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Client Alert: European Central Bank (ECB) Publishes Final Guidance on Leveraged Lending Transactions

EXECUTIVE SUMMARY

Following publication of its draft guidance on leveraged lending transactions on 23 November 2016 and conclusion of a public consultation process, the ECB has published the final form of its guidance on leveraged lending transactions (the "ECB Guidance") on 16 May 2017. From its entry into force on 16 November 2017, the ECB Guidance will apply to all 'significant' credit institutions supervised by the ECB and introduce general criteria to identify leveraged transactions. The ECB Guidance aims to reduce systemic risk in the financial system and strengthen the underwriting and syndication practices of lending banks by providing guidelines for the sound management and supervision of leveraged transactions.

The ECB Guidance is similar to the corresponding guidance (the "U.S. Guidance") on leveraged lending issued for the U.S. financial services industry by the Board of Governors of the Federal Reserve System, the Office of the Controller of the Currency and the Federal Deposit Insurance Corporation (the "U.S. Agencies") already in 2013. It is fair to assume that the effects of the ECB Guidance on the financial services industry in Europe may be broadly similar to the effects the U.S. Guidance had in the last few years in the U.S.

SCOPE OF THE ECB GUIDANCE

Significant credit institutions in the Eurozone

Under the Single Supervisory Mechanism (SSM), the ECB supervises credit institutions, financial holding companies and mixed financial holding companies which are established in the Eurozone (i.e. EU member states which have adopted the euro as their currency) and are treated as 'significant'. 'Significance' is generally determined on any one of the following criteria: size (total value of assets exceeding €30 billion), economic importance (for the specific country of the Eurozone or the EU economy as a whole), relevant cross-border activities (total value of assets exceeding €5 billion and the ratio of cross-border assets/liabilities in more than one other Eurozone member state to total assets/liabilities being above 20%) or benefiting from public financial assistance (funding from the European Stability Mechanism or the European Financial Stability Facility having been requested or received). As of 1 January 2017, 125 entities were under supervision of the ECB, accounting for more than 80% of the banking assets in the Eurozone.

As the United Kingdom does not participate in the SSM, English credit institutions are not subject to the supervision of the ECB. This has been an area of concern during the consultation process of the draft ECB Guidance as it was considered to result in an unlevel playing field among European credit institutions active in the leveraged lending markets. In practice, however, this issue should at least to some extent be mitigated by the fact that Eurozone branches of credit institutions located outside the Eurozone are subject to the supervision of the ECB. Such ECB supervision is likely to result in the ECB Guidance also affecting the leveraged lending businesses of such credit institutions located outside the Eurozone. This e.g. brings European branches of U.S. financial institutions within the scope of the ECB Guidance in the same manner as U.S branches of European credit institutions are already currently covered by the U.S. Guidance. As regards credit institutions domiciled in the United Kingdom, it remains to be seen how the United Kingdom's withdrawal from the European Union (Brexit) will impact such effect of the ECB Guidance on leveraged lending businesses of UK credit institutions.

Leveraged transactions

At the core of the ECB Guidance is the definition of "leveraged transaction". The ECB Guidance does not seek to regulate the lending business generally, but focuses on leveraged transactions. While, similar to the U.S. Guidance, each credit institution is expected to develop its own suitable definition of leveraged transactions, the ECB Guidance, in sharp contrast to the U.S. Guidance which does not provide for a uniform rule for the definition of leveraged transactions, requires that any lending transaction that satisfies one of the following two criteria must be considered a "leveraged transaction":

- all types of loan or credit exposure where the borrower's post-financing leverage level exceeds a Total Debt to EBITDA ratio of 4.0 times; or
- all types of loan or credit exposures where the borrower is owned by one or more financial sponsors.

Both limbs of the definition have been subject of extensive comments and criticism during the consultation process,[1] but have been adopted in the final form of the ECB Guidance largely unchanged.

Ratio-based determination of "leveraged transactions": Total Debt to EBITDA

With respect to the ratio-based determination of leveraged transactions, Total Debt pursuant to the ECB Guidance refers to total committed debt (including drawn and undrawn debt) and any "*additional debt that loan agreements may permit*". The ECB Guidance explicitly only carves out undrawn liquidity facilities and liquidity risk monitoring tools from such calculation. It should be noted that for the determination of Total Debt, available cash may not be netted against debt positions.

[1] 23 out of the 24 submissions made in the consultation process raised this term and/or one or more of its elements as an issue.

While such definition of Total Debt pursuant to the ECB Guidance is in line with the U.S. Guidance, it contrasts to the typical determination of total debt in leveraged loan agreements for purposes of calculating the leverage ratio where available cash is netted against the outstanding debt.

Furthermore, it is unclear which debt items will have to be included in the Total Debt definition by virtue of the phrase "*additional debt that loan agreements may permit*". In light of the apparent intention of the ECB to align its guidance on leveraged transaction to the corresponding U.S. Guidance, it would only be consistent to assume that additional debt permitted under the loan agreement, in particular, 'incremental facilities', but also financial debt permitted to be incurred outside the relevant loan agreement, should be included in the calculation of Total Debt.

Whether this also applies to non-financial debt items permitted under loan agreements, usually set out in the financial indebtedness undertaking, is doubtful. The intended alignment of the ECB Guidance with the U.S. Guidance speaks against the inclusion of such items. Furthermore, it would cause substantial practical difficulties to include permitted non-financial debt items in the definition of Total Debt: A number of such items usually permitted in the financial indebtedness undertaking are uncapped or subject to flexible baskets, e.g. grower baskets the size of which depends on varying reference figures (e.g. total assets). It is unclear how such positions should be reflected in the calculation of Total Debt.

In light of such broad definition of Total Debt, the 4.0 times multiple appears to be rather low and prone to capture transactions the risk-profile of which is not comparable to the usual leveraged lending transactions.

Contrary to the draft guidance, the ECB Guidance now acknowledges adjustments to EBITDA to the extent such adjustments are duly justified and reviewed within the credit institution by a function independent of the front office. This is also in line with the implementation of the U.S. Guidance by the U.S. Agencies.

Ownership of the borrower by a financial sponsor

Under the second limb of the definition, any financing extended to a borrower owned (i.e. ownership or control of more than 50% of the borrower's equity) by one or more financial sponsors shall automatically qualify as a leveraged transaction, irrespective of the debt quantum and/or Total Debt to EBITDA ratio. Again, this has been criticised during the consultation process as the mere ownership by a financial sponsor does not by itself result in an increase of the credit risk for the respective lender. Still, this limb of the definition for leveraged transaction has remained unchanged since the draft form of the ECB Guidance.

Besides stipulating criteria for the assumption of a leveraged transaction, the ECB Guidance also explicitly exempts certain financings from the scope of the ECB Guidance. Such exempted transactions include loans extended to natural persons, other credit institutions, investment firms, public or financial sector entities or small or medium-sized enterprises, loans resulting in an overall exposure of the credit institution of less than €5 million, specialised lending and trade finance transactions and lending to investment-grade borrowers (i.e. borrowers with a rating equivalent to BBB- (S&P)/BBB- (Fitch)/Baa3 (Moody's) or above). Not only external credit ratings assigned by rating agencies, but also internal ratings assigned by the respective credit institution should suffice.

The following table provides an overview of the key similarities and differences between the ECB Guidance and the U.S. Guidance.

KEY SIMILARITIES AND DIFFERENCES BETWEEN THE ECB GUIDANCE AND THE U.S. GUIDANCE

	The ECB Guidance	**The U.S. Guidance**
Nature and goal of guidance	Non-binding and not intended to stipulate non-pass thresholds regarding the origination of transactions, but supervised entities required to set up sound risk-management and monitoring structures for leveraged transactions	
Non-compliance with guidance	No provisions dealing with formal enforcement or disciplinary action that may be taken against credit institutions that are not in compliance with the respective guidelines	
Type of transactions covered	Loan origination, syndication, material modification or refinancing	
Definition of leveraged transactions	*Criteria*: Leverage ratio or financial sponsor ownership as independent and mandatory triggers for assuming a leveraged transaction *Total debt*: Same as per the U.S. Guidance, but doubtful whether permitted non-financial debt items should be included *EBITDA*: Adjustments are included	*Criteria*: No uniform rule when a loan should be considered a leveraged transaction; in particular, leverage ratio[2] considered an (important) indicator (amongst other factors) *Total debt*: Including permitted additional debt (in particular, incremental facilities) under the loan agreement and determined without netting of cash *EBITDA*: Same
Underwriting standards, credit approval, general monitoring and transaction-management policies	Credit institutions shall set up comprehensive framework establishing binding underwriting limits, quantum, types and areas of financings that credit institutions are permitted to participate in and related internal	Banks shall have "clear, written and measurable" underwriting standards

[2] Total Debt to EBITDA ratio of 4.0 times (or above) or senior debt to EBITDA of 3.0 times (or above).

	The ECB Guidance	The U.S. Guidance
	standards and monitoring functions, including by independent risk functions	
Aspects to be taken into account in setting up such standards	Independent pricing verification; leverage test and amortisation test (cf. next row); special monitoring regime and standards for dealing with transactions not syndicated within 90 days ("hung transactions"); tracking of weak covenant features, e.g. absence of any (financial) covenant or presence of significant headroom in financial covenants	Leverage test and amortisation test (cf. next row); undertaking of independent enterprise valuation using capitalised cash flow and/or DCF models
In particular: Leverage test / Amortisation test	*Leverage test*: may be industry-specific; high leverage levels exceeding 6.0 times (at deal inception) should remain exceptional and form part of the credit delegation and risk management escalation framework of the credit institution[3] *Amortisation test*: Cash-flow projections should show the ability of the borrower, over a 5-7 year period, to fully amortise senior secured debt or to repay at least 50% of total debt	
On-going monitoring	On-going internal review of outstanding leveraged transactions and updates to be sent to the senior management of the relevant credit institution. Update reports shall, *inter alia*, include key market trends, information on leveraged transactions across business units and (non-) compliance with internal limits, potential concentration of transactions in type, industry sector or location as well as exposure to weak covenant features.	

OUTLOOK

The ECB Guidance will come into force six months after its publication, i.e. on 16 November 2017. Eighteen months after its publication, i.e. on 16 November 2018, the credit institutions subject to the supervision of the ECB shall draw up an internal audit report and submit such report to the supervisory bodies. The report shall provide details of the implementation of the governance requirements under the ECB Guidance. Until such date, it is to be expected that the ECB Guidance will also become part of the day-to-day supervisory dialogue between the ECB and the

[3] Whereas the draft form of the Guidance provided that leverage levels in excess of 6.0 times always had to be referred to the highest level of credit committee, the final form now permits referral to the competent body within the usual credit delegation and risk management escalation framework of the credit institution.

individual banks supervised by the ECB. Given the non-binding nature of the ECB Guidance, it is currently not yet clear what the consequences of a failure to comply will be.

The practical results of the ECB Guidance on the issuance and syndication of leveraged loans by credit institutions which are under ECB's supervision remain to be seen. Looking at the effects the U.S. Guidance had on the U.S. leveraged loan market, market diligence shows rapid growth of leveraged lending in the U.S. in the years 2011 and 2012 with lending activity peaking around the first quarter of 2013 and a decline in leveraged lending since then, suggesting that the U.S. Guidance may have slowed the origination of leveraged lending transactions. At the same time, subordinated / hybrid financing instruments, e.g. preferred equity instruments, seem to have absorbed a significant part of the decline in senior leveraged lending and led to an additional layer within the capital structure.

In addition, and despite the non-binding nature of the U.S. Guidance, regular reviews undertaken by the U.S. Agencies have shown a constant decline of loan originations from U.S. financial institutions that do not satisfy the requirements under the U.S. Guidance ("non-pass loans") and a continued progress toward full compliance with the underwriting and risk management expectations set forth in the U.S. Guidance. Presumably, the ECB will expect a similar development in the European leveraged lending market, in particular given that its ECB Guidance closely resembles the U.S. Guidance. Apart from avoiding regulatory arbitrage by credit institutions active in the leveraged loan markets in the EU and the U.S., this has presumably been one of the key drivers for the ECB to publish the ECB Guidance.

At the same time, however, the aforementioned reviews noted a migration of leveraged loan origination to non-bank entities as a potential response to the U.S. Guidance. The trend toward non-bank lending in the leveraged lending market may therefore also become stronger in Europe as a result of the new ECB Guidance.

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