Client Update
European Central Bank Issues Draft Guidance on Leveraged Transactions

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On 23 November 2016, the European Central Bank (the "ECB") launched a public consultation on draft guidance on leveraged transactions (the "ECB Guidance"). The consultation period runs until 27 January, 2017. In addition, the ECB will hold a public hearing as part of its consultation on 20 January 2017 in Frankfurt. The hearing will be webcast on the ECB's Banking Supervision website. Following the public consultation the ECB will publish the comments received, together with a feedback statement.

The ECB Guidance summarises key supervisory expectations concerning leveraged transactions, and the ongoing monitoring of both syndication risk and the fundamental credit quality of leveraged exposures. It shares some of the objectives of the US Guidance on Leveraged Lending (Interagency guidance issued in March 2013) (the "US Guidance"), namely to ensure that banks conduct leveraged lending activities with sound origination and distribution practices to contribute to a smooth financing of the real economy.

The ECB Guidance, which is non-binding[1], would apply to all credit institutions directly supervised by the ECB under the regulation establishing the Single Supervisory Mechanism of ECB bank supervision[2] (the "Significant Credit Institutions"). A number of criteria are relevant in determining whether an institution is a Significant Credit Institution under that regulation, including the institution's size, its importance for the economy of the European Union or any Eurozone member state and the significance of its cross-border activities. Institutions with assets exceeding €30 billon will be Significant Credit Institutions (unless circumstances justify classification as a non-Significant

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[1] While the ECB Guidance by its terms is non-binding, we expect that institutions subject to ECB supervision will have to comply with the guidance as a practical matter.

[2] Regulation 1024/2013.

Credit Institution). Market participants which are not designated as Significant Credit Institutions would not be subject to the ECB Guidance. This potentially creates a competitive imbalance not unlike the imbalance in the United States created by the US Guidance, where unregulated originators have been rapidly climbing up the league tables. The ECB Guidance presumably applies to international activities of the Significant Credit Institutions although Significant Credit Institutions may want to clarify this especially with respect to the activities of their branches in foreign countries.

BACKGROUND TO THE ECB GUIDANCE

In 2015, the ECB surveyed the leveraged finance activities of a number of credit institutions and noted the strong recovery of the leverage finance markets since the financial crisis and the strong competitive conditions prevalent in these markets. According to the ECB, these borrower-friendly conditions have translated into a weakening of deal structuring and in many cases have led to greater leniency in credit policies. As a result, the ECB considers that closer supervisory scrutiny of leveraged transactions is justified.

DEFINITION OF LEVERAGED TRANSACTIONS

The ECB expects Significant Credit Institutions to develop a unique and overarching definition of "leveraged transactions" to ensure consistent application across all business units. The ECB Guidance provides that a transaction that meets one of the conditions below is expected to be considered a leveraged transaction:

- a loan or credit exposure where the borrower's post-financing level of leverage exceeds four times Total Debt to EBITDA (a metric also mentioned in the US Guidance); or
- a loan or credit exposure where the borrower is owned by one or more financial sponsors.

The definition of Total Debt under the first condition does not appear to net cash on the balance sheet. Significant Credit Institutions will also need to consider whether they should include structurally subordinated debt higher up the borrower's holding company structure, such as PIK Notes. EBITDA refers to unadjusted EBITDA with no adjustments made for non-recurring expenses, exceptional items, and other one-offs. In many financial covenant calculations, these items would be added back to EBITDA.

It is noteworthy that "exposure" under the first condition refers to all gross direct commitments of a leveraged borrower, including drawn and undrawn

facilities, term loans, bridge loans or revolving credit facilities, committed exposures not yet syndicated or distributed, and expressly being warehoused for a later sale.

The second condition, which appears to target private equity owned portfolio company borrowers for special negative treatment, will likely be a concern for many industry participants.

The ECB Guidance specifies that certain transactions, including asset-based loans, commercial real estate financing, project finance loans and trade finance, are not expected to be covered by the guidance.

DEFINING STRATEGY

The draft guidance recommends that Significant Credit Institutions define their appetite and strategy for leveraged transactions and implement a sound governance structure enabling senior management to have a comprehensive and consistent oversight on all leveraged transactions originated, syndicated or purchased by such institutions. The focus of the ECB on leveraged transactions "purchased by" a given institution is interesting as the US Regulators do not consider the purchase of a trading asset that is a pre-existing leveraged loan to be within the scope of the US Guidance. Significant Credit Institutions will likely want to clarify the impact of the ECB Guidance on their trading activities.

MANDATE AND LEVERAGE METRICS

The ECB Guidance mandates Significant Credit Institutions to: (i) set an underwriting limit and a granular set of sub-limits detailing both the quantum and nature of transactions in which they are permitted to participate; (ii) have in place a credit approval process aimed at ensuring that transactions are aligned with their risk appetite for all leveraged transactions; and (iii) ensure regular monitoring of leveraged transactions, in particular concerning the debt management capacity of the borrower and signs of impairment or default.

The ECB further identifies metrics that are somewhat similar but not identical to the ones set forth in the US Regulation.

First, the ECB believes that, for most industries, a leverage level in excess of 6.0 times Total Debt to EBITDA would raise concerns (as mentioned, Total Debt appears to be a number that is not net of cash on the balance sheet). While Significant Credit Institutions are expected to define acceptable leverage levels as part of their risk appetite statement, the ECB considers that underwriting of transactions presenting high levels of leverage should remain exceptional (and a

potential exception should be justified). The test is not dissimilar to the test applied by the US Guidance which also considers that leverage in excess of 6.0 times Total Debt to EBITDA raises concerns for most industries (whilst making it clear that this is not a bright line test).

Second, the ECB believes that Significant Credit Institutions should ensure that the leveraged borrower is able to repay by cash flow generation a significant share of its debt within a reasonable time frame—where a "significant share" of the debt corresponds to at least half of the total debt and a "reasonable time frame" corresponds to five to seven years. The ECB's focus on deleveraging over the medium term is shared with the US regulators.

The ECB Guidance also deals specifically with transactions subject to failed syndication (i.e. transactions not syndicated within 90 days following the deal closure date). It provides that credit institutions are expected to establish a dedicated framework to deal with these "hung transactions" and should also have policies and procedures in place for reclassifying transactions for which a trading intent is no longer evident from the regulatory trading book to the regulatory banking book.

TIMING

As part of its discussion of the credit approval process and related due diligence requirements, the ECB expresses the view that such requirements should be applicable to a new transaction, a renewal or refinancing of an existing transaction, as well as material modifications of an existing transaction. This approach is similar to the one followed by the US Regulators, which have made it clear that the US Guidance applies to refinancings of existing credits. This approach will inevitably raise many questions as to what constitutes a material modification of an existing transaction, especially in the context of amend and extend transactions or covenant relief amendments.

Market participants will no doubt worry that the ECB Guidance (like the US Guidance) will impair the ability of borrowers whose credit has deteriorated to refinance their debt, especially so for portfolio companies of private equity sponsors.

REPORTING REQUIREMENTS

The ECB Guidance recommends that regular reports should be sent to the management of each Significant Credit Institution covering aspects such as key market trends, all leveraged transactions across the various business units and geographies, the positioning of the institution with regard to internal limits and

the outcome of stress-testing, information on potential concentrations in terms of facility type, geography, sector or individual names and an overview of the quality and profitability of transactions and exposure to weak covenant features and flagging potential material breaches of covenants.

The ECB recommends that, eighteen months after publication of its ECB Guidance, an internal audit report should be drawn up and submitted to the joint supervisory team detailing which of the expectations expressed in the ECB Guidance have been implemented by Significant Credit Institutions in their procedures.

CONCLUSION

The ECB Guidance represents an increasing trend among central banks towards using macro-prudential tools to address potential risks to financial stability arising from an environment of low interest rates. Depending on the outcome of the implementation of the ECB Guidance, the ECB may well adopt binding rules in the future to govern leveraged transactions. In its contribution to the European Commission's consultation on the review of the EU macro-prudential policy framework, the ECB recommended strengthening the legislative framework governing macro-prudential policy, including by granting the ECB powers to impose macro-prudential limits, such as loan-to-income or debt-service to income ratios, by reference to the borrower's condition.[3] It remains to be seen whether the Bank of England will adopt similar restrictions on leveraged transactions. The Bank of England has already been granted powers by the UK Government to impose macro-prudential limits in the residential mortgage market by reference to loan-to-income and loan-to-value ratios and will soon be granted powers to limit the buy-to-let mortgage market by reference to interest coverage and loan-to-value ratios. The ECB Guidance and the US Guidance may well prompt the Bank of England to adopt its own non-binding guidance on leveraged transactions.

Firms subject to the ECB Guidance should begin reviewing their internal processes to ensure compliance by the time it is adopted.

Private equity sponsors will need to study the impact of the guidance on the availability of financing for future transactions (and amendments to existing transactions) and on their ability to secure alternative financing sources if

[3] http://www.ecb.europa.eu/pub/pdf/other/revieweumacroprudentialpolicyframework201612.en.pdf?3454df595862fd69126434644cf3befe.

existing sources are likely to reduce their business or impose stricter conditions in loans.

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Please do not hesitate to contact us with any questions.