Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Joint Release Federal Deposit Insurance Corporation
Office of Thrift Supervision

NR 2001-36
For Immediate Release April 9, 2001

Agencies Issue Risk Management Practices for Leveraged Financing

WASHINGTON -- The federal bank regulatory agencies today issued guidance concerning sound risk management practices for institutions engaged in leveraged financing.

The guidance, issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, augments previously issued individual statements.

Over the past year, deterioration has emerged in leveraged finance portfolios of many banking organizations, 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 clarify supervisors' expectations regarding sound practices and facilitate their adoption.

Leveraged financing has been an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. These transactions are characterized by a degree of financial leverage that significantly exceeds industry norms as measured by various debt, cash flow or other ratios. Consequently, leveraged borrowers generally have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit risk exposure and challenges for bank risk management systems.

Leveraged finance activities can be conducted in a safe and sound fashion if pursued with a risk management structure that provides for appropriate underwriting, pricing, monitoring, and controls. This guidance highlights the need for comprehensive credit analysis processes, frequent monitoring, and detailed portfolio reports to better understand and manage the inherent risk in these leveraged finance portfolios.

Many leveraged transactions are underwritten with reliance on the imputed value of a business ("enterprise value"), which often exhibits a high degree of volatility. The guidance stresses the importance of sound valuation methodologies and ongoing stress testing and monitoring of enterprise values. The statement also provides guidance about risk rating leveraged finance loans and how enterprise value should be evaluated in the risk rating process.

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Attachment

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