CONNELL & ANDERSEN LLP
545 FIFTH AVENUE
NEW YORK, NEW YORK 10017

WILLIAM F. CONNELL
ROY C. ANDERSEN

TELEPHONE: (212) 687-6900
FACSIMILE: (212) 687-6999
randersen@connellandersen.com

OF COUNSEL
GEORGE A. SCHNEIDER
LUCA CANTELLI

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<u>Banking Agency Guidance on Leveraged Lending</u>

On March 22, 2013, the Banking Agencies published their guidance on leveraged lending ("LL") activities of banks. This guidance has been in proposed form for almost a year. This memorandum answers some basic questions about the guidance.

When do Banks have to Comply with this Guidance?

The compliance date for this guidance is May 21, 2013.

What is the key Message in the Guidance?

Banks involved with LL should adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk acceptance criteria, and risk controls.

What if a Bank does not follow this Guidance?

Ignoring the guidance could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices. The guidance sets forth the minimum expectations of the regulators.

What prompted this Guidance?

The agencies have observed tremendous growth in the volume of leveraged credit and in the participation of unregulated investors.

Loan agreements have frequently included features that provided relatively limited lender protection including, but not limited to, the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind (PIK)-toggle features.

The capital structures and repayment prospects of loans have at times been aggressive.

Bank management information systems have provided weak information on exposures and certain banks have been holding large pipelines of higher-risk credits with little ability to offload such loans.

What is the purpose of this Guidance?

It is to replace the last version of guidance in this area that was issued in 2001. It is to encourage banks to participate in transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage.

What should the Compliance Department do?

The compliance function should periodically review the institution's leveraged lending activity. Compliance should insure that the activity is consistent with principles of safety and soundness and other agency guidance related to commercial lending.

Compliance must ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations.

Compliance should ensure that applicable securities laws are observed, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

What is Leveraged Lending?

The Guidance advises each bank to define LL in its own policies and procedures so the application of the definition will be consistent across all that bank's business lines. This definition should employ the financial characteristics common to LL transactions.

Accepted definitions of LL commonly contain some combination of the following:

The proceeds of LL are used for buyouts, acquisitions, or capital distributions.

Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.

A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt to-net-worth ratio.

Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, 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.

What is not Leveraged Lending?

The agencies do not intend for this guidance to apply to small portfolio commercial and industrial loans, or traditional asset-based lending loans.

The designation of a financing as ``leveraged lending'' is typically made at loan origination, modification, extension, or refinancing. Borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included.

This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor.

The Guidance should not discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the Bankruptcy Code.

What if a Bank is just purchasing Participations in LL?

Nonetheless, a bank should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. Obtaining and independently analyzing full credit information, reviewing copies of all executed and proposed loan documents, monitoring the borrower and establishing appropriate risk management guidelines are required.

What needs to be done by Banks to Comply with the Guidance?

The guidance contains specific requirements that must be reviewed carefully and applied to the activities of a bank. In general terms, the following have to be attended to:

New credit policies and procedures that:

Identify risk parameters for LL
Set limits within a framework
Adapt Capital and Loan Loss Reserves to LL risks
Involve senior management
Set return expectations
Set underwriting standards

Establish Due diligence requirements including:

Collateral evaluations
Divestment strategies
Sponsor support
Close review of loan documents
Review of Covenant protections

Valuation Standards need to be reviewed including:
Requiring Independent review
Valuations Need Careful justification

Syndication Systems need Strong Risk Management:
Stated underwriting risk limits
Policies on failed deals (i.e. unsold in 90 days)
Board of Directors involvement
Stress testing exposures
Testing against original expectations
Comprehensive reporting
Limits on commitments
Limits on book
Policies on Hedging

Reporting Requirements such as:
Quarterly trends on exposures
Risk ratings distributions
Industry mix and Maturities
Performance measures
Impairments
Collateral Exposures
Secondary Market Pricing
Performance of Deal Sponsors

Risk Rating of LL

Credit Analysis including:
Cash Flows
Liquidity
Stress-tested Projections
Quarterly Reviews of Credit files
Independent Review of Valuations
Collateral Short fall reviews
Interest rate and FX risks

Problem Credit Management Policies and Action Plans

Policies for working with Deal Sponsors, including financial support from Sponsors

Stress Testing of the LL portfolio should be done on a periodic basis and guidelines need to be developed to guide this process

Policies on Conflicts of Interest for both debt and equity positions should be developed. Such policies should contain controls and procedures and encourage reporting of conflicts.

R.C.A.