New Banking Directive – Leveraged Lending in Israel

In an effort to reduce risk in the Israeli banking system and in adopting the recommendations made in November 2014 by the Committee to Examine Debt Arrangements in Israel, on April 28, 2015, the Supervisor of Banks published the new Proper Conduct of Banking Business Directive 327 – Management of Leveraged Lending ("Directive").

Given the high risk profile of leveraged transactions, the Directive requires that banking corporations, as defined in the Israeli Banking (Licensing) Law, 1981 ("Banking Corporations"), engaged in leveraged lending adopt a risk management framework that has an intensive and frequent review and monitoring process. Such framework should have as its foundation written risk objectives, risk acceptance criteria and risk controls. A lack of robust risk management processes and controls at a Banking Corporation with significant leveraged lending activities may contribute to findings that the Banking Corporation is engaged in unsafe and unsound banking practices.

Although the Directive enters into force on January 1, 2016, Banking Corporations should already begin to take measures towards the implementation of the requirements of the Directive and thus ensure that they are conducting leveraged lending activities in a safe and sound manner. Notably, the provisions of the Directive are almost identical to the United States, 'Interagency Guidance on Leveraged Lending' document, published in March, 2013 (and updating the 2001 guidance), which applies to federally regulated financial institutions engaging in leveraged lending activities.

Among other things, the Directive outlines the following requirements:

- **Definition of Leveraged Lending**: a Banking Corporation's definition should, among other things, describe clearly and objectively the purposes and financial characteristics common to leveraged lending transactions. It should cover risk to the Banking Corporation from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities) that hold leveraged loans;

- **General Policy Expectations**: a Banking Corporation's credit policies and procedures for leveraged lending should address, among other things: (a) identification of the Banking Corporation's risk appetite; (b) setting a limit framework that includes limits or guidelines for single obligors and transactions, aggregate portfolio, aggregate pipeline transaction exposure (pipeline transactions are defined as syndicated transactions whereby the arranging bank has not yet completed the sale or distribution process of the credit to the additional financial institutions that are participating in the syndicate), and industry and geographic concentrations; and (c) setting procedures for ensuring the risks of leveraged lending activities are appropriately reflected in the Banking Corporation's allowance for loan and lease losses (ALLL) and capital adequacy analyses;

- **Board Meetings**: at least annually, the board of directors of the Banking Corporation must hold a meeting and consider its policies in respect of leveraged loans; and bi-annually the board of directors must discuss the state of the overall portfolio of leveraged loans;

- **Underwriting Standards**: a Banking Corporation should have well defined underwriting limits regarding leveraged transactions, including the size that such Banking Corporation will arrange both individually and in the aggregate for distribution. The originating Banking Corporation should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, a Banking Corporation's underwriting standards should include, among other things, the following: (a) whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the Banking Corporation's own portfolio or with the intent to distribute; (b) the borrower's capacity to repay and ability to...
de-lever to a sustainable level over a reasonable period; (c) defences through financial covenants; and (d) demand for appropriate collateral;

- **Evaluation Standards:** both with respect to the borrower and any sponsor (the entity that initiated the transaction which, if relied on by the Banking Corporation, must grant a formal guarantee), including loan-to-value ratios, discount rates and collateral margins;

- **Reporting and Analytics:** Banking Corporations are required to diligently monitor leveraged loans. A Banking Corporation's management should receive comprehensive reports about the characteristics and trends of such exposures at least quarterly, and summaries should be provided to the Banking Corporation's board of directors;

- **Credit Analysis:** the Banking Corporation's policies must address, among other things, the need for a comprehensive assessment of financial, business, industry, and management risks including, among other things, cash flow analyses, liquidity analyses and whether projections are stress tested for one or more downside scenarios, including a covenant breach;

- **Credit Review:** due to the elevated risks inherent in leveraged lending the Banking Corporation's credit review function should assess, more frequently and in greater depth than with respect to other loans in the loan portfolio, the performance of the leveraged portfolio, such assessment to be made at least annually and, depending on the relative size of the Banking Corporation's leveraged lending business; and

- **Stress Testing:** a Banking Corporation must develop and implement guidelines for conducting periodic portfolio stress tests on loans intended to be held as well as loans intended to be distributed, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.

Overall, the Directive is intended to strengthen the risk management frameworks of the Banking Corporations and minimize risk to the banking system through the origination and distribution of poorly underwritten and low-quality leveraged loans. It is designed to ensure that Banking Corporations originate leveraged loans with a sound business premise, a sustainable capital structure, and borrower capacity to repay the loan or to de-lever to a sustainable level over a reasonable period.

Just as in the United States after the issuance of the aforementioned 2001 guidance there were periods of tremendous growth in the volume of leveraged credit and in the participation of unregulated investors, so too the Israeli market may also experience such growth in the volume of leveraged credit with the issuance of the Directive. On the other hand, though, the above requirements may make it more difficult for borrowers to obtain leveraged loans, as Banking Corporations may establish even tighter rules and standards than those implemented in the past when granting such finance.

In any event, the full effect of the Directive will only be known after it comes into force next year. It is envisaged, though, that the Directive will assist Banking Corporations to provide leveraged lending to creditworthy borrowers in a safe and sound manner.