European Central Bank Publishes Draft Guidance on Leveraged Transactions

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The ECB consultation paper sets out guidelines for the origination and monitoring of leveraged finance exposures by European credit institutions

The ECB Guidance

On November 23, 2016, the ECB published draft guidance on leveraged transactions (the “ECB Guidance”) and launched a public consultation process to provide credit institutions and other interested parties with an opportunity to submit comments on the same. The consultation period will expire on January 27, 2017.

While the ECB Guidance itself is not binding, the ECB expects that all credit institutions under its supervision (i.e., significant Eurozone Credit institutions supervised under article 6(4) of the Regulation establishing the single supervisory mechanism) will incorporate it in their internal policies in accordance with the proportionality principle, i.e. in a manner consistent with the size and risk profile of the credit institution’s leveraged transactions relative to their overall assets, earnings and capital.

The ECB Guidance is primarily designed to ensure that relevant banks conduct leveraged activities in a safe and sound manner. In order to achieve this, the ECB Guidance recommends that banks define their own appetite for leveraged transactions and adopt internal policies for underwriting and syndicating such transactions, as well as monitor the resulting leveraged exposures.

A common background: the U.S. Interagency Guidance on Leverage Lending

According to the ECB, the goals of the ECB Guidance are consistent with those of the “Interagency Guidance on Leverage Lending” published in March 2013 by the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency applicable to U.S. credit institutions (the “US Guidance”) and the ECB Guidance is thus aimed, among other things, at creating a level-playing field for financial institutions on a global scale. The issuance of the US Guidance was prompted, in turn, by the growth in the volume of leveraged deals and the increase of borrower-friendly terms in debt agreements, which limited the protection available to lenders (for example, “covenant-lite” structures, which do not require borrowers to comply with maintenance financial covenants, had become increasingly more common across the market).
The similarity of intent and the common background resulted in the European and U.S. regulators adopting a largely consistent approach on a variety of the approval and monitoring procedures that the relevant credit institutions are expected to put in place, although some provisions and guidelines necessarily show some discrepancies.

Definition of Leveraged Transactions

While a broad range of definitions and tests are utilized in the market to capture what represents a leveraged transaction, the ECB Guidance offers a single and overarching definition that a credit institution should apply in determining whether a credit exposure is to be considered as leveraged lending. Specifically, under the ECB Guidance, credit institutions are expected to treat as leveraged transactions all transactions meeting at least one of the following criteria:

(i) loans or exposures where the borrower’s post-financing level of leverage exceeds a total debt to EBITDA ratio of 4.0 times;

(ii) loans or exposures where the borrower is owned by a financial sponsor (i.e., an investment firm that undertakes private equity investments in, or leveraged buyouts of, companies with the intention of exiting the investment in the medium term).

However, regardless of whether the above criteria are met, (a) loans to natural persons, credit institutions and investment firms, (b) loans not exceeding a certain de minimis exposure, (c) commercial real estate financing and other asset-based loans, (d) project finance loans, and (e) trade finance loans are excluded from the definition of leveraged transaction.2

Significantly, the ECB requires that the unadjusted EBITDA of the borrower should be used when determining the leverage ratio of a transaction, such that non-recurring expenses, exceptional and other one-off items should not be excluded in calculating the applicable metrics.3

General Policies: Underwriting Strategies, Credit Approval and Ongoing Monitoring

The ECB Guidance recommends that banks define their own risk appetite and strategy for leveraged transactions, within the framework of credit risk management and governance requirements under Articles 76 et seq. of Directive 2013/36/UE (CRD IV). Credit institutions should also ensure that their underwriting and syndication standards, as well as their credit approval and monitoring processes are aligned with such risk appetite.

In general, the ECB Guidance takes the view that a total debt exceeding 6.0 times EBITDA raises concerns in most industries, and the ECB therefore expects this level of leverage to remain exceptional.4 Underwriting transactions exceeding this leverage ratio should thus be duly justified and referred to the highest level of the bank’s credit committee. Total debt is defined for these purposes as the aggregate of the IFRS current and

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1 In contrast, the US Guidance does not offer a definition of leveraged lending, and instead allows each institution to identify the definition that is most appropriate for itself. The US Guidance notes, however, that the most commonly utilized definitions contain a combination of criteria, based on (i) the purpose of the loan (i.e., if the proceeds are used for buyouts, acquisitions or capital distributions), (ii) leverage metrics (i.e., if the total debt exceeds 4.0 times EBITDA or if senior debt exceeds 3.0 times EBITDA), (iii) the borrower profile (i.e., if a borrower is recognized in the debt market as being highly leveraged), or (iv) industry comparisons (i.e., if the borrower’s post-financing leverage exceeds industry norms or historic levels).

2 Consistently, under the US Guidance it is appropriate not to consider as leveraged transactions certain loans secured by tangible collateral such as ABL or real estate loans where the lender has additional sources of repayment beyond cash flow from operations of the borrower.

3 On the other hand, the U.S. regulators do not seem to have ruled out the use of adjusted EBITDA in ratio calculations per se, although they made clear that situations in which EBITDA is defined so as to allow enhancements without reasonable support are expected to be subject to specific scrutiny.

4 This level is aligned with that identified in the US Guidance. Consistently with the ECB Guidance, U.S. regulators further made clear that this ratio should not be considered a bright line that may not be exceeded in any circumstance but rather a “red flag”, likely to trigger additional scrutiny.
non-current financial liabilities of the borrower after giving effect to the contemplated transactions; therefore, unlike under the US Guidance, any committed but undrawn facilities and any uncommitted “incremental” facilities are not factored in in determining the leverage level for these purposes.

As part of their credit approval process, under the ECB Guidance credit institutions are expected to carry out an analysis of the borrower, the transaction and the relevant industry in order to assign a single rating to the exposure. This analysis should include, among other things:

(i) an assessment of the ability of the borrower to cover debt service by cash-flow generation; in this respect, the ECB assumes that the borrower’s ability to repay at least 50 percent of the total debt granted by a credit institution over a five-to-seven year period would support a positive assessment of the borrower’s adequate repayment capacity;\(^5\) and

(ii) an assessment on the structure of the transaction, including covenant protections provided under the relevant debt agreements.

Following the credit approval, credit institutions should also ensure constant monitoring of the leveraged transactions: this ongoing review should focus on the repayment capacity of the borrower and on the existence of any signs of impairment or default, such as the breach of financial covenants or the worsening of the financial condition of the borrower as compared to the initial projections.

According to the ECB Guidance, this approval and monitoring process should apply to all transactions to be syndicated and all transactions generating settlement risk, including “best efforts deals”.\(^6\)

Impact on the European Leveraged Finance Market

As has been widely noted, following the introduction of the US Guidance, while regulated banks have retrenched from the most aggressive transactions, certain market participants – such as private debt funds, business development companies and other institutional investors who are exempt from the application of the US Guidance – were able to take up some of the banks’ share in the leveraged credit market. Notwithstanding the availability of these alternative sources of credit, leverage levels in the U.S. have been observed to be decreasing since the implementation of the guidelines.

The impact and consequences of the implementation of the ECB Guidance on the European market will of course depend on the final form in which they are issued, but may expected to be similar to those observed in the U.S. Compared to the U.S., however, the European market is smaller, less deep and less diversified; further, regulated banks have traditionally represented a more substantial portion of the investor base and have been typically the primary option to raise finance for the vast majority of borrowers. Accordingly, the effects on liquidity on highly leveraged structures could be expected to be more pronounced, and the ECB Guidance may hasten the process of credit disintermediation already under way in Europe since the 2008 financial crisis. At the same time, unless the Bank of England were to adopt similar measures, the ECB Guidance may confer a competitive advantage to European banks established in the United Kingdom, which are not subject to the ECB supervision and, therefore, to such guidance.

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\(^5\) This requirement echoes a similar parameter set forth by the US Guidance for purposes of assigning a risk rating to the loan. The U.S. approach, however, focuses on the borrower’s ability to repay either 50% of the total debt (without reference to the tranche of debt provided by the relevant bank) or 100% of the senior secured debt.

\(^6\) It is unclear whether “best efforts” arranged transactions are covered by the ECB Guidance only to the extent that they generate a credit exposure for the relevant bank (such as where it has committed to provide a portion of the financing on a “take and hold” basis). In contrast, the U.S. regulators clarified that the US Guidance applies to best efforts arranged deals irrespective of such credit exposure.