-approved plan of reorganization will be immediately delisted from HLT status, if the company's leverage ratio is less than 75 percent at the time of reorganization.

(b) A borrower's credits that were designated as HLTs under the "doubling of liabilities to greater than 50 percent" leverage test or that have reduced leverage to less than 75 percent will be considered eligible for delisting if the company has performed well for one year (since its last buyout, acquisition, or leveraged recapitalization involving financing) and demonstrates an ability to continue satisfactorily servicing debt. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender 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, industry risk, and status of asset sales, if applicable.

(c) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting by banking organizations on a case-by-case basis, if the company demonstrates superior cash flow coverage, relative to the company's industry or peer group, and the

company has adequately serviced debt for a reasonable period of time since its last buyout, acquisition, or leveraged recapitalization involving financing. To verify strong performance, the lender should conduct a thorough review of the obligor to include, at a minimum, the quality and strength of cash flow coverages, operating margins, reduction in leverage, appropriateness of the company's financial projections, overall management performance against the business plan, industry risk, and status of asset sales, if applicable. Credits delisted in this manner will subsequently be reviewed, and potentially subject to relisting, by examiners during the normal course of an examination.

(d) Credits of a company whose leverage continues to exceed the 75 percent leverage test will be considered eligible for delisting if the company has performed adequately for at least three years since its last buyout, acquisition, or leveraged recapitalization involving financing; and the company has a positive net worth. To verify adequate performance and validate the appropriateness of financial projections of a company, the lender 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, industry risk, and status of asset sales, if applicable.

\* Certain fully-collateralized loans will be excluded from HLT reporting by banking organizations as follows:

All loans (credit facilities) that are fully-collateralized with cash or cash equivalents are excluded from HLT reporting by banking organizations. Cash collateral consists of a deposit in the financial institution advancing the loan proceeds, segregated and under the control of the financial institution, and unequivocally pledged to secure the loan. Cash equivalents are deemed to include U.S. Government and certain other readily-marketable securities qualifying for a zero risk-weight under risk-based capital standards. Cash equivalents must be held in custody by and unequivocally pledged to the lending financial institution.