



OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Leveraged Finance

Description:

Sound Risk Management
Practices

TO: Chief Executive Officers of National Banks, Department and Division Heads, and All Examining Personnel

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision have jointly issued the attached guidance on “Sound Risk Management Practices” for leveraged finance.

Over the past year, the leveraged finance portfolios of many banking organizations have deteriorated, driven in part by the relaxation of sound lending standards in past years. In response, affected institutions have strengthened their lending standards and are amending their risk management practices. The purpose of this guidance is to describe the sound practices supervisors expect and to facilitate their adoption.

Leveraged financing has been an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. In these transactions, financial leverage significantly exceeds industry norms as measured by various debt, cash flow, or other ratios. Consequently, the ability of leveraged borrowers to respond to changing economic conditions or unexpected events is usually diminished, which has significant implications for an institution's overall credit risk exposure and which poses challenges to bank risk management systems.

Leveraged finance activities can be conducted safely and soundly if a bank's risk management structure provides for appropriate underwriting, pricing, monitoring, and controls. This guidance describes the essential elements of that risk management: comprehensive credit analysis, frequent monitoring, and detailed portfolio reports. Only by recognizing the importance of these essentials can banks understand and manage the inherent risk in leveraged finance portfolios.

Many leveraged transactions are underwritten with reliance on the imputed value of a business (“enterprise value”). Such values are often highly volatile. The guidance stresses the importance of sound methods of valuing enterprises, regular stress testing of these values, and continual monitoring of them. The statement also describes how to risk-rate leveraged finance loans and how to factor enterprise value into a risk rating.

The guidance is effective immediately.

For further information, please contact Credit Risk Division (202) 874-5170.

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Attachment