Proposed *Leveraged Lending Guidance* from 77 FR 19417-19424 (03/30/2012)[1]

Let's see what is worth "borrowing" for EB-5 Regional Center Plans.

The text of the proposed guidance is as follows:

Purpose

In April 2001, the Agencies (Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision) issued guidance \5\ [2]regarding sound practices for leveraged finance \6\[3] activities (2001 Guidance). The 2001 Guidance addressed 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, both of which lessened lenders' recourse in the event of a borrower's subpar performance. Further, the capital structures and repayment prospects for some transactions, whether originated to hold or distribute, have at times been aggressive.

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

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[1] http://www.gpo.gov/fdsys/pkg/FR-2012-03-30/pdf/2012-7620.pdf

[2]Original footnote numbers shown as \#\:

\5\ SR 01-9, ``Interagency Guidance on Leveraged Financing," April 17, 2001, OCC Bulletin 2001-8, FDIC Press Release PR-28-2001.

[3] \6\ 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 the senior loan and letter of credit tranches held by both bank and non-bank investors.

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 (2012 Guidance). The 2012 Guidance describes expectations for the sound risk management of leveraged finance activities, including the importance for institutions to develop and maintain:

- 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 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.

Applicability

This issuance replaces existing leveraged finance guidance and forms the basis of the Agencies' supervisory focus and review of supervised financial institutions, including subsidiaries and affiliates. Implementation of this guidance should be consistent with the size and risk profile of an institution's leveraged portfolio relative to its assets, earnings, liquidity, and capital. Although some sections of this guidance should apply to all leveraged 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 have leveraged lending activities should discuss with their primary

regulator implementation of cost-effective controls appropriate for the complexity of their exposures and activities.

Risk Management Framework

Given the high risk profile of leveraged exposures, institutions engaged in leveraged financing 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. The lack of robust risk management processes and controls in institutions with significant leveraged finance activities could contribute to a finding that the institution is engaged in an unsafe and unsound banking practice. This guidance outlines minimum regulatory expectations and covers the following topics:

- Definition of Leveraged Finance.
- General Policy Expectations.
- Underwriting Standards.
- Valuation Standards.
- Pipeline Management.
- Reporting and Analytics.
- Rating Leveraged Loans.
- Other Key Risk Management Components.
- Credit Analysis.
- Problem Credits.
- Deal Sponsors.
- Credit Review.
- Conflicts of Interest.
- Anti-tying.
- Reputation Risk.
- Securities Laws.
- Compliance.

Definition of Leveraged Finance

Institutions' policies should include criteria to define leveraged finance. Numerous definitions of leveraged finance exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds are used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt/EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.\7\[4]
- Borrower that is recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions where the borrower's post-financing leverage, when measured by its leverage ratios, 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.\8\[5]

Institutions engaging in this type of activity should define leveraged finance within their policies in a manner sufficiently detailed to ensure consistent application across all business lines.

Examiners should expect the bank's definition to describe clearly the purposes and financial characteristics common to these transactions, and this definition should include the bank's exposure to financial vehicles, whether or not leveraged, that engage in leveraged finance activities.

General Policy Expectations

An institution's credit policies and procedures for leveraged finance should address the following items:

- Management should identify the institution's risk appetite, which should include clearly defined amounts of leveraged finance that the institution is willing to underwrite (pipeline limits) and leveraged loans it is willing to retain (i.e., transaction and aggregate hold levels). The designated risk appetite should be supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by the board of directors.

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[4] \7\ Cash should not be netted against debt for purposes of this calculation.

[5] \8\ Higher quality borrowers not initially designated as part of the leveraged portfolio, but which otherwise meet the institution's definition, should be added to the portfolio if their financial performance and prospects deteriorate (i.e., fallen angels).

- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related approval authorities and exception tracking provisions. In addition to notional pipeline limits, underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or otherwise provide a more nuanced view of potential risk are expected from institutions with significant leveraged finance exposure.
- Ensuring that the risks of leveraged lending activities are appropriately reflected in an institution's Allowance for Loan and Lease Losses and capital adequacy analyses.
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms.
- Appropriate oversight by senior management, including adequate and timely reporting to the board.
- The expected risk-adjusted returns for leveraged transactions.
- Minimum underwriting standards (see Underwriting Standards below).
- The degree to which underwriting practices may differ between primary loan origination and secondary loan acquisition.

Underwriting Standards

An institution's underwriting standards should be clear, written, measurable, and accurately reflect the institution's risk appetite for leveraged finance transactions. Institutions should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. Originating institutions should be mindful of reputational risks associated with poorly underwritten transactions, which may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, underwriting standards should consider:

- Whether the business premise for each transaction is sound and its capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles.

- A borrower's capacity to repay and its ability to de-lever to a sustainable level over a reasonable period. As a general guide, base case cash-flow projections should show the ability over a five-to-seven year period to fully amortize senior secured debt or repay at least 50 percent of total debt. Projections should also include one or more realistic downside scenarios that reflect the key risks identified in the transaction.
- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, and it should clearly define credit risk management's role in such due diligence.
- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods.
- Degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values.
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration their financial capacity, the extent of their capital contribution at inception, and other motivating factors.
- Whether credit agreement terms allow for the material dilution, sale or exchange of collateral or cash flow-producing assets without lender approval.
- Credit agreement covenant protections, including financial performance (such as debt to cash flow, interest coverage or fixed charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (i.e., debt that must be serviced from operating cash flow) in
- excess of 6x for Total Debt/EBITDA raises concerns for most industries.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies.
- Standards for asset-based loans should also outline expectations for the use of collateral controls (e.g., inspections, independent valuations, and lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements.
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants/investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which banks should consider separate underwriting and risk rating guidance.

Valuation Standards

Lenders often rely upon enterprise value and other intangibles when:

(1) evaluating the feasibility of a loan request,
(2) determining the debt reduction potential of planned asset sales,
(3) assessing a borrower's ability to access the capital markets, and
(4) estimating the strength of a secondary source of repayment.

Lenders may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed or validated by qualified persons independent of the origination function.

Conventional appraisal theory provides three approaches for valuing closely held businesses--asset, income, and market. Asset approach methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income approach methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market approach methods derive value multiples from comparable company data or sales transactions. Although value estimates should reconcile results from the use of all three approaches, the income approach is generally considered the most common and reliable method.

There are *two common methods* to the income approach. They are:

- The “capitalized cash flow” method determines the value of a company as the present value of all the future cash flows that the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable.

- The “discounted cash flow” method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (discount rate) that reflects the risk inherent therein and matches the cash flow. This method is most appropriate when future cash flows are cyclical or variable between periods. Both methods involve numerous assumptions, and supporting documentation should therefore fully explain the evaluator's reasoning and conclusions.

When an obligor is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a firm's assets should be tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress testing of enterprise values and their underlying assumptions should be conducted and documented both at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Valuations derived with even the most rigorous valuation procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, establishing limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value may be appropriate. ***Whatever the methodology, assumptions underlying enterprise valuations should be clearly documented, well- supported, and understood by institutions' appropriate decision-makers and risk oversight units. Examiners should ensure that the valuation approach is appropriate for the company's industry and condition.***[6]

Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those

[6] This basic principle applies across-the-board for the entire Regional Center “Overall Project”.

to be distributed. An institution should be able to differentiate transactions according to tenor, investor class (e.g., pro-rata, institutional), structure, and key borrower characteristics (e.g., industry).

In addition, an institution should develop and maintain:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from these positions.
- Written procedures for defining and managing distribution fails and ``hung'' deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from closing). The institution's board should establish clear expectations for the disposition of pipeline transactions that have not been sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be included in reports to management and the board of directors.
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic/market conditions on asset quality, earnings, liquidity, and capital.
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication/distribution variances, and reporting if distribution was achieved through a recourse sale.
- Reports that include individual and aggregate transaction information that accurately portrays risk and concentrations in the pipeline.
- Limits on aggregate pipeline commitments and periodic testing of such exposures under different market scenarios.
- Limits on the amount of loans that an institution is willing to retain on its own books (i.e., borrower/counterparty and aggregate hold levels), and limits on the underwriting risk that will be undertaken for amounts intended for distribution.
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles.
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures. Policies should address acceptable types of hedges and the terms considered necessary for providing hedge credit (netting) for exposure measurement.

- Plans and provisions addressing contingent liquidity and compliance with Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

Reporting and Analytics

The Agencies expect financial institutions to diligently monitor higher risk credits, including leveraged loans. An institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the board of directors.

Policies should identify the fields to be populated and captured by an institution's MIS, which should yield accurate and timely reporting to management and the board that may include:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline.
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to changes in their financial characteristics and overall risk profile.
- Industry mix and maturity profile.
- Metrics derived from probabilities of default and loss given default.
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts and charge-offs.
- Amount of impaired assets and the nature of impairment (i.e., permanent, temporary), and the amount of the Allowance for Loan and Lease Losses attributable to leveraged lending.
- The aggregate level of policy exceptions and the performance of that portfolio.
- Exposure by collateral type, including unsecured transactions and those where enterprise value is a source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu treatment for all
- lenders and thus dilute secondary support from collateral value.
- Secondary market pricing data and trading volume when available.
- Exposure and performance by deal sponsor.
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions.

- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for syndication inventory. Pipeline definitions should clearly identify the type of exposure (e.g., committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed).
- Guidelines for conducting periodic portfolio stress tests (including pipeline exposures) or sensitivity analyses to quantify the potential impact of changing economic/market conditions on asset quality, earnings, liquidity, and capital. The
- sophistication of stress-testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of the leveraged loan portfolio. The leveraged portfolio also should be included in any enterprise-wide stress tests.
- Total and segment leveraged finance exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposure, including situations where institutions have indirect exposure to an obligor or are holding a previously sold position as collateral or as a reference asset in a derivative.
- Borrower/counterparty leveraged finance reporting should consider exposures booked in other business units throughout the institution, including indirect exposure such as default swaps and total return swaps naming the distributed paper as a covered or reference asset or collateral exposure through repo transactions.
- Additionally, the institution should consider positions held in available for sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Risk Rating Leveraged Loans

The Agencies have previously issued guidance on rating credit exposures and credit rating systems, which applies to all credit transactions, including those in the leveraged lending category.\9\[7]

[7] \9\ FRB SR 98-25 ``Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations;" OCC Handbooks ``Rating Credit Risk" and ``Leveraged Lending;" FDIC Risk Management Manual of Examination Policies, ``Loan Appraisal and Classification."

Risk rating leveraged loans involves the use of realistic repayment assumptions to determine the borrower's ability to de-lever to a sustainable level within a reasonable period of time. If the projected capacity to pay down debt from cash flow is nominal, with refinancing the only viable option, the credit will usually be criticized even if it has been recently underwritten. In cases where leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard classification is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that they are not merely masking repayment capacity problems.

If the primary source of repayment becomes inadequate it would generally be inappropriate to consider enterprise value as a secondary source unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual.

Other Key Risk Management Components

Credit Analysis

Effective underwriting and management of leveraged finance risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. Policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, but not limited to, whether:

- Cash flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies.
- Liquidity analyses include performance metrics appropriate for the borrower's industry, predictability of the borrower's cash flow, measurement of the borrower's operating cash needs, and ability to meet debt maturities.
- Projections exhibit an adequate margin for unanticipated merger-related integration costs.
- Projections are stress tested for several downside scenarios, including a covenant breach.

- Transactions are reviewed at least quarterly to determine variance from plan, the risk implications thereof, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance.
- Enterprise and collateral valuations are derived or validated independently of the origination function, are timely, and consider potential value erosion.
- Collateral liquidation and asset sale estimates are conservative.
- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions.
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity.
- The borrower is adequately protected from interest rate and foreign exchange risk.

Problem Credit Management

Financial institutions should formulate individual action plans when working with borrowers that are experiencing diminished operating cash flows, depreciated collateral values, or other significant variance to plan. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for lenders as well as result in less favorable outcomes.

Institutions should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors

Institutions should develop guidelines for evaluating the qualifications of financial sponsors and implement a process to regularly monitor performance. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide a source of financial support for a borrower that fails to achieve

projections. Institutions generally rate borrowers based on their analysis of the borrowers' standalone financial condition. However, lending institutions may consider support from a sponsor in assigning an internal risk rating when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, a sponsor's potential contributions may not mitigate examiner criticism absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

- Sponsor's historical performance in supporting its investments, financially and otherwise.
- Sponsor's economic incentive to support, including the nature and amount of capital contributed at inception.
- Documentation of degree of support (e.g., guarantee, comfort letter, verbal assurance).
- Consideration of the sponsor's contractual investment limitations.
- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals.
- Consideration of the sponsor's dividend and capital contribution practices.
- Likelihood of supporting the borrower compared to other deals in the sponsor's portfolio.
- Guidelines for evaluating the qualifications of financial sponsors and a process to regularly monitor performance.

Credit Review

Institutions should have a strong and independent credit review function with a demonstrated ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to senior management. Due to the elevated risk inherent in leveraged finance, and depending on the relative size of an institution's leveraged finance business, it may be prudent for the institution's credit review function to examine the leveraged portfolio more frequently than other segments, go into greater depth, and be more selective in identifying personnel to assess the underlying transactions. Portfolio reviews should generally be conducted at least annually.

For many institutions, the ***risk characteristics*** *of the leveraged portfolio*, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, *may* ***dictate*** *more frequent reviews*.

Institutions should staff their internal credit review function appropriately and ensure that it has *sufficient resources to ensure* timely, independent, and accurate *assessments of* leveraged *finance transactions.* Reviews should evaluate the level of risk and risk rating integrity, valuation methodologies, and the quality of risk management.

Internal credit *reviews* also should encompass a review of the institution's leveraged *finance practices, policies and procedures to ensure* that they are consistent with *regulatory guidance*.

Conflicts of Interest[8]

Institutions should develop appropriate policies to address and prevent potential conflicts of interest. [Here are some] example[s]:

- [A] lender may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of the *lender's equity interest*.
- A lender may receive pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. *Such conflicts also may occur where the* <u>*underwriting*</u> *bank serves* <u>*as financial advisor to*</u> *the* ***seller*** <u>*and*</u> *simultaneously offers financing to* ***multiple buyers*** *(i.e., stapled financing)*.
- Similarly, there may be conflicting interests between the different lines of business or between the institution and its affiliates. These and other situations may arise that create conflicts of interest between the institution and its customers.

Policies should clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable law.

[8] Minor stylistic changes made from original for easier reading.

Further, *management should* **establish responsibility for training employees** on how to avoid conflicts of interest, as well as provide for reporting, tracking, and resolution of any conflicts of interest that occur.

Anti-Tying Regulations

Because leveraged finance transactions often involve a number of types of debt and several bank products, institutions should ensure that their policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the BHC Act Amendments of 1970 prohibits certain forms of product tying by banks and their affiliates. The intent behind section 106(b) is to prevent institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

Reputational Risk

Leveraged finance transactions are often syndicated through the bank and institutional markets. An institution's apparent failure to meet its legal or fiduciary responsibilities in underwriting and distributing transactions can damage its reputation and impair its ability to compete. Similarly, institutions distributing transactions that over time have significantly higher default or loss rates and performance issues may also see their reputation damaged in the markets.

Securities Laws

Equity interests and certain debt instruments used in leveraged finance transactions may constitute “securities” for the purposes of federal securities laws. When securities are involved, institutions should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. Institutions should also establish procedures to appropriately manage the internal dissemination of material nonpublic information about transactions in which it plays a role.

Compliance Function

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure that potential conflicts are avoided and laws and regulations are adhered to, an independent compliance function should periodically review an institution's leveraged finance activity. Additional information is available in the Agencies' existing guidance on compliance with laws and regulations.

Conclusion

Leveraged finance is an important type of financing for the economy, and the banking industry plays an integral role in making credit available and syndicating that credit to investors. Institutions should ensure they do not heighten risks by originating poorly underwritten deals that find their way into a wide variety of investment instruments. Therefore, it is important this financing be provided to creditworthy borrowers in a safe and sound manner that is consistent with this guidance.

The above **Proposed Guidance on Leveraged Lending** was jointly put forth by three Treasury Department components, namely**:** Office of the Comptroller of the Currency, Treasury (‘‘OCC’’); Board of Governors of the Federal Reserve System (‘‘Board’’ or ‘‘Federal Reserve’’); and the Federal Deposit Insurance Corporation (‘‘FDIC’’).

The proposed 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.

Even though this guidance was actually written for Federal Reserve-supervised, FDIC-supervised, and OCC-supervised financial institutions substantively engaged in leveraged lending activities; it has good information that can readily apply to an EB-5 Regional Center. Regional Center “Applicants or Sponsors” need to develop their plans with such principles in mind when they first apply for RC designation. After USCIS designates a Regional Center, the “Sponsors or Principals” will be better equipped to serve their EB-5 investors with later compliance activities and through production of corroborating evidence to meet the *back-end burden-of-proof for* I-829s. Surely, all investors in these projects including domestic capital investors & project partners, and the RC’s themselves (if also making equity investments) will be well-served by adopting the best parts of the *Treasury Department’s Leveraged Lending Guidance* to their own specific best advantage.

Ignore at your own risk!

Joseph P. Whalen (April 1, 2012)