

# ECB Guidance on Leveraged Transactions

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The European Central Bank ('**ECB**') published its final guidance ('**Final Guidance**') on leveraged transactions on 16 May 2017, marking the end of a public consultation process that began on 23 November 2016. In addition to its Final Guidance, the ECB published a Feedback Statement which presents an overall assessment of the comments received during the public consultation.

The Final Guidance is broadly aligned with the draft guidance ('**Draft Guidance**') published by the ECB in November 2016<sup>1</sup>, with a few key adjustments in response to feedback from industry participants.<sup>2</sup> These adjustments have, for the most part, resulted in greater conformity with the approach taken by the three U.S. federal banking regulatory agencies - the Office of the Comptroller of the Currency (the '**OCC**'), the Board of Governors of the Federal Reserve System (the '**Board**') and the Federal Deposit Insurance Corporation (the '**FDIC**') - in the Interagency Guidance on Leveraged Lending in the U.S. ('**US Guidance**').<sup>3</sup>

The Final Guidance becomes applicable from 16 November 2017, after which date all significant institutions<sup>4</sup> directly supervised by the ECB will be expected to implement the guidelines.

Like the US Guidance, the Final Guidance remains non-binding. However, the ECB aims for the Final Guidance to be incorporated into credit institution's internal policies (subject to the principle of proportionality) and, given its supervisory role, the Final Guidance needs to be observed in order to avoid regulatory intervention by the ECB.

## Key differences between the Draft Guidance and Final Guidance

The Final Guidance differs from the Draft Guidance in the following ways:

<sup>1</sup> We addressed the issues raised in the Draft Guidance in our previous client alert, 'Draft ECB Guidance on Leveraged Transactions – 10 January 2016). See: <https://www.whitecase.com/publications/alert/draft-ecb-guidance-leveraged-transactions>.

<sup>2</sup> A total of 24 respondents commented on the ECB's Draft Guidance. Most comments focused on ensuring consistency between the ECB's Guidance and the 2013 Interagency Guidance on Leveraged Lending in the US and ensuring market viability in Europe.

<sup>3</sup> For the US Guidance, see: For the US Guidance, see: <https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf>.

<sup>4</sup> For a list of all significant credit institutions supervised by the ECB, under Article 6 (4) of Regulation No. 1024/2013 (the Single Supervisory Mechanism Regulation), see: [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list\\_of\\_supervised\\_entities\\_201701.en.pdf?fa67031bce20d0ce07da37a4c0685435](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list_of_supervised_entities_201701.en.pdf?fa67031bce20d0ce07da37a4c0685435)

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## Definition of leveraged transactions: the meaning of ‘Total Debt’

The Draft Guidance provided that an ECB institution’s definition of a Leveraged Transaction should include any loan or credit exposure that meets at least one of the following conditions:

- the borrower’s post-financing leverage level exceeded a Total Debt to EBITDA ratio of 4.0 times; or
- the borrower is owned by one or more financial sponsors (i.e. the financial sponsor owns or controls more than 50% of the borrower’s equity).

The Final Guidance retains the two-limbed definition of Leveraged Transaction proposed in the Draft Guidance, despite requests to the ECB to remove the ‘financial sponsor test’ due to its conflict with the US Guidance.

The Final Guidance clarifies that Total Debt applies to ‘*total committed debt*’, which includes drawn and undrawn debt, as well as ‘*any additional debt that the/a loan agreement could permit*.’ The new definition may therefore capture uncommitted incremental borrowings, ‘accordion’ facilities and side-by-side facilities (see ‘Areas of Concern’ below). Baskets and ratios for additional permitted debt may also, arguably, be factored into the calculation. Only committed undrawn liquidity facilities<sup>5</sup>, such as commercial paper programmes, are withdrawn from the definition of Total Debt and the ECB has noted that caution should be exercised when applying this exception.

## Netting cash against debt for the purposes of calculating Total Debt

Remaining consistent with the US Guidance, the ECB has stated that cash should not be netted against debt for the purposes of calculating Total Debt, in response to industry commentators’ requests for clarification.

## The classification of shareholder loans for the purposes of calculating Total Debt

The ECB’s Feedback Statement confirms that PIK statements and other shareholder loans that pay interest in the form of additional debt/equity, rather than cash, should be regarded as liabilities for the purpose of leverage calculations, though market clarification is likely to be sought on this point.

## Calculation of leverage at consolidated borrower level

The Final Guidance has clarified that the leverage multiple of 4.0 times is to be calculated at consolidated borrower level, in case the borrowing entity is experiencing financial difficulties, unless group support (in the form of guarantees, comfort letters, *etc.*) cannot be assumed. Any deviation from a calculation at consolidated group level must be justified and documented on a case-by-case basis.

## Definition of leveraged transactions: the meaning of EBITDA

Under the Draft Guidance, it was envisaged that only unadjusted EBITDA<sup>6</sup> could be used for the purposes of the first limb of the definition of a Leveraged Transaction. Adjustments to EBITDA are now permitted, signifying an important convergence with the US Guidance, though, unlike the US Guidance, the adjustments must be ‘*duly justified and reviewed by a function [bank] independent of the front office*’. The ECB has warned against overly optimistic adjustments, with respect to ‘future synergies’, ‘future earnings’ or ‘run-rate EBITDA’, that could leave investors vulnerable to the next downturn in the credit default cycle.

## Exclusions from definition of leveraged transactions

The Final Guidance makes further additions to the list of transactions that are excluded from the scope of the ECB’s guidance and therefore do not qualify as leveraged transactions. In addition to loans with natural persons, credit institutions, investment firms, public and financial sector entities, loans where the consolidated exposure of

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<sup>5</sup> *Committed undrawn liquidity facilities* is to be defined in accordance with the Basel III liquidity standards (‘Basel III: The Liquidity Coverage Ratio and liquidity risk-monitoring tools’).

<sup>6</sup> Realised EBITDA over the previous 12 months without any adjustments for non-recurring or exceptional items.

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the credit institution is below EUR 5 million<sup>7</sup> and trade finance<sup>8</sup>, the Final Guidance now excludes: loans to small and medium-sized enterprises<sup>9</sup>, except where the borrower is owned by one or more financial sponsors; loans classified as specialized lending<sup>10</sup> and loans to investment grade borrowers<sup>11</sup>.

## Repayment capacity

The Draft Guidance recommended that a borrower should be able to show a cash-flow ability to repay at least 50% of its Total Debt within five to seven years. The Final Guidance brings this assessment into greater conformity with the US guidance by permitting a borrower to, alternatively, show an ability to repay all of its senior secured debt (or to '*deliver [it] to a sustainable level*') within the same period of time.

## Pricing by syndication units

Syndication units should perform detailed analyses to help price leveraged loans; the price should then be verified, prior to the loan's issuance, by a function independent of the syndication unit.

## Risk in relation to highly leveraged syndicated transactions

The Final Guidance, like the Draft Guidance, states that underwriting of highly leveraged syndicated transactions (i.e. where the Total Debt is in excess of 6.0 times EBITDA at closing) should remain exceptional. However, these transactions no longer need to be referred to the '*highest level of credit committee or similar decision-making level*'. Instead, the ECB expects credit institutions to implement more stringent credit delegation and risk management escalation practices for highly leveraged transactions.

## Risk review

The Draft Guidance proposed that all leveraged transactions implying credit, underwriting or settlement risks *during syndication* ought to be preceded by a review and approval of an independent risk function. This has been replaced with a broader requirement to subject all leveraged transactions implying credit, syndication or underwriting risks to review and approval by an independent risk function, irrespective of when those risks are implied. This provision extends to all syndicated loans, including underwritten and 'best efforts' deals<sup>12</sup>, 'club deals'<sup>13</sup> and bilateral loans.

## Failed syndications

Credit institutions are expected to treat transactions that have not been syndicated within 90 days after the date on which the related loan agreement is signed as failed syndications for internal monitoring, booking, accounting, regulatory classification and capital requirements calculation purposes.

## Ongoing monitoring of 'hold book' exposures

The ECB has clarified that institutions must outline clearly defined criteria to identify indicators of a borrower's unlikelihood to pay. Institutions are also expected to assess a borrower for financial difficulty and conduct an

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<sup>7</sup> The ECB declined commentators' requests for the EUR 5 million threshold for excluded transactions to be raised to EUR 10 million.

<sup>8</sup> This comprises financing, including guarantees, connected to the exchange of goods and services through financial products of fixed short-term maturity, generally of less than one year, without automatic rollover.

<sup>9</sup> As defined by Commission Recommendation 2003/361/EC13.

<sup>10</sup> This comprises project finance, real estate, object financing and commodities financing.

<sup>11</sup> A borrower with a rating equivalent to BBB- (S&P)/BBB- (Fitch)/Baa3 (Moody's) or above.

<sup>12</sup> A 'best efforts deal' refers to a transaction where the arranger of the deal agrees to use all efforts to sell down as much of the loan as possible.

<sup>13</sup> A 'club deal' refers to a transaction that is pre-marketed to a small group of lenders with an agreement before closing on individual banks' loan attrition.

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impairment test in the event of material covenant breaches, refinancing at increased leverage ratios, refinancing of a bullet facility granted owing to financial difficulties or when there are justified concerns about a borrower's future ability to generate sufficient cash in the 'base case' and 'stress case' scenarios outlined above.

## **Budget requirement**

The Final Guidance has dispensed with the heavily criticised requirement for senior management to approve an annual budget for leveraged transactions.

## **Supervisory expectations**

Credit institutions are actively encouraged to apply the supervisory expectations that are expressed in the guidance to non-leveraged transactions, where relevant.<sup>14</sup>

## **Areas of concern**

Whilst the Final Guidance has resolved some of the concerns raised after publication of the Draft Guidance, the following concerns remain:

### **Uncertain definition of Total Debt**

The definition of Total Debt has expanded considerably following the addition of "*additional debt that loan agreements may permit*". There is uncertainty as to whether this definition captures incremental borrowings, accordion facilities, side-by-side facilities and baskets – items that would ordinarily fall within the category of 'Permitted Financial Indebtedness' in a loan's covenants – even if they are never actually borrowed.

### **Internal costs for acquisition financings**

The requirement to treat a transaction as a failed syndication if it has not been syndicated within 90 days of the commitment date as a failed syndication will impact banks' internal costs for acquisition financings that are only intended to be syndicated after the closing of the acquisition.

### **Failure to syndicate within 90 days**

It remains to be seen how financings that have not been syndicated within 90 days of the commitment date will be allocated to the lender's hold book. Further guidance is needed on how this will be applied in the context of acquisition financings and bid commitment papers with signed interim loan agreements.

### **Subordinated shareholder debt**

Whilst the Feedback Statement provides that shareholder loans and PIK instruments should be regarded as liabilities for the purposes of calculating Total Debt, it is unclear whether this also captures subordinated shareholder debt. This could be a cause for concern, given the importance of subordinated shareholder loans in facilitating the upstreaming of cash in leveraged European financings.

### **Uneven playing field in the leveraged finance market**

More generally, concerns have been raised about the possibility of the Final Guidance resulting in a disproportionately large number of higher leveraged transactions being undertaken by sources that are not governed by the ECB's guidance, such as non-EU banks, EU banks that are not subject to direct ECB supervision, EU banks which do not participate in the SSM, banks which are not regarded as 'significant' by the ECB and non-bank lenders. It remains to be seen whether this will result in an uneven playing field in the leveraged finance market and, if so, how regulators and supervisors will react.

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<sup>14</sup> The Draft Guidance provided that similar expectations, in particular, those relating to underwriting and syndication, could be applied to other transactions.

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