CHAPMAN AND CUTLER LLP

To the Point!

legal, operations, and strategy briefs for financial institutions April 4, 2013

Interagency Guidance on Leveraged Lending

On March 21, 2013, the banking regulatory agencies (FRB, FDIC and OCC) (the *"Agencies"*) issued guidance on leveraged lending (the *"Guidance"*) which replaces their guidance issued in April 2001. The updated Guidance is effective as of the publication date with a mandatory effective date of May 21, 2013. The Guidance distinguishes between leveraged lending and asset-based lending (to which the Guidance does not apply).

The Agencies issued the Guidance due to the increased volumes of leveraged lending and the deterioration of prudent underwriting process they observed. Specifically, the Agencies identified:

- debt agreements that included features that weakened lender protection by excluding meaningful maintenance covenants and included other features that could limit lenders' recourse in the event of weakened borrower performance;

- aggressive capital and repayment structures for some transactions, whether originated to hold or to distribute; and

- less than satisfactory management information systems that were unable to aggregate exposure on a timely basis.

Banks are required to define leveraged lending in their policies and procedures to ensure consistent application across all business lines using criteria appropriate to the institution. The Guidance provides the following examples for a bank to consider in developing its definition of leveraged lending activities subject to the Guidance:

- proceeds 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 exceeds 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; and

- 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.

The Guidance includes key areas to be addressed by financial institutions engaged in leveraged lending, such as:

Establishing a sound risk-management framework: The Agencies expect that management and the board of directors will identify an institution's risk appetite for leveraged finance, establish appropriate credit limits, and ensure prudent oversight and approval processes.

Underwriting standards: An institution's underwriting standards should clearly define expectations for cash flow capacity, amortization, covenant protection, collateral controls, and the underlying business premise for each transaction, and should consider whether the borrower's capital structure is sustainable, regardless of whether the transaction is underwritten to hold or to distribute.

Valuation standards: An institution's standards should concentrate on the importance of sound methods in the determination and periodic revalidation of enterprise value.

Pipeline management: An institution should be able to accurately measure exposure on a timely basis, establish policies and procedures that address failed transactions and general market disruptions, and ensure periodic stress tests of exposures to loans not yet distributed to buyers.

Reporting and analytics: An institution should ensure that management information systems accurately capture key obligor characteristics and aggregate them across business lines and legal entities on a timely basis, with periodic reporting to the institution's board of directors.

Risk rating leveraged loans: An institution's risk rating standards should consider the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time.

Participations: An institution that participates in leveraged loans should establish underwriting and monitoring standards similar to those for loans underwritten internally.

Stress testing: An institution should perform stress testing on leveraged loans held in a portfolio as well as those planned for distribution, in accordance with existing interagency issuances.

Financial institutions should consider whether they engage in leveraged lending as described in the Guidance. If engaged in leveraged lending, a financial institution must review and revise its policies and procedures, underwriting standards, and management processes, including reports and analytics, to ensure they address these issues contained in the Guidance before May 21, 2013.

Fair Lending and Indirect Auto Lending

The Consumer Financial Protection Bureau (*"CFPB"*) issued a bulletin entitled "Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act" (the *"Bulletin"*). The Bulletin is intended for bank and nonbank indirect auto lenders that permit dealers to increase consumer interest rates and that compensate dealers with a share of increased interest revenues. The CFPB clarified that it will apply the disparate impact doctrine to those indirect lenders it determines to be creditors under the Equal Credit Opportunity Act (the *"ECOA"*). An indirect lender may be deemed to be a "creditor" under the ECOA, and thus liable for the dealer's actions, if the indirect lender is an assignee that in the regular course of business participates in the credit decision.

The CFPB recommended that indirect lenders develop fair lending compliance management programs including the features contained in the CFPB's Fall 2012 Supervisory Highlights. In addition, indirect lenders should either (1) impose controls on dealer markup and monitor the effects of the policies so that they can address unexplained pricing disparities on a prohibited basis or (2) eliminate dealer markup and adopt another mechanism to compensate dealers that does not result in discrimination.

Finally, those lenders that continue to permit dealer markup should also initiate the following steps:

- sending communications to all participating dealers explaining the ECOA, stating the lender's expectations with respect to ECOA compliance, and articulating the dealer's obligation to mark up interest rates in a non-discriminatory manner in instances where such markups are permitted;

- conducting regular analyses of both dealer-specific and portfolio-wide loan pricing data for potential disparities on a prohibited basis resulting from dealer markup and compensation policies;

- commencing prompt corrective action against dealers, including restricting or eliminating their use of dealer markup and compensation policies or excluding dealers from future transactions, when analysis identifies unexplained disparities on a prohibited basis; and

- promptly remunerating affected consumers when unexplained disparities on a prohibited basis are identified either within an individual dealer's transactions or across the indirect lender's portfolio.

To mitigate risk of non-compliance with the ECOA, indirect auto lenders that permit dealers to increase consumer interest rates and compensate dealers with a share of the increased interest revenues should review their indirect auto lending program and assess whether it will be necessary to implement changes to address the requirements outlined by the CFPB.

Elimination of Sticker Disclosure Requirement at Automated Teller Machines

In December 2012 Congress passed legislation amending the Electronic Funds Transfer Act (the *"EFTA"*) to eliminate the requirement that an ATM operator post a fee "on or at" an ATM notifying a consumer that a fee may be charged by the ATM operator for use of the ATM. The EFTA continues to require ATM operators to provide an on-screen notice. The CFPB amended Regulation E and its commentary to implement this change.

The revised rule was effective on March 26, 2013, the date of publication in the Federal Register.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

To the Point! is a summary of items of interest and current issues for financial institutions with primary focus on regulatory, consumer, and corporate issues. Chapman and Cutler LLP maintains a dedicated practice group with expertise to counsel on these issues and other enterprise risk management matters facing financial institutions. If you would like to discuss any of the items contained in these briefings or other legal, regulatory, or compliance issues facing your institution, please contact one of the partners in our Bank Regulatory Group:

Marc Franson • 312.845.2988
Scott Fryzel • 312.845.3784
Heather Hansche • 312.845.3714
Doug Hoffman • 312.845.3794
John Martin • 312.845.3474
David Worsley • 312.845.3896
Dianne Rist • 312.845.3404

Chapman and Cutler LLP | 312.845.3000 | 111 West Monroe Street | Chicago | IL | 60603