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Draft ECB Guidance on Leveraged Transactions

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Regulatory update: Draft ECB Guidance on Leveraged Transactions – US Comparison

Introduction

The European Central Bank ("**ECB**") is consulting on guidance relating to leveraged transactions ("Proposed Guidance"). The ECB regards the goals of the Proposed Guidance as being aligned with guidance adopted in March 2013 by the US bank supervisors ("US Guidance").[1]

When implemented, the Proposed Guidance, which is mostly qualitative in nature, will apply to all "significant" Eurozone credit institutions supervised by the ECB[2]. The US Guidance too is largely qualitative, but, by contrast, the US Guidance applies more broadly to all supervised financial institutions, including their subsidiaries and affiliates.

Like the US Guidance, the Proposed Guidance is non-binding in nature, but, like the US Guidance, the ECB views an institution's need for adequate policies and monitoring as integral to the management of the risks of its leveraged lending activities. In the United States, the US supervisors implemented the US Guidance to respond to the "tremendous growth in the volume of leveraged credit," in particular, of so-called "covenant-lite" loans that were seen by the US regulators as not providing "meaningful maintenance covenants" to give lenders recourse in the event of a borrower's subpar performance. The Proposed Guidance similarly focuses on the "borrower-friendly conditions" that, among other things, are seen by the ECB as leading to greater leniency in the credit policies of institutions as evidenced by the increased leverage levels of loans and the import of covenant-lite structures to the EU market. The ECB expects that credit institutions will implement the Proposed Guidance in a proportionate manner, considering the size and risk profile of the institution's leveraged transactions relative to its assets, earnings and capital. The US Guidance similarly requires an institution to adopt a risk-based compliance program that takes into account the size and risk profile of the its leveraged lending activities relative to its assets, earnings, liquidity and capital. Under the Proposed Guidance, in-scope EU institutions will need to report to supervisors on their compliance with the guidance within eighteen months of its implementation.

US bank supervisors review compliance with the US Guidance as part of their annual bank examinations and as a result of their review of syndicated, underwritten or participated loans which are required to be reported to and reviewed by the US banking supervisors as part of the Shared National Credit ("SNC") program that has as its goal the uniform risk classification of large and complex credits shared by multiple financial institutions.

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[1] The US Guidance is available at https://www.federalreserve.gov/bankinforeg/srletters/sr1303a1.pdf and subsequent FAQs issued by the US regulators are available at https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141107a3.pdf.

[2] For a list of all significant entities supervised by the ECB click here : https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list_of_supervised_entities_20160101en.pdf

Key aspects of the Proposed Guidance are as follows:

- In-scope credit institutions should ***define*** what constitutes a leveraged transaction, with some minimum standards on what must always be included in the definition;
- Such institutions should ***define*** their strategy for leveraged transactions, including their risk appetite for underwriting and syndication;
- There should be a solid ***credit approval process*** and ***regular monitoring*** of leveraged portfolios to ensure that realised transactions adhere to the bank's risk appetite standards; and
- Senior management should regularly receive ***comprehensive reports*** about leveraged transactions.

The consultation period runs until 27 January 2017.

Background

Given the recovery in leveraged finance markets since the 2008 financial crisis, the quality of credit standards in the leveraged finance market has become a key supervisory focus. The Proposed Guidance, like the US Guidance, results from supervisors awareness of the pressure of increased competition between banks and other market participants in the context of search for yield strategies in a market punctuated by sustained low interest rates.

The guidance in more detail

Definition of leveraged transaction

Credit institutions must have a unique and overarching definition of what amounts to a leveraged transaction. The definition should encompass all business units and geographical areas; the scope and implementation of the definition should be regularly reviewed by an appropriate independent audit unit to ensure that no undue omissions have been made.

The US Guidance requires institutions to adopt a definition of leveraged lending that is "appropriate to the institution" and "sufficiently detailed to ensure consistent application across all business lines."

- **What is a leveraged transaction?**

  Any transaction which meets one of the conditions below should be considered to be a leveraged transaction:

  - All types of loan or credit exposure where the borrower's post-financing level of **leverage exceeds a Total Debt to EBITDA[3] of 4.0 times**; or
  - All types of loan or credit exposure where the **borrower is owned by one or more financial sponsors[4]**.

For these purposes, it is immaterial whether the exposure is recorded in the banking book or trading book; and "exposure" refers to all gross direct commitments to a leveraged borrower, including drawn and undrawn facilities, term loans, bridge loans, revolving credit facilities, committed exposures not yet syndicated or distributed and exposures being warehoused for future sale.

3 EBITDA (earnings before interest, tax, depreciation and amortisation) refers to unadjusted EBITDA, that is, realised EBITDA over the past 12 months with no adjustments made for non-recurring expenses, exceptional items and other one offs

4 A "financial sponsor" for these purposes is an investment firm which undertakes private equity investments in, and/or leveraged buyouts of companies with the intention of exiting those investments on a medium-term basis (i.e., more than 6 months).

The US Guidance also includes Total Debt to EDITDA exceeding 4.0 as within the definition of leverage lending although for these purposes adjusted EBITDA may be used where reasonable support can be provided. While the US Guidance does not expressly single out exposures to "financial sponsors," it does specify that loans whose proceeds are used for buyouts, acquisition or capital distributions may fit within the definition, in particular, if coupled with one of the other characteristics common to leveraged loans. The US Guidance enumerates those characteristics, in addition to Total Debt to EBITDA exceeding 4.0, including loans resulting in Senior Debt to EBITDA of more than 3.0; loans to borrowers recognized as a "highly leveraged firm" (i.e., high debt-to-net-worth ratio); loans resulting in the borrower's post-financing leverage exceeding industry norms or historical levels; and loans whose proceeds are used for buyouts, acquisitions or capital distributions, at least to the extent coupled with one of the other characteristics.

- **Exclusions**

  Certain kinds of transactions are not expected to fall within the definition of leveraged transaction, as follows:

  - Loans with natural persons, credit institutions and investment firms.
  - Loans where the consolidated exposure is below Euro 5m.
  - Certain asset-based secured loans (e.g., aircraft or ship finance).
  - Commercial real estate funding.
  - Project finance.
  - Trade finance.

  The US Guidance also excludes asset-based lending that is the "dominant" source of ongoing funding for a borrower. The US Guidance also excludes "fallen angels," i.e., those credits whose market or credit conditions post-origination deteriorate to the point of bringing them within the leveraged lending definition unless the credit is modified, extended or refinanced.

Definition of risk appetite and strategy

Credit institutions should define their risk appetite and strategy for leveraged transactions in a way that encompasses the various business units involved in such operations. This will involve senior management defining, reviewing and endorsing at least annually, the budget and limits allocated to leveraged transactions. Exceptions should be justified.

The governance structure should enable senior management to have a comprehensive and consistent oversight of all leveraged transactions originated, syndicated or purchased by the credit institution.

On a more granular level, the guidance contemplates that, as a minimum:

- Senior management and risk management should have a **consistent and integrated view** of all leveraged transactions;
- New transactions are to be subject to an **in-depth review and approval** by an independent risk function; the risk function should also check that the transaction is in line with the credit institution's risk appetite; and
- Where the transaction does not merit separate originating and trading functions, credit institutions must ensure that dedicated procedures and confidentiality agreements are in place to ensure that **potential conflicts of interested are prevented** and private information is kept confidential.

The US Guidance also require an institution to identify and clearly define the amounts of leveraged lending that the institution is willing to underwrite (i.e., pipeline limits) and to retain (i.e., syndication requirements). The institution's risk appetite should reflect consideration of its potential negative effect on earnings, capital and liquidity as well as the other risks that could result from such lending and should be approved by the institution's board of directors. In addition to aggregate pipeline and portfolio limits, an institution subject to the

US Guidance would be expected to have in place overarching limits on exposures to any single obligor, transaction, industry or geographic area.

Underwriting and syndication

Credit institutions should define their appetite for underwriting and syndicating transactions by setting an underwriting limit and a more granular set of sub-limits specifying quantum and the nature of transactions that a credit institution is permitted to participate in.

Internal standards and monitoring functions should be "mindful" of the following:

- Each transaction posing an underwriting or syndication risk requires prior approval and detailed analysis assessing the market's ability to absorb the issuance and related pricing risk for the institution.
- Credit institutions are expected to define acceptable leverage levels as part of their risk appetite statement, including at industry sector level when relevant. Underwriting of transactions presenting high levels of leverage – defined as the ratio of Total Debt to EBITDA exceeding 6.0 times at deal inception – should remain exceptional.
- The syndication unit should monitor and report on an ongoing basis all the pending transactions to be syndicated, irrespective of the type of syndication, and all transactions generating a settlement risk, such as "best effort deals"[5] (including non-investment grade corporate bonds) and "club deals". An independent risk function should be involved in the monitoring of the underwriting and syndication risks.
- The syndication unit should both monitor and target an appropriate diversification of investor categories. Distribution channels internal to credit institutions – such as other business units, other banking entities having the same parent company, or secondary trading desks – should be specifically monitored. Credit institutions are expected to develop a stress-testing framework aimed at capturing the impact of market-wide disruptions on the underwriting and syndication pipeline.
- Credit institutions should identify transactions subject to failed syndications – that is, a transaction which has not been syndicated within 90 days following the deal closure date. Credit institutions are expected to establish a dedicated framework to deal with these "hung transactions" in terms of holding strategy, booking and accounting practices, regulatory classification and subsequent capital requirements calculation.
- Credit institutions should have policies and procedures in place for reclassifying transactions for which a trading intent is no longer evident (specifically "hung transactions") from the regulatory trading book to the regulatory banking book.
- Credit institutions are expected to develop and ensure adherence to internal policies aimed at avoiding reputational risk or potential conflicts when syndicating and distributing leveraged transactions.

The US Guidance requires institutions to have in place clear, written and measureable underwriting standards that reflect the institution's leveraged lending risk appetite and that take into account a number of factors relating to any specific financing, including whether the borrower's business premise for the transaction is sound and the borrower's capital structure is sustainable and an assessment of the borrower's capacity to repay the credit and its ability to de-lever. The US regulators also expect an institution's underwriting standards to provide for adequate "depth and breadth" of due diligence, including the methods for evaluating collateral; measures of expected risk-adjusted returns; acceptable levels of reliance on enterprise value or intangibles for loan repayment; expectations for degree of sponsor support and financial capacity. Institutions also are expected to consider the adequacy of loan agreement covenant protections, collateral requirements and required dissemination of borrower financial information.

[5] Contrast the scope here with the US Guidance which does not apply to bonds

Internal procedures for new deal approval, monitoring and managing leveraged transaction holdings

The guidance addresses both credit approval processes and ongoing monitoring of leveraged transactions. Internal audit should regularly review leveraged transactions and compliance with the ECB guidance as part of the audit cycle, and at least every three years.

- Credit approval:
  - In-depth due diligence should be conducted on new transactions, renewals, refinancings and modifications of existing transactions. This will involve detailed due diligence on the borrower and an assessment of the structure of the transaction and related term sheets.
  - Internal systems should flag any structures involving weak covenant features, such as the absence of any covenant or financial covenant or where there is significant headroom in the financial covenants.
  - Credit and liquidity facilities granted in connection with leveraged transactions should be adequately taken into account in calculating the bank's liquidity coverage ratio (**LCR**). This will involve an assessment based on the nature of the facility and a behavioural analysis of the borrower's appetite to drawn commitments, in order to correctly classify the commitment for the purposes of the LCR.
  - Banks should ensure that the various due diligence dimensions are sufficiently weighted in the internal rating methodology. Banks which do not rely on internal ratings must nevertheless reflect the factors in the credit approval process.
- Ongoing monitoring:
  - Credit institutions should ensure regular monitoring of the portfolio, including all relevant risks for leveraged investments held for the longer term and an updated review of the credit approval due diligence requirements outlined above.
  - "Final take" exposures and exposures the institution has not been able to sell within 90 days of transaction closing should be reviewed at least once a year. More frequent reviews of deteriorated exposures should take place.
  - Particular focus to be given on the borrower's ability to repay the debt. The guidance sets out circumstances in which impairment tests should be run by the bank and the circumstances in which a strong presumption of default should be made.

The US Guidance lays out detailed due diligence expectations in the form of underwriting, valuation, credit analysis and risk rating standards that institutions are expected to apply to their leveraged lending activities that in large part mirror those contemplated by the Proposed Guidance. The US Guidance also lays out the need for policies and procedures to address and prevent conflicts of interest in financings where an institution also retains an equity interest or that may involve an affiliate.

Secondary market transactions

Compliance and risk management functions should institute and regularly review policies and procedures to ensure proper adherence of secondary market transactions with regulations on market conduct. The use of Chinese walls and the treatment of privileged information received as part of primary issuances by origination teams should be addressed.

Secondary market leveraged transaction exposures are to be reported as part of the global reporting on leveraged transactions.

Reporting and management information systems

Regular comprehensive reports about trends in the leveraged markets and characteristics of a credit institution's leveraged transactions should be sent to the management of each credit institution, including information about both the underwriting book and a credit institution's hold book.

The reports should cover at least the following aspects:

- key market trends;
- all leveraged transactions across the various business units and geographies, taking into account both long-term credit exposures and the underwriting and syndication pipeline of leveraged transactions;
- the positioning of a credit institution with regard to internal limits and the outcome of the stress scenarios performed;
- information on potential concentrations in terms of facility type, geography, sector or individual names and an overview of the quality (rating, share of non-performing loans/defaults, coverage by provisions) and profitability of transactions; and
- a credit institution's exposure to weak covenant features, flagging potential material breaches of covenants.

Management information systems ("MIS") should be sufficiently granular and sound enough to enable management to identify, aggregate and monitor leveraged transactions and capture all the relevant aspects of the guidance.

The US regulators specify their expectation for financial institutions to "diligently" monitor higher risk credits and in the US Guidance establish the expectation that a financial institution's management will receive comprehensive periodic (at least quarterly) reporting on the characteristics and trends in such the institution's leveraged credit exposures and that its board of directors receives summaries of such reports. The expectation is that MIS systems are sufficient to identify and capture individual and portfolio existing and pipeline exposures; analyze risk rating distribution and migration, industry mix and maturity; measure exposures by collateral, sponsor, industry and other criteria; and create metrics on performance, default probabilities.

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