Please note that the comments expressed herein are solely my personal views

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- Docket No. OP-1439
- Proposed Guidance on Leveraged Lending

Dear Jennifer Johnson.

Thank you for giving us the opportunity to comment on your proposed joint guidance with request for public comment: Proposed Guidance on Leveraged Lending.

The OCC, Board, and the FDIC (the Agencies) request comment on proposed guidance on leveraged lending. The proposed guidance outlines high-level principles related to safe and sound leveraged lending activities, which include: underwriting considerations; assessing and documenting enterprise value; risk management expectations for credits awaiting distribution; stress testing expectations and portfolio management; and risk management expectations. This proposed guidance would apply to all Federal Reserve-supervised, FDIC-supervised, and OCC-supervised financial institutions substantively engaged in leveraged lending activities. The number of community banking organizations with substantial exposure to leveraged lending is very small; therefore the Agencies generally expect that community banking organizations largely would be unaffected by this guidance.

I agree that the proposed guidance is an improvement on your 2001 Guidance, and which describes "expectations for the sound risk management of leveraged finance activities". However, very much of the proposed guidance reads like a simple (and by definition non-exhaustive) list of points that should be considered in order to meet these expectations, rather than true guidance. I would recommend that you should provide some more robust rules, guidance and definitions, in order to strengthen the risk management of leveraged lending, and to promote greater consistency in risk management frameworks, whilst retaining the basic principles-based nature of the proposed guidance. I will comment on some points that could be improved in order to expedite this.

Definition of leveraged finance

The 2001 Guidance states that: "The loan policy should specifically address the institutions' leveraged lending activities by including: A definition of leveraged lending". The proposed guidance expands on this by stating that: "Institutions' policies should include criteria to define leveraged finance. Numerous definitions of leveraged finance exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds are used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt/EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.
- Borrower that is recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions where the borrower's post-financing leverage, when measured by its leverage ratios, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors, significantly exceeds industry norms or historical levels."

The proposed guidance is not complete or objective enough in order to provide a robust definition of leveraged finance as this will depend on:

- The risk tolerance of the institution;
- Markets' views, which tend to be cyclical;
- Markets' views, which tend to be irrational, in particular during crises.

I would recommend that you propose some fixed ratios, quantities or percentiles, which will provide a more objective metric to quantify leveraged finance. This would at least provide a robust framework for defining leveraged finance, compared to the subjective and circular guidance that you have proposed. This is an important point, as the definition of leveraged finance will affect the quality of the risk management framework adopted by institutions.

Stress testing

Stress testing is mentioned several times in the proposed guidance. Naturally stress testing should allow for shocks and variations along the following lines:

1) changing individual assumptions and parameters (sensitivity testing);
2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
3) changing the dependencies assumed between assumptions and parameters.

The importance of point 3 above is often underestimated. I would strongly recommend that you specifically emphasise the importance of considering dependencies and correlations under stress testing, particularly as typically observed and expected dependencies may not apply in the tail conditions and events that underlie many stress conditions and scenarios.

Reputational risk

The proposed guidance contains a new section on reputational risk, which is very valuable. Reputational risk is often overlooked as it is quite difficult to measure and quantify before the event. However, it is important that reputational risk should be considered as part of any risk management framework. I would strongly recommend here that you should expand its scope to specifically include both reputational risk and misselling risk, as one risk often precedes and promotes the other.

Yours sincerely

Chris Barnard