

**Supporting Statement for the
Recordkeeping Provisions Associated with
Guidance on Leveraged Lending
(FR 4203; OMB No. to be assigned) (Docket No. OP-1439/1438)**

Summary

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), proposes to implement the Recordkeeping Provisions Associated with Guidance on Leveraged Lending (FR 4203; OMB No. to be assigned). The Paperwork Reduction Act (PRA) classifies these recordkeeping and disclosure requirements as an “information collection.”¹ On March 30, 2012, the Office of the Comptroller of the Currency (OCC); Board of Governors of the Federal Reserve System (Board); and Federal Deposit Insurance Corporation (FDIC), collectively (the Agencies) published a joint notice of proposed guidance in the *Federal Register* for public comment titled “Proposed Guidance on Leveraged Lending” (the Guidance).²

The proposed interagency guidance outlines high-level principles related to safe and sound leveraged lending activities, including 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 financial institutions substantively engaged in leveraged lending activities supervised by the Agencies.

The Agencies identified certain aspects of the proposed guidance that may constitute a collection of information. In particular, these aspects are the provisions that state a banking organization should (a) have underwriting policies for leveraged lending, including stress testing procedures for leveraged credits; (b) have risk management policies, including stress testing procedures for pipeline exposures; and (c) have policies and procedures for incorporating the results of leveraged credit and pipeline stress tests into the firm’s overall stress testing framework.

The Federal Reserve’s total annual burden is estimated to be 74,570 hours for the 41 financial institutions that are likely to be subject to the Guidance. There are no required reporting forms associated with the Guidance.

Background and Justification

In April 2001, the Agencies (and Office of Thrift Supervision) issued guidance³ regarding sound practices for leveraged finance⁴ activities (2001 Guidance). The 2001 Guidance addressed

¹ 44 U.S.C. § 3501 *et seq.*

² (77 FR 19417).

³ SR 01-9, “Interagency Guidance on Leveraged Financing,” April 17, 2001, OCC Bulletin 2001-8, FDIC Press Release PR-28-2001

⁴ For the purpose of this guidance, references to leveraged finance or leveraged transactions encompass the entire debt structure of a leveraged obligor (including senior loans and letters of credit, mezzanine tranches, senior and subordinated bonds). References to leveraged lending and leveraged loan transactions and credit agreements refer to

expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, and the importance of stress testing exposures and portfolios.

Since the issuance of that guidance, the Agencies have observed tremendous growth in the volume of leveraged credit and in the participation of non-regulated investors. As the market has grown, debt agreements have frequently included features that provided relatively limited lender protection, including the absence of meaningful maintenance covenants in loan agreements and the inclusion of payment-in-kind (PIK)-toggle features in junior capital instruments (i.e., a feature where the borrower has the option to pay interest in cash or in-kind, which increases the principal owed), both of which lessen lenders' recourse in the event that a borrower's performance does not meet projections. Further, the capital structures and repayment prospects for some transactions, whether originated to hold or distribute, have at times been aggressive in light of the overall risk of the credit.

Absent meaningful limits and to support burgeoning demand from institutional investors, the pipeline of aggressively priced and structured commitments has grown rapidly. Further, management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, and many institutions have found themselves holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly. In light of these changes, the Agencies have decided to replace the 2001 Guidance with new leveraged finance guidance (proposed guidance).

All financial institutions⁵ should have the capacity to properly evaluate and monitor underwritten credit risks, to understand the effect of changes in borrowers' enterprise values upon credit portfolio quality, and to assess the sensitivity of future credit losses to changes in enterprise values. Further, in underwriting such credits, institutions need to ensure that borrowers are able to repay credit as due and at the same time that borrowers have capital structures, including their bank borrowings and other debt, that support the borrower's continued operations through economic cycles (that is, have a sustainable capital structure). Institutions should also be able to demonstrate that they understand their risks and the potential impact of stressful events and circumstances on borrowers' financial condition. The recent financial crisis further underscored the need for banking organizations to employ sound underwriting, to ensure that the risks in leveraged lending activities are appropriately incorporated in the Allowance for Loan and Lease Losses and capital adequacy analyses, to monitor the sustainability of their borrowers' capital structures, and to incorporate stress testing into their risk management of both leveraged portfolios and distribution pipelines, as banking organizations unprepared for stressful events and circumstances can suffer acute threats to their financial condition and viability. The proposed guidance is intended to be consistent with industry practices while building upon the recently proposed guidance on Stress Testing.⁶

the senior loan and letter of credit tranches held by both bank and non-bank investors.

⁵ For purposes of this guidance, the term "financial institution" means national banks, federal savings associations, and Federal branches and agencies supervised by the OCC; state member banks, bank holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember insured banks and other institutions supervised by the FDIC.

⁶ "Annual Stress Test," Notice of Proposed Rulemaking, 77 FR 3408 (January 24, 2012).

Description of Information Collection

Principal Elements of the Proposed Guidance

The proposed guidance describes expectations for the sound risk management of leveraged finance activities, including the importance of institutions developing and maintaining:

- Transactions that are structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these considerations should clearly support a borrower's capacity to repay and de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute.
- A definition of leveraged finance that facilitates consistent application across all business lines.
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt.
- A credit limit and concentration framework that is consistent with the institution's risk appetite.
- Sound MIS that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines.
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels.
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

As mentioned above, the proposed guidance would replace existing leveraged finance guidance and forms the basis of the Agencies' supervisory focus and review of supervised financial institutions, including, as applicable, subsidiaries and affiliates involved in leveraged lending. In implementing the guidance, the Agencies would consider the size and risk profile of an institution's leveraged portfolio relative to its assets, earnings, liquidity, and capital. Although some sections of this proposal are intended to apply to all leveraged lending transactions (e.g., underwriting), the vast majority of community banks should not be affected by this guidance as they have no exposure to leveraged credits. The limited number of community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator implementation of cost-effective controls appropriate for the complexity of their exposures and activities.

Time Schedule for Information Collection

The documentation required by the Guidance is maintained by each institution; therefore, are not collected or published by the Federal Reserve System. These recordkeeping requirements are documented on occasion. Bank examiners would verify compliance with this recordkeeping requirement during examinations.

Consultation Outside of the Agency and Discussion of Public Comment

On March 30, 2012, the Agencies published a joint notice of proposed guidance in the *Federal Register* for public comment (77 FR 19417). The comment period for this notice expired June 8, 2012. The agencies received two comments from addressing the PRA burden estimate. Both comments mentioned how substantially burdensome the guidance will be to implement. The agencies recognize that the amount of time with the guidance may be higher or lower than the estimates, but believe that the numbers stated are reasonable averages. The final *Federal Register* notice, implementing the Guidance, was published on March 22, 2013 (77 FR 17766). This guidance is effective on March 22, 2013. The compliance date for this guidance is May 21, 2013.

Sensitive Questions

This information collection contains no questions of a sensitive nature, as defined by OMB guidelines.

Legal Status

Authorization: The Board's Legal Division has determined that all financial institutions supervised by the Board and substantively engaged in leveraged lending activities are subject to the FR 4203:

- Regarding state member banks, the information collection is authorized by Section 11 (a)(2) of the Federal Reserve Act, 12 U.S.C. § 248(a)(2), which authorizes the Board to require any depository institution to make such reports of its assets and liabilities as the Board may determine to be necessary or desirable to enable the Board to discharge its responsibilities to monitor and control monetary and credit aggregates.
- With respect to bank holding companies, Section 5(c) of the Bank Holding Company Act, 12 U.S.C. § 1844(c), authorizes the Board to require a bank holding company and any subsidiary "to keep the Board informed as to –(i) its financial condition, [and] systems for monitoring and controlling financial and operating risks"
- Regarding branches and agencies of foreign banking organizations, Section 7(c)(2) of the International Banking Act of 1978, 12 U.S.C. § 3105(c)(2), subjects such entities to the requirements of section 248(a) "to the same extent and in the same manner as if the branch or agency were a state member bank."
- Under Section 25 of the Federal Reserve Act, 12 U.S.C. § 602, state member banks are required to furnish to the Board "information concerning the condition of" Edge and Agreement Corporations in which they invest. More generally with respect to Edge and Agreement Corporations, under Section 25A of the Federal Reserve Act, 12 U.S.C. § 611a, the Federal Reserve may "issue rules and regulations" governing such entities "consistent with and in furtherance of the purposes" of that subchapter.
- Under Section 312 of the Dodd-Frank Act, 12 U.S.C. § 5412, the Board succeeded to all powers and authorities of the OTS and its Director with respect to savings and loan holding companies, including the Director's authority to require SLHCs to "maintain such books and records as may be prescribed by the Director." 12 U.S.C. § 1467a(b)(3).

Obligation to Respond: Because the information collection is called for in guidance and not in a statute or regulation, it is considered voluntary.

Confidentiality: Because the information collected by the Proposed Guidance is maintained at the institutions, issues of confidentiality would not normally arise. Should the information be obtained by the Board in the course of an examination, it would be exempt from disclosure under exemption 8 of Freedom of Information Act (FOIA), 5 U.S.C. § 552(b)(8). In addition, some or all of the information may be confidential commercial or financial information protected from disclosure under exemption 4 of FOIA, under the standards set forth in National Parks & Conservation Ass'n v. Morton, 498 F.2d 765 (D.C. Cir. 1974).

Estimate of Respondent Burden

The total annual burden for the recordkeeping and disclosure requirements of this information collection is estimated to be 74,570 hours, as shown in the table below. The Federal Reserve estimates that it would take the 41 Federal Reserve-supervised institutions on average 1,064.4 hours to implement and 754.4 hours to maintain these provisions annually. This information collection represents less than 1 percent of total Federal Reserve System paperwork burden.

	<i>Number of respondents⁷</i>	<i>Estimated annual frequency</i>	<i>Estimated average hours per response</i>	<i>Estimated annual burden hours</i>
Implementation (guidance)	41	1	1,064.4	43,640
Maintenance (guidance)	41	1	754.4	<u>30,930</u>
<i>Total</i>				74,570

The total cost to the public is estimated to be \$3,721,043.⁸

Estimate of Cost to the Federal Reserve System

Since the FR 4203 does not require the Federal Reserve to collect any information, the cost to the Federal Reserve System is negligible.

⁷ Of the 41 respondents required to comply with this information collection, none are small entities as defined by the Small Business Administration (*i.e.*, entities with less than \$175 million in total assets) www.sba.gov/contractingopportunities/officials/size/table/index.html.

⁸ Total cost to the public was estimated using the following formula: percent of staff time, multiplied by annual burden hours, multiplied by hourly rate (30% Office & Administrative Support at \$18, 45% Financial Managers at \$59, 15% Lawyers at \$63, and 10% Chief Executives at \$85). Hourly rate for each occupational group are the mean hourly wages (rounded up) from the Bureau of Labor and Statistics (BLS), Occupational Employment and Wages 2012, www.bls.gov/news.release/ocwage.nr0.htm Occupations are defined using the BLS Occupational Classification System, www.bls.gov/soc/