

HIGH LEVERAGE BUYOUT FINANCING

Introduction (12/02)

1. (a) Financing the purchase of control or means of control in corporations is characterized by large sums or high financing rates, where the ability to repay the credit is based primarily on the purchased corporation and sometimes without recourse to the borrower. In addition, credit without recourse to the borrower often involves ownership risk and misgivings about share-price inflation.
- (b) Because of the complexity and level of risk inherent in financing the purchase of means of control in corporations, the board of directors and management of a banking corporation must ensure that the banking corporation's involvement in this activity is administered in accordance with appropriate policy, credit and legal analyses, controls, and sound management information systems.
- (c) (1) In view of the foregoing, a banking corporation shall take special precautions when extending and monitoring credit for the purchase of control or means of control, particularly in transactions without recourse to the borrower, or a loan whose principal and interest is not repaid in periodical payments (whether monthly or quarterly), or in transactions extending credit to a borrower who has purchased control or means of control in several corporations by means of credit the repayment of which is based primarily on the purchased corporation.
- (2) In view of the difficulty in determining the value of the purchased corporation and the collateral for the credit, the banking corporation must ascertain their value independently, taking the potential decline in their value into consideration and without relying solely on the assessment of value undertaken by parties related to the purchased corporation or the borrower.
- (d) Without impairing the general nature of the above, this regulation, which concerns quantitative restrictions and the management of exposure, is promulgated.

Definitions (12/02)

2. **“Capital”** -

As defined in [Regulation no. 311](#) (Minimum Capital Ratio);

“Means of control” -

As defined in the Banking (Licensing) Law, and including convertible securities when the possibility of conversion exists.

“Credit for the purchase of means of control” -

Credit for the purchase of control or means of control in a corporation or in a corporation controlled by it, provided the following conditions are met:

- (a) The amount of the aforesaid credit is higher than 0.5% of the capital of the financing banking corporation, or NIS 25 million (indexed to the CPI for June 1998), whichever is higher;
- (b) The repayment of credit is based primarily on the purchased corporation (whenever no other main source of credit repayment is identified, i.e., another principal cash flow, the repayment of credit shall be considered as being based on the purchased corporation);

Including additional credit extended to the borrower at a later date than the financing of the purchase of the means of control in the purchased corporation, where the repayment of the credit is based mainly on a cash flow resulting from the means of control whose purchase was financed by the banking corporation;

“Financing rate” -

The ratio (percentage) of credit extended for the purchase of means of control of a corporation to the cost of the purchase. Similarly:

- (1) If the means of control were purchased in installments, the financing rate shall be calculated as follows: the ratio of the outstanding credit extended for the purchase of means of control of the corporation to the cost of each purchase, adjusted in accordance with the index published prior to balance sheet date for the month in which the credit was extended;
- (2) Collateral which is deductible in accordance with section 5 of [Regulation no. 313](#) may be deducted from the outstanding credit;
- (3) If a portion of the means of control is sold, the financing rate shall be calculated as specified in section (1) respectively, after the adjusted proceeds of the sale have been deducted from the adjusted purchase price

Risk management (12/02)

3. (a) The board of directors of a banking corporation shall discuss at least once a year the banking corporation’s policy with regard to extending credit for the purchase of means of control of corporations. The discussion shall focus *inter alia* on:
 - (1) The banking corporation’s policy with regard to extending credit for the purchase of means of control of corporations by others (type of corporation, financing rate, categories of credit, types of collateral, safety margins on them, etc.);
 - (2) The extent of total and desired exposure relative to the banking corporation’s capital, to credit for the purchase of means of control, and the desired rate of exposure of a single corporation to the aforesaid credit;

- (3) Credit for the purchase of means of control in corporations controlling other corporations, the purchase of the means of control in which was financed by the banking corporation;
 - (4) Credit for the purchase of means of control without recourse to the borrower.
- (b) Every six months the board of directors shall hold a discussion regarding the state of overall credit for the purchase of means of control including adherence to the financial terms set, and a detailed discussion of all credit exceeding the minimum set by it.

Quantitative restriction (12/02)

4. (a) (1) The outstanding credit for the purchase of means of control in all the corporations, in cases where the financing rate for the purchase of means of control in a corporation exceeded 50% of the cost of purchasing it, shall not exceed 70% of the capital of the banking corporation extending the credit.
- (2) Without impairing the aforesaid in section (1), the outstanding credit extended by a banking corporation for the purchase of means of control of another banking corporation, or of a bank holding corporation, in cases where the financing rate for the purchase of the means of control of the other banking corporation exceeded 30% of the cost of its purchase, shall not exceed the lower of the following:
- (a) 5% of the capital of the banking corporation extending the credit;
 - (b) 5% of the capital of the banking corporation purchased or of a bank holding corporation (in accordance with its last published financial statements), or another rate determined by the Supervisor of Banks for a banking corporation whose capital is lower than NIS 500 million.
- (b) (1) At the end of every quarter the banking corporation shall adjust the amounts and rates for the purpose stated in subsection (1);
- (2) The adjustment as stated in subsection (1) shall be undertaken for each corporation in accordance with the following calculation:
The ratio of actual outstanding credit to the cost of the purchase, adjusted in accordance with the CPI. Adjusted amount of dividends received by the

borrower from accrued profits in the purchased corporation prior to the date of purchase and profits from other substantial operations not within the corporation's ordinary course of business, the purchase of the means of control in which were financed by the banking corporation (e.g., the sale of holdings in controlled corporations or those held on the equity-basis) shall be deducted from the adjusted purchase cost.

Credit to several borrowers (12/02)

- 4a. (a) Credit extended separately to several borrowers for the purchase of control or means of control in the same corporation or in a corporation controlled by it shall be considered as a single credit for the purposes of this restriction.
- (b) For the purposes of sub-section (a), a banking corporation may disregard credit extended to certain borrowers for the purchase of means of control if the credit amount is lower than half the amount specified in paragraph (a) to the definition of "Credit for the purchase of means of control".

Indexation of amounts to foreign currency (12/04)

5. For a purchased corporation whose functional currency for financial reporting is not the New Israeli Shekel, the reference in this regulation to the CPI or CPI differences shall be regarded as a reference to the functional currency rates or fluctuations in it, wherever circumstances require this.

Transitional regulations

6. A banking corporation which have deviated from the quantitative restrictions specified in section 4(a)(2), on the date of publication of the amendment to the regulation (14.3.1999), shall annul the deviation not later than 1.1.2005.

ANNEX TO REGULATION NO. 323 (HIGH LEVERAGE BUYOUT FINANCING)

QUESTIONS AND ANSWERS FOR CLARIFICATION

1. Regarding section 1 (c) (2) (Introduction): Does the requirement for independently ascertaining value apply solely to non-recourse credit?

ANSWER:

The requirement applies to all credit, regardless of whether it is non-recourse or not. In general, the regulation makes no distinction between non-recourse credit and other credit.

2. In section 2(b), the definition of “Credit for the purchase of means of control”, states that the “repayment of credit is based primarily on the purchased corporation”. Does this mean that if the repayment of credit is based on income from the purchased corporation and in addition there are other significant collateral, this is not included in the regulation?

ANSWER:

- The aforesaid credit is included in the regulation. The guiding rule is as stated in section (b) of the definition. i.e., whether there is another principal cash flow for the credit.
- The existence of significant additional collateral does not constitute a principal cash flow.

3. In places where there is CPI indexation (as in section 2 of the regulation), is the basis the latest index published prior to balance sheet date or the index of the last month of the period?

ANSWER:

For purposes of consistency and convenience, the index published prior to balance sheet date is to be used.

4. In order to calculate “the financing rate” (section 2 of the regulation), how should the cost of the purchase be reckoned, when credit for the purchase of means of control is extended by more than one bank?

ANSWER:

The cost of the purchase provided by each bank shall be calculated on the basis of its relative share of the credit.

If, for example:

- A borrower receives credit of NIS 200 from two banks (NIS 50 from Bank A and NIS 150 from Bank B) for purchasing the means of control at NIS 300.
- The cost of purchase put up by Bank A is $300 \times 50/200 = 75$, and by Bank B it is $300 \times 150/200 = 225$.

5. What should a bank do if it has deviated from the quantitative restrictions set out in section 4(a)(2) of the regulation regarding the last amendment to the regulation?

ANSWER:

It should submit a detailed request to the Supervisor of Banks as soon as possible after the publication of this regulation.

6. Regarding section 4(a)(2) of the regulation - In relying on “capital”, which “capital” is referred to in the restriction?

ANSWER:

Any reference to “capital” is in accordance with its definition in [Regulation no. 311](#) (Minimum Capital Ratio).

- With regard to paragraph (a) of the above section, in accordance with the latest report submitted to the Bank of Israel.
- With regard to paragraph (b) of that section, in accordance with the last published financial statement, which includes information about “capital” as defined in [Regulation no. 311](#) (Minimum Capital Ratio).

7. Regarding section 4(b)(2) of the regulation - How can a distinction be made between dividends received by the borrower from accrued profits prior to the purchase and dividends accrued after it?

ANSWER:

This difficulty does exist, and it is necessary to act wisely in this respect. If there is a doubt, the dividend should be deducted from the cost of the purchase.

8. Does single credit, or credit that has those characteristics, extended to several borrowers, fall in the category of section 4a of the regulation?

ANSWER:

In general, the regulation deals with credit rather than with the borrower, so that credit of that kind will be regarded as single credit for all practical purposes. Section 4a of the regulation refers to an instance in which credit is extended separately to borrowers between whom there is no relation.

9. An example of the issue raised in section 4a of the regulation (credit to several borrowers):

1. Bank A lent Oren NIS 80 million to buy the means of control in Company C for NIS 100 million.
2. Bank A lent Erez NIS 70 million to buy the means of control in Company C for NIS 100 million.
3. Bank A lent Tomer NIS 10 million to buy the means of control in Company C for NIS 100 million.
4. The credit was extended to each borrower separately, there is no connection between them, and the credit is not single.

ANSWER:

The credit extended to Tomer should not be considered, as it is less than half the amount specified in the definition of "Credit for the purchase of means of control".

Hence, Credit balance: 150

Purchase cost: 200

Financing rate: 75% = 150

200

10. Should the calculation be based on gross or net credit after the specific provision for doubtful debts?

ANSWER:

For the purposes of this regulation, net credit should be used in the calculation. In the reporting regulation, data on gross credit is also required, however.

11. Is financing the purchase of options included in the regulation?

ANSWER:

Yes. When defined as a means of control, securities also include options.

12. For the purposes of the quantitative restriction, may collateral be deducted from outstanding credit balance?

ANSWER:

Yes, provided the collateral can be deducted in accordance with the provisions of section 5 of [Regulation no. 313](#).

13. Can the means of control purchased without bank credit (usually as additional collateral at a later date) be added to the denominator?

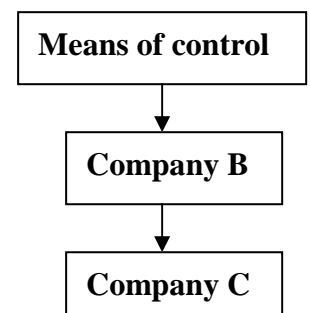
ANSWER:

This may be done only if the means of control yields an *additional* cash flow to the repayment of the credit extended by the bank. A condition for this is that there is no lien to others on this means of control and the dividend on it serves to repay the credit.

14. In the latest amendment, the term “or a corporation controlled by it”, has been added in various places. What does this mean?

ANSWER:

- Credit for the purchase of the means of control in a corporation or a corporation controlled by it is regarded as single credit.
- For example:
 1. Banking corporation A lends Tomer NIS 80 to purchase the means of control in company B (company B controls company C) for NIS 100 million.
 2. Banking corporation A lends Mor NIS 70 to purchase the means of control in company C for NIS 100 million.
 3. Credit balance: NIS 150 million
Purchase cost: NIS 200 million
Financing rate= 75%: NIS 150 million
NIS 200 million



ONLY THE HEBREW VERSION IS BINDING

15. Credit included in “credit for the purchase of means of control” is repaid in part, and the current outstanding balance is less than the minimum determined in the definition. Should the unpaid credit continue to be included in outstanding balance for the purpose of the restrictions of this regulation?

ANSWER:

No.

16. Under the Reporting Regulations to the Supervisor of Banks, data are required that are not necessary under the terms of the Proper Conduct of Banking Business (gross credit, loan-loss provisions, means of control used as collateral, etc.). Why?

ANSWER:

The reporting requirements ask for additional data, some of which are not relevant for the quantitative restrictions.

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