

Client Update

ECB Publishes Final Guidance on Leveraged Transactions

LONDON

Alan J. Davies
ajdavies@debevoise.com

Pierre Maugué
pmaugue@debevoise.com

Thomas Smith
tsmith@debevoise.com

Aatif Ahmad
aahmad@debevoise.com

The European Central Bank (“ECB”) published its final guidance on leveraged transactions on 16 May 2017, following the completion of a public consultation on draft guidance that began on 23 November 2016. We addressed the issues raised in the draft guidance in our previous client update “European Central Bank Issues Draft Guidance on Leveraged Transactions”.¹ This update considers the key differences between the final guidance and the draft guidance.

The final guidance broadly follows the approach set out in the draft guidance, with only a few minor revisions. For example, any loan or credit exposure where the borrower is owned by one or more financial sponsors will constitute a leveraged transaction, irrespective of the actual leverage assumed by the borrower. Accordingly, the ECB has retained the approach taken in the draft guidance of applying a somewhat discriminatory standard to private equity-sponsored transactions.

The final guidance differs from the draft guidance in the following respects:

- The draft guidance proposed a two-limb definition of “leveraged transaction”, with the first limb referring to loans or other credit exposures where the borrower’s post-financing leverage level exceeded a Total Debt to EBITDA ratio of 4.0 times, and the second limb referring to loans or credit exposures where the borrower is owned by one or more financial sponsors. The final guidance retains this two-limb definition, including the application to borrowers owned by one or more financial sponsors and the leverage multiple of 4.0 times in the second limb.² However, in the first limb, the

¹ Available at: <http://www.debevoise.com/insights/publications/2016/12/european-central-bank-issues-draft-guidance>.

² The term “financial sponsor” is defined, as in the draft guidance, as an investment firm undertaking private equity investments in and/or leveraged buyouts of companies with the intention of exiting those investments on a medium-term basis.

definition of “Total Debt” now applies to total committed debt (including drawn and undrawn debt) and any additional debt that loan agreements may permit. Committed undrawn liquidity facilities are, however, excluded.³ Cash must not be netted against debt in calculating Total Debt. In addition, the leverage multiple of 4.0 times is to be calculated at the consolidated borrower level, unless group support cannot be assumed if the borrowing entity is experiencing financial difficulties.

- The inclusion of “additional debt that loan agreements may permit” in the calculation of Total Debt is very broad and would capture uncommitted incremental or accordion borrowings and probably even items typically falling within “Permitted Financial Indebtedness” in the loan agreement’s covenants, even if they are never actually borrowed.
- The definition of EBITDA, for the purposes of the first limb referred to above, now permits enhancements, whereas previously only unadjusted EBITDA (*i.e.*, realised EBITDA over the previous 12 months without any adjustments for non-recurring or exceptional items) was to be used. However, the final guidance requires enhancements to EBITDA (such as inclusion of exceptional or non-recurring items) to be duly justified and reviewed by a function independent of the front office function.
- The draft guidance proposed excluding certain transactions from the scope of the guidance. The final guidance continues that approach, although it adds the following types of transactions to the list of exclusions: (i) loans with public sector entities and financial sector entities (thus bringing into the scope of the exclusion third country banking and insurance firms); (ii) loans to small and medium-sized enterprises⁴, except where the borrower is owned by one or more financial sponsors; and (iii) loans to investment-grade borrowers (*i.e.*, with a rating equivalent to BBB- (S&P and Fitch) or Baa3 (Moody’s) or above).
- The standard proposed in the draft guidance for all leveraged transactions implying credit, underwriting or settlement risks during syndication to be preceded by a review and approval of an independent risk function is

³ “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 (BCBS 238)). Accordingly, general corporate revolving credit facilities (such as revolving credit facilities in place for general corporate or working capital purposes) will not be classified as liquidity facilities, but as credit facilities included within the calculation of Total Debt, even if undrawn.

⁴ Enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million.

replaced with a broader requirement to subject all leveraged transactions implying “credit, syndication or underwriting risks” (whether or not during syndication) to review and approval by an independent risk function. Such review and approval should extend to all syndicated loans, including underwritten and “best efforts” deals, as well as “club deals” and bilateral loans.

- The recommendation in the draft guidance that syndicating transactions presenting high levels of leverage (*i.e.*, where the ratio of Total Debt to EBITDA exceeds 6.0 times) should remain exceptional and be escalated is retained. However, rather than requiring referral to the “highest level of credit committee or similar decision-making level”, the final guidance states that such transactions form part of the credit delegation and risk management escalation framework of the institution concerned.
- For syndication activities, the final guidance states that the syndication unit should perform a detailed analysis to help price the loan and the price should be verified by a function independent of the syndication unit prior to issuance of the loan.
- The existing policies and procedures recommended for new deal approval are retained. As with the US guidance on leveraged lending, the draft guidance recommended institutions to ensure that the borrower was able to repay at least half of its total debt owed to credit institutions within a time frame of five to seven years. This is retained in the final guidance, although there is an option to substitute adequate repayment capacity with an ability to de-lever (presumably through asset sales). In addition, adequate repayment capacity now includes the ability to fully amortise senior secured debt over the five-to-seven year period.

The guidance will enter into force six months after the date of its publication. The implementation of the guidance by institutions subject to direct supervision by the ECB may well reduce the supply of finance from these institutions for certain leveraged borrowers. The result may be to shift the supply to institutions which are not subject to the guidance, such as smaller EU banks and certain UK banks not subject to direct ECB supervision, loan originating funds or non-EU banks. In addition, although the guidance is non-binding, widespread adoption by EU banks is likely to result in the guidance assuming the nature of legally binding regulations and thus undercut banks’ flexibility in extending loans to more highly leveraged borrowers.

We would be pleased to discuss the guidance and its likely consequences with you further.

* * *

Please do not hesitate to contact us with any questions.